Clients&FriendsMemo

The European Central Bank Publishes Draft Guidance on Leveraged Transactions

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ECB Consultation Paper

On 23 November 2016, the European Central Bank (the "**ECB**") launched a public consultation in relation to draft guidance for Eurozone banks intended to develop clear and consistent definitions, measures and monitoring with regard to leveraged transactions. The draft guidance sets out how the ECB expects banks to maintain the credit quality of their leveraged transactions and to monitor related risks to their balance sheets. The consultation period runs until 27 January 2017.

Background to the ECB's involvement in this area

The search for yield in the current low interest rate environment has made leveraged finance activities more significant for banks. This development prompted the ECB to survey a number of Eurozone banks in 2015 to examine their involvement in leveraged finance activities.

The outcome of the survey highlighted that the leveraged finance markets have experienced a strong recovery since the financial crisis and that they are characterised by increased competition between banks in the search for yield. These borrower-friendly conditions have led to increased leverage levels and the import of "covenant-lite" structures into European markets and, in many cases, have led to greater leniency in banks' credit policies.

The ECB has identified aspects of banks' monitoring practices that could be improved, as well as highlighting significant discrepancies between the approaches of different banks in defining, measuring and monitoring leveraged transactions.

This is the background to the draft ECB guidance, which sets out the ECB's main regulatory expectations concerning leveraged transactions, and the monitoring of syndication risk and the credit quality of leveraged exposures.

Scope of the guidance

The guidance will apply to all significant EU banks supervised by the ECB[1] (which essentially means significant Eurozone banks). All such banks will be expected to adhere to the guidelines once they are published.

Status of the guidance

Although the guidance will be non-binding, the ECB expects all significant Eurozone banks to translate this guidance into their internal policies proportionally, having regard to the size and risk profile of the bank's leveraged transactions, in relation to its assets, earnings and capital.

Definition of leveraged transactions

As part of a bank's internal policies, the ECB expects it to consider the following as a leveraged transaction:[2]

(i) a loan or credit exposure where the borrower's post-financing level of leverage exceeds four times total debt to EBITDA[3]; and/or

(ii) a loan or credit exposure where the borrower is owned by a "financial sponsor".[4]

Obligations on banks

The draft guidance recommends that banks clearly define their strategy and appetite for underwriting and syndicating leveraged transactions. Banks should ensure, through their credit approval process and regular monitoring of leveraged portfolios, that transactions adhere to their risk appetite standards.

As part of this monitoring, particular attention should be placed on the assessment of the debt repayment capacity of the borrower and whether the transaction shows signs of impairment or default.

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1 All significant credit institutions supervised by the ECB under Article 6(4) of the Single Supervisory System Regulation i.e. Council Regulation (EU) No 1024/2013 of 15 October 2013, conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions.

2 The following transactions are not expected to be covered by the leveraged transaction definition: (i) loans with natural persons, credit institutions and investment firms; (ii) loans where the own consolidated exposure of the credit institution is below €5 million; (iii) loans secured by an asset that pertains to asset-based loans; (iv) commercial real estate financing; (v) project finance loans; and (vi) trade finance.

3 EBITDA (earnings before interest, tax, depreciation and amortisation) refers to unadjusted EBITDA, i.e. realised EBITDA over the previous 12 months with no adjustments made for non-recurring expenses, exceptional items and other one-offs.

4 A financial sponsor refers to an investment firm that undertakes private equity investments in and/or leveraged buyouts of companies with the intention of exiting those investments on a medium-term basis (i.e. more than six months).

Underwriting and syndication

The ECB notes that the underwriting of transactions presenting high levels of leverage - which it considers to be those with a total debt to EBITDA ratio in excess of six - should remain exceptional. The ECB thinks that, for most industries, such a leverage level would raise concerns and that such transactions should be referred to the highest credit decision-making level.

A bank's syndication unit should monitor and report on all transactions to be syndicated. It should also have procedures to identify and deal with transactions subject to failed syndications (which the ECB terms a transaction that has not been syndicated within 90 days following the deal closure date).

Credit approval and ongoing monitoring

As regards a bank's credit approval process for leveraged transactions, this should ensure that such transactions are aligned with the bank's risk appetite.

The draft guidance describes the ECB's view of the factors to be covered, as a minimum, in a bank's due diligence requirements in its credit approval process. These include the borrower's ability to cover debt service by way of cash-flow generation and a bank's review of the overall structure of the transaction.

Banks should ensure regular monitoring of leveraged transactions, in particular concerning signs of impairment or default (such as covenant breach, or an increase of leverage in a refinancing of a transaction).

The draft guidance recommends that a bank's independent audit function regularly reviews its leveraged transactions and that the bank's senior management should be a regular recipient of reports regarding such transactions.

Conclusion

The draft ECB guidance is designed to mitigate, to some extent, the potential risks associated with banks' leveraged transactions. It is similar to the existing US guidance on leveraged lending, which is also intended to ensure that banks conduct leveraged lending activities in a safe and sound manner.

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