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EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Draft guidance on leveraged transactions

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GUIDANCE OF THE EUROPEAN CENTRAL BANK

on leveraged transactions

1. Introduction

The prolonged period of very low interest rates and the ensuing search for yield strategies have warranted specific monitoring of credit quality by the European Central Bank (ECB) in general and of leveraged finance exposures in particular. In connection with this a number of credit institutions in different jurisdictions across the euro area were surveyed in 2015 to capture their involvement in leveraged finance activities.

The outcome of the survey highlights that globally leveraged finance markets have experienced a strong recovery since the crisis and are characterised by fierce competition. Both the appetite to underwrite a transaction and the propensity to retain parts of the exposure have grown among the significant credit institutions supervised by the ECB.

Borrower-friendly conditions have further translated into a weakening of deal structures (increased leverage levels, import of “covenant-lite” structures into European markets) and in many cases have led to greater leniency in credit institutions’ credit policies.

Moreover, several areas for improvement in credit institutions’ monitoring practices have been identified, as well as significant discrepancies in individual institutions’ approaches to defining, measuring and monitoring leveraged transactions.

Considering the above-mentioned developments and also in view of Articles 76 and 79 of Directive 2013/36/EU[1] and of Recital 30 and Article 4(1)(e) of Council Regulation (EU) No 1024/2013[2] (the “SSM Regulation), the ECB considers that closer supervisory scrutiny of leveraged transactions is justified. This closer scrutiny has led to the release of guidance from the ECB summarising key supervisory expectations concerning leveraged transactions, and the ongoing monitoring of both syndication risk and the fundamental credit quality of leveraged exposures.

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[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

[2] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

2. Scope of the guidance on leveraged transactions

This guidance applies to all significant credit institutions supervised by the ECB under Article 6(4) of the SSM Regulation.

While all significant credit institutions should make this guidance part of their internal policies, the implementation of each aspect of this guidance should be consistent with the size and risk profile of institutions' leveraged transactions relative to their assets, earnings and capital.

Whereas this guidance focuses primarily on leveraged transactions, similar expectations could be applied – where relevant – to other types of transactions, in particular the considerations that pertain to underwriting and syndication.

3. Definition of leveraged transactions

Credit institutions should have in place, as part of their internal policies, a unique and overarching definition of leveraged transactions. This definition would encompass all business units and geographical areas so as to enable the institution's senior management[3] to have a comprehensive overview of the institution's leveraged activities.

As part of its internal definition, the credit institution is expected to consider as a leveraged transaction any transaction that meets at least one of the conditions below:

(i) all types of loan or credit exposure[4,5] where the borrower's post-financing level of leverage exceeds a Total Debt[6] to EBITDA[7] ratio of 4.0 times[8];

(ii) all types of loan or credit exposures where the borrower is owned[9] by one or more financial sponsors[10].

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3 Senior management has the meaning ascribed to it in point (9) of Article 3(1) of Directive 2013/36/EU.

4 Irrespective of the classification in the regulatory banking book or regulatory trading book.

5 For the purpose of this guidance, exposure refers to all gross direct commitments to a leveraged borrower, including drawn and undrawn facilities, term loans, bridge loans or revolving credit facilities, committed exposures not yet syndicated or distributed, and exposures being warehoused for a later sale.

6 Refers to IFRS current and non-current financial liabilities (or similar nGAAP requirements applicable to the institution). For the purpose of leverage multiple, when calculated at transaction origination, the pro forma financial statements of the resulting company after the transaction has taken place should be considered.

7 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.

8 The designation of a financing as a "leveraged transaction" is made at loan origination, modification, extension or refinancing.

9 As per point (37) of Article 4(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1) (the Capital Requirements Regulation – CRR), financial sponsor ownership (see below for the definition) is given if the financial sponsor(s) controls or owns more than 50% of the borrower's equity.

The following transactions are not expected to be covered by the leveraged transaction definition:

(i) loans with natural persons, credit institutions and investment firms[11];

(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[12];

(iv) commercial real estate financing;

(v) project finance loans[13];

(vi) trade finance.[14]

Moreover, the scope and implementation of the definition of a leveraged transaction by a credit institution should be regularly reviewed by an appropriate independent audit department to ensure that no undue exclusion has been made.

4. Risk appetite and governance

As part of their internal risk appetite framework, credit institutions should define their appetite and strategy for leveraged transactions, as defined above, in a way that encompasses the various business units involved in such operations. To this end senior management is expected to define, review and endorse at least on an annual basis the budget and limits allocated to leveraged transactions. Exemptions and increases in limits, if any, should be duly justified.

Credit institutions are expected to have a sound governance structure in place for leveraged transactions, enabling senior management to have a comprehensive and consistent oversight on all leveraged transactions originated, syndicated or purchased by a credit institution.

The ECB considers that the following dimensions should be envisaged as minimum requirements.

- Irrespective of business organisation or commercial focus, senior management and risk management should have a consistent and integrated view of all leveraged transactions.

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[10] 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].

[11] The terms “credit institution” and “investment firm” are defined in points (1) and (2) of Article 4(1) of the CRR.

[12] Asset-based loans, for example such as for shipping or aircraft financing, are defined as secured transactions where the conversion of collateral into cash is the primary repayment source and where the loan is limited to a percentage of eligible collateral (the “borrowing base”), the value of collateral being actively monitored. Any other type of financing granted to this borrower should be considered as a leveraged transaction if it meets the above criteria (see the definition of leveraged transactions).

[13] Project loans are defined as long-term secured financing of infrastructure/industrial projects based on the projected cash flows of the project. Any other type of financing granted to this borrower should be considered as a leveraged transaction if it meets the above criteria (see the definition of leveraged transactions).

[14] As per Article 4(80) of the CRR, trade finance means financing, including guarantees, connected to the exchange of goods and services through financial products of fixed short-term maturity, generally of less than one year, without automatic rollover. Any other type of financing granted to this borrower should be considered as a leveraged transaction if it meets the above criteria (see definition of leveraged transactions).

- All leveraged transactions that imply credit, underwriting or settlement risks during syndication should be preceded by a review and approval of an independent risk function. The approval process should allow sufficient time for the risk function to carry out an in-depth review of the transaction and ensure that it is in line with a credit institution's risk appetite.
- Should the size of leveraged transactions be such that separate originating and trading functions are not required, a credit institution is nevertheless expected to have in place dedicated procedures and confidentiality requirements to ensure that potential conflicts of interest are prevented and that private information is kept confidential.

5. Underwriting and syndication

Credit institutions should define their appetite for underwriting and syndicating transactions; this intention should be used to set an underwriting limit and a granular set of sub-limits detailing both quantum and the nature of transactions that a credit institution is permitted to participate in.

Internal standards and monitoring functions of a credit institution engaged in underwriting and syndication should be mindful of the following aspects.

- Each transaction posing an underwriting or syndication risk requires prior approval and a detailed analysis assessing the market's ability to absorb the issuance and the related pricing risk for the credit institution.
- Credit institutions are expected to define acceptable leverage levels as part of their risk appetite statement, including at industry sector level when relevant. Underwriting of transactions presenting high levels of leverage – defined as the ratio of Total Debt[15] to EBITDA[16] exceeding 6.0 times at deal inception – should remain exceptional (and a potential exception should be duly justified) and trigger a referral to the highest level of credit committee or similar decision-making level. For most industries, a leverage level in excess of 6.0 times Total Debt to EBITDA raises concerns.
- The syndication unit should monitor and report on an ongoing basis all the pending transactions to be syndicated, irrespective of the type of syndication, and all transactions generating a settlement risk, such as "best effort deals"[17] (including non-investment grade corporate bonds)

[15] As defined above.

[16] As defined above.

[17] The term "best effort deal" refers to a transaction where the arranger of the deal agrees to use all efforts to sell down as much of the loan/bond as possible (although the arranger often commits to fund a small portion if the loan is fully syndicated, i.e. "final take"). In case the arranger is unable to sell down the entire amount, it is not responsible for any unsold portions.

and "club deals"[18]. An independent risk function should be involved in the monitoring of the underwriting and syndication risks.

- To mitigate credit institutions' exposure to a potential lack of investor appetite, the syndication unit should both monitor and target an appropriate diversification of investor categories[19]. Distribution channels internal to credit institutions – such as other business units, other banking entities having the same parent company, or secondary trading desks – should be flagged and specifically monitored. Moreover, credit institutions are expected to develop a stress-testing framework aimed at capturing the impact of market-wide disruptions on the underwriting and syndication pipeline.
- Credit institutions should identify transactions subject to failed syndications – that is, a transaction which has not been syndicated within 90 days following the deal closure date. Credit institutions are expected to establish a dedicated framework to deal with these "hung transactions" in terms of holding strategy, booking and accounting practices, regulatory classification[20] and subsequent capital requirements calculation.
- Credit institutions should have policies and procedures in place for reclassifying transactions for which a trading intent is no longer evident (specifically "hung transactions") from the regulatory trading book to the regulatory banking book.
- Credit institutions are expected to develop and ensure adherence to internal policies aimed at avoiding reputational risk or potential conflicts when syndicating and distributing leveraged transactions.

6. Policies and procedures for new deal approval, and monitoring and managing of longer-term leveraged transaction holdings

(i) Credit approval

Credit institutions should have in place a credit approval process for all leveraged transactions. The aim of the credit approval process is to ensure that transactions are aligned with a given credit institution's risk appetite. A new transaction, a renewal or a refinancing of an existing leveraged transaction, as well as a material modification of an existing transaction, should trigger in-depth due diligence by the originating function and a critical review, to be performed by an independent risk function.

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[18] A "club deal" refers to a transaction that is pre-marketed to a small group of lenders with an agreement before closing on individual banks' loan attribution. A club deal may not be governed by a single loan agreement; however, participating lenders usually have very similar, if not identical, terms.

[19] E.g. collateralised loan obligation funds, pension fund, insurer, loan fund, hedge fund or distressed fund, banks, other institutional investors.

[20] The institution should define sound criteria for classifying/reclassifying leveraged transactions to/from the regulatory trading book and the regulatory banking book. More specifically, all leveraged transactions that meet the criteria of "trading intent", as per the CRR, should be classified to the regulatory trading book.

The due diligence requirements should as a minimum include, but not be limited to, the following.

- An assessment of the industry sector and an in-depth assessment of the borrower; in particular, an assessment of the sustainability of the debt of the borrower should be performed to ascertain its ability to cover debt service by cash-flow generation. Credit institutions should ensure that the leveraged borrower is able to repay a significant share of its debt within a reasonable time frame – where a significant amount of the debt corresponds to at least half of the total debt granted by a credit institution and a reasonable time frame corresponds to five to seven years. The effective ability of a borrower to repay its debt as per the above criteria should form part of a sound collective provisioning framework.
- A critical review of the business plan and projections provided by the corporate borrower or the private equity sponsor – this should be incorporated in a credit institution's "bank case" and in a "stress case" scenario. The latter should be sufficiently conservative to capture tail-end market events and idiosyncratic events directly impacting a borrower's credit portfolio throughout the life cycle of the transaction.
- An enterprise valuation of the borrower reviewed and validated by an independent unit other than the originating unit.
- An assessment of the structure of the transaction and related term sheets (covenant, leverage level, dividend distribution, capex features). Internal systems at credit institutions are expected to flag any structures presenting weak covenant features, such as the absence of any covenant, the absence of financial covenants in the contractual agreements with a borrower or where there is significant headroom in these financial covenants. Any breach of covenant should also be tracked.
- Credit and liquidity facilities granted to finance or back leveraged transactions should be adequately taken into account in the liquidity coverage requirement[21]. When determining whether an off-balance-sheet commitment should be classified as a liquidity facility or a credit facility (as per Article 31(1) of Commission Delegated Regulation 2015/61), credit institutions should not only consider the formal denomination or the legal form of the facility. Both the assessment of the nature of the facility and a behavioural analysis of the borrower's appetite to drawn commitments, including in times of stress (as per Article 5 of Commission Delegated Regulation No 2015/61), should be part of a sound classification of the commitment between a credit line and a liquidity line for the purpose of calculating the liquidity coverage ratio (LCR).
- A detailed analysis that will help price the loan, prepared by a front office function and independently verified by the risk function prior to the credit granting.

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[21] Article 31 of Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (OJ L 11, 17.1.2015, p. 1).

All these dimensions should be translated into a single rating that ensures all appropriate features of the leveraged transaction, such as leverage level and a potentially weak covenant structure, are sufficiently weighted in the internal rating methodology. For credit institutions that do not rely on internal ratings, the above dimensions should be sufficiently reflected in the credit approval process.

(ii) Ongoing monitoring

Credit institutions should ensure regular monitoring of the portfolio, encompassing all relevant risks for leveraged transactions held for the longer term, including an update of the above-mentioned due diligence requirements. While the frequency of the review of "hold book"[22] exposures should occur at least once a year, it is expected that more targeted and frequent reviews be performed on deteriorated exposures (low ratings, high leverage, watch-listed, forborne performing and non-performing, defaulted).

As part of the ongoing review, 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.

Concerning signs of impairment or default, and in addition to the procedures already in place, credit institutions are expected both to ensure that their internal default triggers are aligned with the specificities of leveraged transactions (covenant breach, increase of leverage) and to run an impairment test in each of the following situations:

- breach of a material financial covenant or non-remediation of a covenant breach;
- where the transaction is a refinancing of a borrower at an increased level of leverage compared with respective leverage levels at origination or previous refinancing – that is, where the leverage level is defined as the ratio of Total Debt to EBITDA;
- where the transaction is a refinancing of a borrower that was granted a bullet facility;
- The current financial situation of the borrower is worse than initially projected as part of the "stress-case" scenario outlined above;

The internal default procedure should also recognise a strong presumption of default in the following cases:

- conversion of part or the full amount of the bank debt into equity;
- where the valuation of the borrower, which corresponds to a multiple of its EBITDA, is below the borrower's total debt.

The monitoring of exposures should be complemented by a stress-testing framework that captures tail-end market events such as a surge in default rates, rating migrations or collateral discounts. The stress of "hold book" exposures should be performed in addition to the stress-testing framework referred to in section 5 for the underwriting and syndication pipeline.

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[22] "Hold book" refers to transactions kept by the institution as long-term risk positions. It includes all "final take" exposures and facilities to be syndicated that the institution has not been able to sell within 90 days of the transaction closing.

The credit institution's internal audit function is expected to perform a regular review of leveraged transactions and of the compliance with this guidance as part of its audit cycle, and at least every three years.

7. Secondary market activities on leveraged transactions

To avoid reputational risks, credit institutions' compliance and risk management functions should put in place and regularly review policies and procedures to ensure proper adherence of secondary market transactions with regulations on market conduct, including Chinese walls, as well as the treatment of privileged information received as part of primary issuances by origination teams.

Secondary market leveraged transaction exposures should be reported as part of the global reporting on leveraged transactions, as per section 8.

8. Reporting requirements and IT systems

Regular comprehensive reports about trends in the leveraged markets and characteristics of a credit institution's leveraged transactions should be sent to the management of each credit institution, including information about both the underwriting book and a credit institution's "hold book".

The reports should cover at least the following aspects:

- key markets trends;
- all leveraged transactions across the various business units and geographies, taking into account both long-term credit exposures and the underwriting and syndication pipeline of leveraged transactions;
- the positioning of a credit institution with regard to internal limits[23] and the outcome of the stress scenarios performed as per sections 5 and 6;
- information on potential concentrations in terms of facility type, geography, sector or individual names and an overview of the quality (rating, share of non-performing loans/defaults, coverage by provisions) and profitability of transactions;
- a credit institution's exposure to weak covenant features as defined above, flagging potential material breaches of covenants (these last points to be included in a dedicated section of the reports).

Management information systems (MIS) should be sufficiently granular and sound enough to enable management to identify, aggregate and monitor leveraged transactions and capture all the relevant

[23] Including, but not restricted to, the positioning of the underwriting and syndication pipeline compared with the limit referred to in section 5.

aspects of this guidance. The annex outlines the key information that should be incorporated into the source system to ensure correct identification of leveraged transactions.

9. Ad hoc requirement following release of the ECB guidance

Eighteen months following publication of this guidance an internal audit report should be drawn up and submitted to the joint supervisory team, detailing which of the expectations expressed in this guidance have been implemented by the credit institutions in their procedures.

Annex

Criteria	Criteria type	Variable	Variable type
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	Inclusion criteria	Facility type	Categorical
		Total Debt	Nominal
		Unadjusted EBITDA	Nominal
All types of loan or credit exposures where the borrower is owned by one or more financial sponsors	Inclusion criteria	Facility type	Categorical
		Financial sponsor involvement (yes/no)	Categorical
		Investment share of financial sponsor	Nominal
Loans with natural persons, with credit institutions and investment firms	Exclusion criteria	Counterparty type	Categorical
Own consolidated exposure is below €5 million	Exclusion criteria	Financing size	Nominal
Loans secured by an asset that pertains to commercial real estate, asset-based loans, project finance loans or trade finance loans	Exclusion criteria	Facility type	Categorical
		Commercial real estate (yes/no)	Categorical
		Asset-based loan (yes/no)	Categorical
		Asset based loan is the only type of transaction available to this borrower (yes/no)	Categorical
		Project loan (yes/no)	Categorical
		Project loan is the only type of transaction available to this borrower (yes/no)	Categorical
		Trade finance (yes/no)	Categorical
		Trade finance is the only type of transaction available to this borrower (yes/no)	