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## ECB Publishes Draft US-Style Guidance On Leveraged Transactions

On 23 November 2016, the European Central Bank (“ECB”) published for consultation draft guidelines on leveraged transactions (“Draft Guidance”), similar to the US Guidance on Leveraged Lending issued by the US federal bank regulatory agencies in 2013 (“US Guidance”). The aim of the Draft Guidance is to promote sound origination and distribution practices in the leveraged lending market. Interested parties will have the opportunity to comment on the Draft Guidance until 27 January 2017.

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### Background and Scope

The publication of the Draft Guidance and the opening of the consultation come at a time when the ECB has increasingly been monitoring credit quality and leveraged finance exposures as a result of its survey of 40 banks last year that revealed a 35% increase in risky loans between 2012 and 2015. The survey also highlighted the fierce competition that currently exists in the leveraged finance markets, which are characterised by ultra-low interest rates, a supply/demand imbalance and borrower-friendly deal terms.

Responding to these considerations, the ECB is seeking to develop clear guidelines on leveraged lending that are aligned with the US Guidance, with the intended goal of “strengthening the level-playing field for financial institutions on a global basis”. The Draft Guidance provides a draft set of guidelines for banks to follow in order to help them define, measure and monitor their leveraged transactions.

### Does the Draft Guidance Apply to All Lending Institutions?

The Draft Guidance states that it applies to all significant credit institutions supervised by the ECB under the Single Supervisory Mechanism (“SSM”), which is the system of banking supervision in Europe involving the ECB and the national supervisory authorities of the countries participating in the SSM. All countries that have Euro as their currency participate automatically in the SSM, whereas other EU countries that are not part of the Eurozone can choose to participate. Any subsidiary of a third country bank (i.e. a bank established in a country outside the European Economic Area) that is itself established in the Eurozone or a participating country will be subject to the SSM.

The application of the Draft Guidance to “significant credit institutions” means that non-banks and other alternative lenders are not covered. The decision on whether a bank is deemed significant (and therefore under the ECB’s direct supervision) is set out in the SSM Regulation and SSM Framework Regulation. To qualify as significant, banks must fulfil at least one of several criteria, including, for example, relating to the bank’s size (where the total value of its assets exceeds EUR 30 billion), its cross-border activities and its economic importance. The ECB assesses the banks annually in order to make this determination and banks that are not deemed to be significant will be supervised by their national competent authority, subject to the ECB’s oversight. The ECB’s latest annual review of the significance of credit institutions brought the number of banks directly supervised by the ECB in 2016 to 127, and these banks currently hold almost 82% of banking assets in the Eurozone according to the ECB.

The UK is not in the Eurozone and is not a participant in the SSM. Credit institutions established in the UK are therefore not subject to direct supervision by the ECB and are not subject to the Draft Guidance. It is unclear whether this will provide UK banks with a competitive advantage or whether the Bank of England will propose any similar guidance for UK banks in the near future. In 2015, the Bank of England, following its own survey of UK banks and the leveraged loan markets, concluded that the UK banking system was resilient to stress in these markets. However, it is possible that the Bank of England will wait until the Draft Guidance is finalised before deciding whether to develop its own guidance in alignment with that of the ECB.

### Nature of the Draft Guidance

The Draft Guidance, once finalised, will be non-binding. However, banks will be required to integrate the Draft Guidance into their internal policies in a manner that will differ depending on the size and risk profile of their leveraged transactions relative to their assets, earnings and capital.

Pursuant to the SSM, each significant bank has a dedicated Joint Supervisory Team (“JST”) responsible for the supervision of the bank, comprising staff of the ECB and the national supervisors. Banks will be expected to submit an internal audit report to the JST 18 months after the Draft Guidance is finalised and implemented, and to outline which of the expectations have been implemented. At present, it is unclear how non-compliant deals will be sanctioned, but we expect this to be determined during the consultation process.

### What Is a Leveraged Transaction?

The ECB recommends and invites market participants to comment on a definition of leveraged transactions that would include loans or credit exposures: (a) to borrowers “owned” by their financial sponsors (where ownership means the control or ownership of more than 50% of the borrower’s equity), and/or (b) resulting in a post-financing total leverage ratio exceeding 4.0 times. It is expected that the definition will exclude the following transactions:

- i. loans made with natural persons, credit institutions and investment firms;
- ii. loans where the own consolidated exposure of the credit institution is below EUR 5 million;
- iii. asset-based loans;
- iv. commercial real estate financing;
- v. project finance loans; or
- vi. trade finance.

### Leverage Restrictions

Similar to the US Guidance, the Draft Guidance recommends that banks should not underwrite transactions presenting a ratio of Total Debt to EBITDA exceeding 6.0 times. Any exception would need to be justified and referred for approval at the highest level of credit committee or similar decision-making level internally. However, unlike in the US Guidance, EBITDA refers to “unadjusted EBITDA”, which the ECB explains is “realised EBITDA over the previous 12 months with no adjustments made for non-recurring expenses, exceptional items and other one-offs”. The US Guidance uses adjusted calculations, as do the rating agencies, which permit some assumptions regarding, for example, synergy savings to be factored into the calculation. The ECB’s recommendation for unadjusted EBITDA follows an increased prevalence in the use of complex EBITDA add-backs in leveraged loan transactions to circumvent regulatory restrictions. This aspect of the Draft Guidance is likely to promote particular commentary by market participants during the consultation process, some of whom will no doubt argue that the use of unadjusted EBITDA could lead to a further reduction in leveraged lending.

Generally, there is no mention of any grandfathering for deals that are underwritten now but which might exceed the prescribed leverage level after the Draft Guidance takes effect. Furthermore, unlike the US Guidance, which is not applicable to bonds, “best efforts deals” (including non-investment grade corporate bonds) and “club deals” as well as all pending transactions to be syndicated will be subject to monitoring and reporting requirements under the Draft Guidance.

## Hung Deals

The ECB recommends that credits be monitored by banks, with any risky transactions requiring prior approval. Hung deals, where a transaction has not been syndicated within 90 days of the closing date, also need to be identified and managed in accordance with a robust framework for managing these types of transactions.

## Defining Appetite and Strategy

Each bank will need to define its own appetite and strategy for underwriting and syndicating leveraged transactions. Senior management will need to set the budget allocated to leveraged transactions on an annual basis; oversee all leveraged transactions originated, syndicated or purchased by the bank; and ensure that the bank does not exceed the approved appetite. This will require the development of appropriate information systems and the receipt of regular reports on market trends and on the bank’s leveraged transactions.

## Approving New Deals

A credit approval process for leveraged transactions will be required to be put in place at each covered bank. Due diligence with respect to this approval process should include, among other things, checks to ensure that the borrower will be able to repay at least half of the total debt granted by the bank within five to seven years and a stress test of the borrower’s or private equity sponsor’s business plan and projections.

## Monitoring Holdings and Stress Testing

The ECB recommends on-going monitoring of a bank’s portfolio of leveraged loans, a yearly review of hold book exposure and more frequent reviews for deteriorated exposures. The debt repayment capacity of the borrower should be part of the review, and banks will be required to pay particular attention to any concerning signs of impairment or default.

## Compliance Procedures

The ECB recommends that compliance with its guidance should be part of a bank’s regular internal auditing and should be reviewed at least every three years. Compliance procedures also need to be put in place in respect of secondary market transactions.

## What Is the Likely Impact of the Draft Guidance?

In the US, as a result of the leverage restrictions, the largest leveraged lenders have reduced their exposure to leveraged loans and have begun to focus on lending to companies with stronger debt service capacity and balance sheet liquidity. There have been attempts to circumvent the issue of the leverage levels and take advantage of the fact that a few exceptional credits are permitted under the guidelines, but as a whole, leverage levels for US leveraged buyouts, which were well above 6.0 times EBITDA during 2014, have declined to below 6.0 times.<sup>1</sup>

The European leveraged loan market, being sensitive to developments across the Atlantic, has seen a corresponding reduction in bank lending following introduction of the US Guidance. Leverage levels are currently even lower than in the US, meaning that the Draft Guidance when finalized might not have a significant impact on leveraged lending. Nevertheless, in certain sectors a fair number of European leveraged buyouts this year were leveraged above 6.0 times and so the Draft Guidance could have a more significant impact in these sectors.

In response to the reduction in bank lending in the leveraged markets globally, private equity firms have been seeking funding from a greater number of regulated banks when contemplating transactions. They have also expanded their relationships with non-banks and other non-traditional funding sources, which have stepped in to fill the funding gap. Since the European leveraged lending market has a higher proportion of bank lenders than in the US, the European leveraged lending guidance may arguably have a greater impact in Europe than in the US and that the rise in non-bank lending in Europe will accelerate as a consequence.

It is also likely that other trends that we have seen following the launch of the US Guidance will continue when the Draft Guidance comes into effect. Less risky targets will continue to be more appealing to private equity sponsors, and the proportion of equity funding in transactions is also likely to rise.

In general, the leverage ratio cap proposed under the Draft Guidance could help to calm the market and create a shift towards less aggressive deal structures and terms. On the other hand, it is also thought that if the leverage ratio cap leads to significant further reduction in leveraged lending in Europe, this will exacerbate the imbalance between the demand for yield and the lack of supply of investments. This imbalance could help sustain the current borrower-friendly environment, with its aggressive documentation terms and structures.

### Conclusion

The ECB has said that the Draft Guidance is not aimed at reducing leveraged borrowers' access to financing solutions but at improving leveraged lending practices. Until the Draft Guidance is finalised, the ramifications will remain uncertain; however, it is clear for now that banks will need to spend more time making sure that their monitoring, reporting and compliance procedures are in place and that their leveraged lending activities are compliant. There are many actions that banks can begin to take now in preparation for when the Draft Guidance takes effect, which is likely to be in the first quarter of 2017.

Comments from market participants on the Draft Guidance will be considered before it is finalised. The ECB has announced that, following implementation, the guidance will serve as the basis for supervisory dialogue between banks and the ECB or JSTs, following which, the ECB will ascertain whether banks have addressed supervisory expectations appropriately.

We will continue to monitor developments in connection with the Draft Guidance. In the meantime, if you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney, or any of the attorneys listed.