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European Central Bank Publishes Final Guidance on Leveraged Transactions

The ECB final guidance reflects market feedback and is more closely aligned to the US leveraged lending guidance.

The European Central Bank (ECB) published the long-awaited final guidance on leveraged lending on 16 May 2017. The final guidance is broadly in line with the draft published in November 2016, with a few significant adjustments in response to feedback from market participants that, among other things, eliminate some of the differences between the ECB and the US guidance.

The guidance will come into force in November 2017 (six months after its publication) and credit institutions that come within the scope of the guidance will be required to prepare and submit to the Joint Supervisory Teams (JST) an internal audit report in November 2018 (18 months after its publication), that details how the expectations expressed in the guidance have been implemented.

Further, while the guidance is not binding, the ECB has indicated in the Feedback Statement that accompanied the guidance, that it will be enforced through the ongoing supervision of credit institutions by the JSTs and dedicated on-site inspections. Additionally, the Supervisory Review and Evaluation Process (SREP) will take the guidance into account. This implementation and oversight is not dissimilar to the implementation of the US guidance.

Key points

The final guidance differs from the draft guidance in the following points:

- Adjustments to EBITDA "*when duly justified and reviewed by a function independent of the front office*" are now allowed — an important convergence with the US approach.
- Leverage is calculated on the basis of *total committed debt*, which includes drawn and undrawn debt plus *any additional debt that the loan agreement may permit* (*e.g.*, potentially incremental/accordion facilities, baskets, side-by-side facilities, etc.). Only liquidity facilities that backstop other debt (*e.g.*, commercial paper programs) are excluded, with the ECB noting that care should be taken in applying the liquidity facility exception.
- As with the draft guidance, cash is *not* to be netted against debt for the purposes of calculating total debt — consistent with the US approach.
- The draft guidance, like the US guidance, required an assessment that the borrower could repay at least 50% of its total debt within 5-7 years. This required assessment is retained but the guidance

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brings it into conformity with the US guidance by allowing alternatively a showing that the borrower's senior secured debt could be fully amortised in that time.

- While only appearing in the Feedback Statement, the ECB notes that shareholder loans are to be included in the calculation. The market will likely seek clarification on this point given that subordinated shareholder loans are commonly used to facilitate the repatriation of cash flows in European acquisition financings.
- Notably the guidance excludes high yield bonds (now like the US guidance) but also - unlike the US guidance - exposures under €5 million and loans to small and medium-sized enterprises (SMEs) provided that the borrower is not owned by financial sponsors.
- Leverage threshold to be calculated at the *consolidated borrower level*, unless group support (*i.e.*, guarantees, letters of comfort, etc.), cannot be assumed.
- The guidance covers all leveraged transactions that entail credit, syndication or underwriting risk — including "best efforts" transactions, "club deals" and bilateral loans — but how the reference to "best efforts" transactions is applied where the arranging institution never holds €5 million or more remains to be seen.
- The ECB now takes the position that a financing must be treated as a failed syndication for internal monitoring, booking and other purposes, if it has not been syndicated within 90 days after the date on which the related loan agreement is signed. This requirement may have implications for banks' internal costs for any acquisition financings only intended to be syndicated *after* acquisition close, although some institutions already seem to be applying a similar approach. The market may also seek guidance on how to apply this in the context of bid commitment papers, often supported in Europe by an interim facility agreement that in effect is a fundable bridge to the full documents.
- The requirement to develop a budget (which attracted adverse comment), has been dropped.
- The ECB is encouraging credit institutions to apply the supervisory expectations expressed in the guidance to other types of transactions, where relevant.

According to the ECB, the objectives of the guidance are twofold: (1) to facilitate identification of leveraged transactions in order to give a credit institution's senior management a comprehensive overview of its leveraged lending activities; and (2) to establish expectations around risk management and reporting requirements for such leveraged transactions. The ECB also "*expect[s] credit institutions to ensure that more stringent risk management practices are put in place for transactions where total debt is in excess of 6.0 times EBITDA.*" The ECB reiterated that the guidance is not intended to prevent credit institutions from providing financing solutions to leveraged borrowers, nor — importantly and different from how the US guidance has been most recently administered — to establish non-pass thresholds in terms of the origination of transactions. The ECB also notes that it does not regard total debt of 6.0 times EBITDA as a bright line.

Overview and Comparison to US guidance

Some of the key components of the ECB guidance, as well as key differences from the US guidance, include:

Institutions Covered: The ECB guidance applies to all "significant credit institutions" supervised by the ECB under the Single Supervisory Mechanism (SSM) regulation. The categorization of a credit institution

as significant depends on a number of criteria, including its size and its cross-border activities. Currently there are 127 institutions under the ECB's direct supervision. “Less significant” credit institutions (*i.e.*, credit institutions not categorized as significant) and credit institutions based in EU member states which do not participate in the SSM (*e.g.,* the UK) are outside the scope of the ECB guidance. The required implementation will be subject to the principle of proportionality, by reference to the size and risk profile of an institution’s leveraged transactions relative to its assets, earnings and capital.

By way of contrast, the US guidance applies to federally regulated financial institutions, including US branches of non-US banks. For US banking organizations, the US guidance applies on an enterprise-wide basis, including bank holding companies and nonbank subsidiaries and affiliates of banks. The booking location of a leveraged loan by a US banking organization is irrelevant, as the guidance applies to leveraged lending activities by such organizations both inside and outside the US. For non-US institutions with US charters or licenses, the US guidance applies to all leveraged loans that are both originated and distributed in the United States. As drafted, the ECB guidance would apply to significant credit institutions also on an enterprise-wide basis. Notably, the US guidance does not expressly provide for any kind of proportionality principle although inevitably there is a degree to which credit institutions apply proportionality in their review of implementation of the guidance.

Definition of Leveraged Lending: Similar to the approach taken in the US guidance, institutions subject to the ECB guidance are expected to develop and implement a comprehensive, institution-specific internal definition of leveraged lending. Under the ECB guidance, an institution's definition of leveraged lending should include any loan or credit exposure that meets at least one of two conditions: (i) the borrower's post-financing leverage exceeds a total debt to EBITDA ratio of 4.0 times; or (ii) the borrower is owned by one or more financial sponsors (*i.e.*, financial sponsor owns or controls more than 50% of borrower's equity).

In contrast, the US guidance sets out four characteristics that, either separately or in combination, are common to leveraged lending transactions. The factors are quantitative (*i.e.*, the borrower's total debt to EBITDA ratio exceeds 4.0 times or its senior debt to EBITDA ratio exceeds 3.0 times) as well as qualitative (*i.e.*, the proceeds are used for buyouts, acquisitions or capital distributions; the borrower is recognized in the debt markets as a highly leveraged firm; and the borrower's post-transaction leverage significantly exceeds industry norms or historical levels). Unlike the ECB guidance, loans that meet any one of the four common characteristics under the US guidance are not automatically considered leveraged. Also, in a significant difference from the ECB guidance, control of the borrower by a financial sponsor is not included in the factors defining leveraged loans under the US guidance. However, under the US guidance, banks that rely on sponsor support for repayment of a leveraged loan are expected to have guidelines for evaluating and monitoring the financial condition of sponsors.

Transactions Covered: Similar to the US guidance, the ECB guidance applies to all types of leveraged lending exposures, including drawn and undrawn facilities, term loans, bridge loans, revolving credit facilities, committed exposures not yet syndicated or distributed, and exposures being warehoused for later sale. Bonds are excluded (aligning the ECB guidance with the US guidance). The ECB guidance also applies to new loan “originations,” which refers to a new extension of credit, refinancing or modification of an existing loan agreement, or a renewal of a matured or maturing transaction. “Modification” is intended to cover any restructuring of or change to an existing non-matured loan. The ECB has also clarified that “fallen angels” are excluded unless that credit is modified, extended or refinanced.

While the US guidance specifically excludes asset-based loans that are not part of the borrower’s debt structure, the ECB guidance appears to exclude a broader range of asset-based loans. The ECB

guidance also excludes other types of loans that are not specifically addressed in the US guidance, such as: loans to natural persons; loans to credit institutions, investment firms, public sector entities and financial sector entities; loans with a consolidated exposure for the institution of less than €5 million; loans to small and medium- sized enterprises unless the borrower is owned by a financial sponsor; loans classified as “specialised lending” (being, project finance, real estate, object financing and commodities financing); trade finance; and loans to investment-grade borrowers that meet the specified rating criteria.

Inclusion of Pre-baked Additional Debt: The ECB expects banks to account for pre-approved additional term or revolving facilities in the total debt metric. A footnote in the guidance adds that “*any additional debt that loan agreements may permit*” is also to be included, and therefore arguably baskets and ratios for additional permitted debt must also be factored in, which would be consistent with the US approach.

Subordinated Debt: While not covered in the guidance, the feedback statement refers to PIK instruments and other shareholder loans as types of credit facilities that pay interest in the form of additional debt or equity, rather than cash, and would count towards liabilities to be included in the calculation of the total debt metric. It is unclear whether this category extends to subordinated shareholder debt as well. This point may be a cause of concern given that subordinated shareholder loans are commonly used in European financings as a part substitute for equity to assist with repatriation issues.

Definition of EBITDA: As mentioned earlier, a major improvement from the draft guidance is the allowance of EBITDA adjustments. The ECB has noted that any enhancements to EBITDA should be duly justified and reviewed by a function independent of the front office function, with a warning about overly optimistic adjustments with respect to pro forma “future synergies,” “future earnings” or “run-rate EBITDA” that would leave investors vulnerable to the next downturn in the credit default cycle.

Total Debt: As noted earlier, the ECB has clarified that cash should not be netted against debt for purposes of calculating total debt, remaining consistent with the US guidance.

Borrower’s Ability to Repay: The ECB expects banks to ensure that a leveraged borrower has “an adequate repayment capacity,” which is defined as the ability of the leveraged borrower to (1) fully amortise senior secured debt *or* (2) repay at least 50% of total debt over a period of 5-7 years (in line with the US guidance). The ECB has further stated that an assessment of a borrower’s repayment and deleveraging capacity should be carried out irrespective of whether the repayment profile is contractually required under the loan agreement.

Failed Syndications: A hung deal is defined as a transaction that is not syndicated within 90 days of signing of a loan agreement, and is required to be allocated to the lender’s “hold book”. While many market participants already seem to apply a not dissimilar standard, how this will be applied for acquisition financings and in particular, commitment papers with *signed* interim loan agreements remains to be seen.

Conclusion

The ECB guidance mirrors the US guidance in a number of additional key aspects. With respect to maximum leverage levels, both the ECB and the US guidance provide that a leverage level in excess of 6.0 times total debt to EBITDA raises concerns for most industries. Both the ECB guidance and the US guidance set out expectations for monitoring and reporting leveraged lending exposures across the

institution, but the monitoring and reporting requirements under the US guidance appear to be somewhat more robust that those under the ECB guidance.

On a practical level, as a matter of good practice, many credit institutions affected by the ECB guidance likely already follow many of the key aspects contained in the guidance. When conducting the survey in 2015, the ECB provided feedback to credit institutions on their leveraged lending activities (consistent with a similar Bank of England exercise in 2014) coming to the conclusion that no action was required. In addition, some national supervisory authorities have issued guidelines (not specifically relating to leveraged lending) which provide for or can be interpreted to provide for similar requirements on credit approval and monitoring (*e.g.*, in Germany the circular by the Federal Financial Supervisory Authority (BaFin) on the minimum requirements for risk management).

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