

# Thoughts on the recently published ECB guidance on leveraged transactions

On 16 May 2017, the European Central Bank (ECB) published its finalised guidance on leveraged transactions, which will apply to banks supervised by the ECB under the Single Supervisory Mechanism (SSM). This guidance aims to harmonise the definition of leveraged transactions and ensure sound and consistent risk management practices. It enters into force six months after publication, on 16 November 2017.

## Overview

The publication of the ECB's [guidance](#) on leveraged transactions follows a 2015 thematic review on leveraged finance and a public consultation on draft guidance, launched in November 2016. The ECB has also published a [feedback statement](#), indicating where it has made changes to the guidance following feedback received during the consultation process.

The guidance seeks to facilitate identification of leveraged transactions and give senior management a comprehensive overview of the bank's leveraged lending activities, by providing an overarching definition of leveraged transactions which encompasses all business units and geographical areas. The guidance also sets out the ECB's expectations regarding risk management and reporting

requirements for leveraged transactions.

The ECB expects banks to implement the supervisory expectations expressed in the guidance in a proportionate manner, in line with the size and risk profile of their leveraged transaction activities relative to their assets, earnings and capital. The feedback statement accompanying the guidance states that although the guidance is not binding, it will be enforced through ongoing supervision of significant credit institutions by Joint Supervisory Teams (made up of staff of the ECB and of national supervisors) and on-site inspections. Significant credit institutions are required to draw up an internal audit report on compliance and submit this to the relevant Joint Supervisory Team in November 2018.

In March 2013 the US Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and

## Key points

- Guidance enters into force on 16 November 2017. Several issues raised in relation to the draft guidance have been addressed, but some questions remain.
- Significant eurozone credit institutions are expected to make the ECB guidance an integral part of their internal policies, subject to the principles of proportionality
- Guidance is non-binding but will be enforced through ongoing supervision of significant credit institutions by Joint Supervisory Teams. Significant credit institutions will have to produce an internal audit report on compliance by November 2018.
- Similar guidance on leveraged lending was published by the US agencies in March 2013. While the two sets of guidance are broadly similar there remain some key differences between the ECB guidance and the US Guidance.

the Board of Governors of the Federal Reserve System published similar guidance on leveraged lending (the US Guidance). There are some key differences between the ECB guidance and the US Guidance which are discussed further below. The US Government Accountability Office has been asked to review the US Guidance with a view to potentially overturning or substantially changing the US Guidance, so further divergences may still develop.

Implementation of the US Guidance has led to increased competition from lenders that are not subject to the US Guidance. Some lenders have gained market share by doing deals that banks subject to the US Guidance are unable to do. However, this may create a problem for future refinancings as it potentially creates a population of loans that cannot be refinanced by regulated lenders due to the US Guidance. Although the ECB reiterates in its feedback statement that the aim of the guidance is not to prevent credit institutions from providing financing solutions to leveraged borrowers, it remains to be seen whether the ECB guidance may cause a similar effect in the EU.

## Scope

The guidance applies to all 'significant' credit institutions supervised by the ECB under the SSM. As a result, it will apply to 'significant' eurozone credit institutions. We are not aware of any proposals to apply similar guidance to credit institutions in non-eurozone Member States (including the UK). The ECB expects this guidance to form an integral part of these banks' internal policies, subject to the principle of proportionality.

Whilst the guidance focuses primarily on leveraged transactions, the ECB is also encouraging banks to apply the guidance to other types of transactions, where relevant. Therefore, this guidance may have broader applicability and may inform the ECB's supervisory expectations across other lending activities.

## Definition of leveraged transactions

The 2015 thematic review identified considerable variation in banks' definitions of leveraged transactions. The ECB guidance therefore aims to harmonise this definition and requires banks to include in their internal policies a single overarching definition of leveraged transactions, which is consistent with the definition set out in the guidance. This contrasts with the approach taken under the US Guidance, which requires a financial institution to have policies defining leveraged lending that are appropriate to the institution but which does not mandate a particular definition.

According to the ECB guidance, a leveraged transaction includes:

- all types of loan or credit exposure, where the borrower's post financing level of leverage exceeds a Total Debt to EBITDA ratio of 4.0 times (for these purposes, Total Debt includes drawn and undrawn debt, as well as any additional debt that the loan agreement may permit, e.g. incremental facilities, but does not include committed undrawn liquidity facilities); and
- all types of loan or credit exposures where the borrower is owned by one or more financial sponsors (defined as 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).

Significant credit institutions are required to designate a financing as a leveraged transaction at loan origination, on renewal or refinancing of an existing leveraged transaction or on material modification of an existing transaction. The ECB guidance does not indicate what would be considered to be a "material" modification.

The inclusion of "any additional debt that the loan agreement may permit" in the calculation of Total Debt raises questions about the extent to which other permitted financial indebtedness under loan agreements may count towards Total Debt. For example, lenders will need to consider whether they need to count the various baskets in a facility agreement for other third party permitted financial indebtedness, and whether, where there is an incurrence covenant, they would need to assume that the permitted ratio plus any basket that sits on top of it should automatically be treated as having been utilised. It is unclear at present whether these questions will have an effect on how lenders will need to structure deals in order to be able to quantify Total Debt for the purposes of compliance with the guidance.

In its feedback statement, the ECB clarified that for the purposes of the guidance, leveraged transactions cover the entire debt structure of the leveraged obligor, with the exception of bonds and high-yield bonds (although bonds and high-yield bonds may be relevant to the calculation of Total Debt where permitted by the facility agreement).

The ECB also indicated in its feedback statement that it considers that payment-in-kind (PIK) instruments and other shareholder loans are essentially liabilities and so should be included in the calculation of Total Debt. This is not reflected in the guidance and we would expect the market to seek clarification on this point.

It was unclear in the ECB's previous draft of the guidance whether Total Debt should be calculated on a gross or net basis. The final guidance takes a similar approach to the US Guidance and clarifies that calculations for leverage purposes should be on a gross debt basis and that cash should not be netted against debt for the purposes of calculating Total Debt.

The final guidance also takes a similar approach to the US Guidance regarding EBITDA, permitting enhancements to EBITDA so long as these are duly justified and reviewed by a function independent of the front office function. Although this function is required to be independent, the ECB guidance does not specify that it must be an external function, so it should be possible to satisfy this requirement through an internal review.

The requirement to include loans made to borrowers which are owned

by one or more financial sponsors is a significant difference from the US Guidance, which does not include control of the borrower by a financial sponsor as a factor defining leveraged transactions.

The ECB expressly excludes from the definition of leveraged transactions:

- loans to credit institutions, investment firms, public sector entities, financial sector entities, as each is defined in the Capital Requirements Regulation (CRR), and natural persons;
- loans where the bank's own consolidated exposure is below €5 million;
- loans to small and medium-sized enterprises (SMEs) except where the borrower is owned by one or more financial sponsors;
- loans classified as specialised lending (as defined in CRR and comprising project finance, income-producing real estate, object finance and commodities finance);
- trade finance (as defined in CRR); and
- loans to investment-grade borrowers (i.e. with a rating equivalent to BBB- (S&P) / BBB- (Fitch) / Baa3 (Moody's) or above).

The exclusion for loans where the

bank's consolidated exposure is below €5 million is more restrictive than the US Guidance, which excludes loans where consolidated exposure is below \$10 million. The ECB guidance also contains no exclusion for provision of financing to borrowers engaged in restructuring (or "workout" negotiations), in contrast to the US Guidance which contains specific recognition of this.

## Governance

### Risk appetite and setting limits

The ECB expects banks to define their appetite and strategy for leveraged transactions, including syndication activities, as part of their internal risk appetite framework. This includes setting limits allocated to leveraged transactions, which should be defined, reviewed and endorsed by senior management at least annually.

In the context of syndication activities, the ECB expects banks to create a comprehensive limit framework, including underwriting limits and sub-limits detailing the quantum and nature of permitted transactions. It considers that syndicating transactions with high levels of leverage (where the Total Debt to EBITDA ratio exceeds 6.0 times at inception) should be exceptional and form part of a risk management

## Role of the audit function

- Prepare and submit a report to the ECB joint supervisory team by 16 November 2018 (18 months after publication of the guidelines) setting out how the bank has implemented the ECB guidelines
- Regular review of scope and implementation of the definition of leveraged transactions
- Regular review of leveraged transactions and compliance with the ECB guidance as part of its audit cycle, at least every three years
- May also carry out other independent reviews, including reviewing enhancements to EBITDA, reviewing and validating any enterprise valuation of the borrower and verifying pricing of loans to be syndicated

escalation framework.

The ECB does not envisage these limits as hard, no-pass thresholds but expects any exceptions and increases to limits to be justified.

The final guidance no longer refers to a budgeting process, on the basis that this would be operationally difficult given that budgets are often determined by business lines. However, the ECB does expect relevant business units to be involved in defining the bank's risk appetite for leveraged transactions.

#### Credit approval

Banks should have a credit approval process for all new leveraged transactions, as well as renewals, refinancing or material modifications of existing transactions, to ensure they are aligned with the bank's risk appetite.

As part of this process, the ECB expects the originating function to carry out in-depth due diligence, subject to review by an independent risk function, including:

- an assessment of the industry sector and the borrower, including an assessment of the borrower's capacity to service and repay a significant share of its debt or de-lever to a sustainable level within a reasonable timeframe;
- a critical review of the borrower's (or private equity sponsor's) business plan and projections;
- an enterprise valuation of the borrower (subject to independent review and validation);
- an assessment of the transaction structure and term sheets, including identification of any weak covenant features; and

- an assessment of liquidity coverage, taking into account credit and liquidity facilities granted to finance or back leveraged transactions.

#### Ongoing monitoring of syndication activities

As part of their ongoing monitoring activities, the ECB expects the bank's syndication unit to:

- monitor and report on an ongoing basis all the pending transactions to be syndicated, irrespective of the type of syndication;
- monitor and target an appropriate diversification of investor categories, including monitoring of internal distribution channels (to other business units, secondary trading desks etc.);
- identify failed syndications (i.e. those not syndicated within 90 days following commitment date) and establish a dedicated framework to deal with these transactions; and
- implement policies and procedures to reclassify leveraged transactions where trading intent is no longer evident from the trading book to the banking book.

Any exceptions to the 90 day timeline mentioned above should be justified as part of the credit institution's internal policies and procedures. This may be necessary where there are good reasons for not syndicating in the short term, for example in relation to certain acquisition finance processes.

#### Ongoing monitoring of "hold book" exposures

The ECB expects banks to monitor "hold book" exposures at least annually, with more frequent, targeted reviews of deteriorated exposures (including low rated, high leveraged,

## Role of the risk function

- Review and approve all leveraged transactions that imply credit, syndication or underwriting risks
- Monitor risks related to the bank's syndication activities
- Critical review of originating function's due diligence on any new transaction or any renewal, refinancing or material modification of an existing leveraged transaction

watch-listed, forbore performing and non-performing, defaulted exposures).

Banks should pay particular attention to a borrower's debt repayment capacity, and whether there are any indicators of financial difficulties or unlikelihood to pay (UTP) criteria. The ECB defines an adequate repayment capacity as the ability to fully amortise senior secured debt or repay at least 50% of Total Debt over a period of five to seven years.

The ECB expects banks to assess the borrower for financial difficulty and conduct an impairment test where:

- there has been a breach of a material financial covenant or non-remediation of a covenant breach;
- the transaction is a refinancing at an increased level of leverage;
- the transaction is a refinancing of a bullet facility owing to financial difficulties or when it is expected that a bullet loan cannot be refinanced in current market conditions; or

- there are justified concerns arising from "base case" and "stress case" scenario analysis about a borrower's ability to generate stable and sufficient cash flows.

#### **Stress testing**

The ECB also expects banks to implement a stress-testing framework comprising severe but plausible scenarios for "hold book" exposures and capturing the impact of market-wide disruptions on the underwriting and syndication pipeline. Internal audit should perform a regular review of leveraged transactions and compliance with the ECB guidelines at least every three years.

#### **Reputational risk and conflicts**

Banks should develop and ensure adherence to internal policies aimed at avoiding reputational risk or potential conflicts of interest when syndicating and distributing leveraged transactions. Similarly, they should put in place and regularly review policies and procedures to ensure they adhere with confidentiality and market conduct requirements (including Chinese walls) for secondary market activity.

#### **Reporting**

Senior management should receive regular comprehensive reports on leveraged transactions, including information about the syndication pipeline, "hold book" and secondary market activity. The reports should include information on key market trends as well as granular information about the bank's leveraged transactions, identifying the position with regard to internal limits, the outcome of stress scenarios, information on potential concentrations and profitability. The reports should also include a dedicated section on weak covenant features and potential material breaches of covenants.

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