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Memorandum

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European Central Bank Finalises Guidance on Leveraged Transactions

On 16 May 2017, the European Central Bank ("ECB") published its final guidance on leveraged transactions (the "guidance"). The guidance will become effective on 16 November 2017. The guidance provides for certain "significant credit institutions" to adopt internal policies and procedures to develop clear and consistent definitions, measures and monitoring procedures for leveraged transactions. You can find a copy of the guidance here. We previously reported on the draft guidance and public consultation process, which was launched last year, here.

The guidance is non-binding, though the "supervisory expectation" is that it will be enforced through supervision of significant credit institutions with an internal ECB audit within 18 months of publication to detail whether the expectations in the guidance have been implemented. The guidance applies only to certain "significant credit institutions" supervised by the ECB under the single supervisory mechanism ("SSM") regulation – a list of which can be found here. This means that "less significant" credit institutions and institutions in member states outside the SSM (such as the UK) are outside the scope of the guidance, although branches of UK banks established in a country to which the SSM applies may be subject to the guidance.

In addition, the ECB acknowledges that, the implementation of each aspect of the guidance should be proportionate to the size and risk profile of a significant credit institution's leveraged transactions relative to its assets, earnings and capital.

Key Recommendations

The guidance makes the following key recommendations for significant credit institutions:

- to implement a unique and overarching definition of leveraged transactions;
- to define a strategy for leveraged transactions and appetite for underwriting and syndicating such transactions (noting that syndicating highly leveraged transactions (defined as the ratio of total debt to EBITDA exceeding 6.0 times at deal inception) should remain exceptional (and a potential exception should be duly justified));
- to ensure through a robust credit approval process by an independent risk function and regular monitoring of leveraged portfolios, that leveraged transactions adhere to stated risk appetite standards; and
- to provide regular comprehensive reports about leveraged transactions to senior management.

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Definition of Leveraged Transaction

The guidance defines "leveraged transactions" as transactions which meet one of the following criteria:

(i) loans or credit exposures where the borrower's post-financing level of leverage on a consolidated and pro forma basis exceeds a total debt to EBITDA ratio of 4.0 times; or

(ii) loans or credit exposures (regardless of leverage, in contrast to leveraged lending guidelines in the US) where the borrower is more than 50% owned or controlled by one or more financial sponsors.

The following are not expected to be covered by the definition of "leveraged transaction" under the guidance:

(i) loans with natural persons, credit institutions, investment firms, public sector entities and financial sector entities (as defined in Article 4(1) of the Capital Requirements Regulation);

(ii) loans where the own consolidated exposure of the credit institution is below €5million;

(iii) loans to small and medium-sized enterprises (SMEs) (as defined by Commission Recommendation 2003/361/EC13), except where the borrower is majority-owned by one or more financial sponsors;

(iv) loans classified as specialised lending (which comprises project finance, real estate finance, object financing and commodities financing);

(v) trade finance; and

(vi) loans to investment-grade borrowers (i.e. with a rating equivalent to BBB-(S&P)/BBB-(Fitch)/Baa3 (Moody's) or above).

Comparison to US Guidelines

By comparison, the leveraged lending guidelines in the US stipulate the following characteristics which, alone or in combination, may result in a transaction qualifying as a leveraged lending transaction:

(1) the borrower's total debt to EBITDA ratio exceeds 4.0 times or its senior debt to EBITDA ratio exceeds 3.0 times;

(2) the proceeds are used for buyouts, acquisitions, or capital distributions;

(3) the borrower is recognised in the debt markets as highly-leveraged; that is, having a high debt-to-net-worth ratio; and/or

(4) the borrower's post-transaction leverage, which can be measured by a number of different leverage ratios, significantly exceeds industry standards or historical levels.

Unlike under the ECB guidance, a transaction is not necessarily considered leveraged if it meets only one of the characteristics listed in the US leveraged lending guidelines. Rather, US institutions are required to use the above described characteristics as a starting point for developing an institution-specific definition

of leveraged lending, taking into account the institution's individual risk management framework and risk appetite.

The report by the US Department of the Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* (June 2017) recommends that the 2013 US leveraged lending guidelines be reissued for notice and comment, and that afterwards revised guidance should be issued that provides (1) a more clear definition of leveraged lending and (2) any potential penalties for noncompliance with the guidance. The report also urges regulators to encourage banks to use a set of "clear and robust" metrics in underwriting leveraged loans, rather than relying on a single metric (the total debt to EBITDA ratio).

The ECB guidance states that scope of leveraged transactions to which the significant credit institution's monitoring and risk procedures should apply include all syndicated loans, underwritten and "best efforts" deals, "club deals" and bilateral loans. While the US leveraged lending guidelines expressly exclude bonds, the ECB guidance is silent on this point, although in its feedback statement the ECB clarified that the guidance should not apply to bonds held by banks and non-bank investors. The ECB guidance recommends that significant credit institutions ensure that any leveraged borrower has the capacity to repay a significant share of its debt or de-lever to a sustainable level within a reasonable time frame (i.e. fully amortise senior secured debt or repay at least 50% of total debt over a period of five to seven years).

Comparison of Total Debt and EBITDA definitions in ECB guidance and US leveraged lending guidelines

- Total Debt: the term "total debt" refers to total committed debt (whether drawn or undrawn) and any additional debt that loan agreements may permit and, consistent with the US leveraged lending guidelines, cash should not be netted against debt. Arguably, it should be assumed that all debt baskets (including incremental facilities) are fully utilised to the extent permitted and, with the exception of committed undrawn liquidity facilities meeting the requirements of Basel III liquidity standards, all debt (including shareholder loans and bonds) must be considered in calculating total debt.

- EBITDA: the draft guidance previously specified that EBITDA should be determined on an unadjusted basis, however the guidance now provides that enhancements to EBITDA may be permitted, but they should be reviewed and justified by a separate independent risk function at the significant credit institution (which is not inconsistent with the approach taken in the US leveraged lending guidelines).

Conclusion

Generally, the guidance provides detailed recommendations for certain significant credit institutions' policies and procedures around leveraged lending. There remain certain open issues regarding the application of the guidance that will be subject to discussion in the next few months. Borrowers, bank lenders and non-bank lenders alike may want to consider the future impact this guidance could have for their business. Additionally, institutions subject to the ECB guidance and the US leveraged lending guidelines should consider how to implement the varying guidelines across their institution.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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