



EUROPEAN CENTRAL BANK  
BANKING SUPERVISION

## Guidance on leveraged transactions

BANKENTOEZICHT

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# 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 in view of Articles 76 and 79 of Directive 2013/36/EU<sup>1</sup> and Recital 30 and Article 4(1)(e) of Council Regulation (EU) No 1024/2013<sup>2</sup> (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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<sup>1</sup> 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 (OJ L 176, 27.6.2013, p. 338).

<sup>2</sup> 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 an integral part of their internal policies, the implementation of each aspect of this guidance is subject to the principle of proportionality. Accordingly the internal implementation of supervisory expectations expressed in 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, credit institutions are encouraged to apply the supervisory expectations expressed in this guidance to other types of transactions, where relevant.

### 3 Definition of leveraged transactions

Credit institutions should have in place, as part of their internal policies, a single 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<sup>3</sup> to have a comprehensive overview of the institution's leveraged activities.

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

1. all types of loan or credit exposure<sup>4, 5</sup> where the borrower's post-financing level of leverage exceeds a Total Debt<sup>6</sup> to EBITDA<sup>7</sup> ratio of 4.0 times<sup>8, 9</sup>;
2. all types of loan or credit exposures where the borrower is owned<sup>10</sup> by one or more financial sponsors<sup>11</sup>.

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

1. loans with natural persons, credit institutions, investment firms, public sector entities and financial sector entities<sup>12</sup>;

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

<sup>4</sup> Irrespective of the classification in the regulatory banking book or regulatory trading book.

<sup>5</sup> 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.

<sup>6</sup> The term "Total Debt" refers to total committed debt (including drawn and undrawn debt) and any additional debt that loan agreements may permit. Committed undrawn liquidity facilities, according to the Basel Committee on Banking Supervision's Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (BCBS 238), are excluded. Cash should not be netted against debt. 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.

<sup>7</sup> EBITDA refers to earnings before interest, tax, depreciation and amortisation. Any enhancements to EBITDA should be duly justified and reviewed by a function independent of the front office function.

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

<sup>9</sup> The leverage multiple should be calculated at the consolidated borrower level, unless group support cannot be assumed in case the borrowing entity is experiencing financial difficulties. Any deviation from the calculation at consolidated level should be justified and documented on a case-by-case basis.

<sup>10</sup> 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), a financial sponsor (for which definition see footnote 11 below) is deemed to be the owner if it controls or owns more than 50% of the borrower's equity.

<sup>11</sup> The term "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.

<sup>12</sup> The terms "credit institution", "investment firm", "public sector entity" and "financial sector entity" are defined in points (1), (2), (8) and (27) respectively of Article 4(1) of the CRR.

2. loans where the own consolidated exposure of the credit institution is below €5 million;
3. loans to small and medium-sized enterprises (SMEs) as defined by Commission Recommendation 2003/361/EC<sup>13</sup> except where the borrower is owned10 by one or more financial sponsors11;
4. loans classified as specialised lending<sup>14</sup>;
5. trade finance<sup>15</sup>;
6. loans to investment-grade borrowers (i.e. with a rating equivalent to BBB- (S&P)/BBB- (Fitch)/Baa3 (Moody's) or above<sup>16</sup>).

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.

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<sup>13</sup> Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (OJ L 124, 20.5.2003, p. 36).

<sup>14</sup> The term "specialised lending" is defined in Article 147(8) of the CRR; and also in the EBA's Regulatory Technical Standards on Assigning Risk Weights to Specialised Lending Exposures under Article 153(9) of the CRR; and in the BCBS's Working Paper on the Internal Ratings-Based Approach to Specialised Lending Exposures of 2001. "Specialised lending" comprises project finance, real estate, object financing and commodities financing.

<sup>15</sup> 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.

<sup>16</sup> If the borrower is not rated internally or externally, the investment grade exclusion test is redundant.

## 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 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.
- All leveraged transactions that imply credit, syndication or underwriting risks should be preceded by a review and approval of an independent risk function. The scope of transactions should include all syndicated loans, including underwritten and “best efforts” deals<sup>17</sup>, as well as “club deals”<sup>18</sup> and bilateral loans. The approval process should allow sufficient time for the risk function to review 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.

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<sup>17</sup> The term “best efforts deal” refers to a transaction where the arranger of the deal agrees to use all efforts to sell down as much of the loan as possible (although the arranger often commits to fund a small portion if the loan is fully syndicated, in what is known as “final take”). If the arranger is unable to sell down the entire amount, it is not responsible for any unsold portions.

<sup>18</sup> 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 do usually reach agreement with the borrower on very similar, if not identical, terms.

## 5 Syndication activities

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

The internal standards and monitoring functions of a credit institution engaged in syndicating leveraged transactions should be mindful of the following aspects.

- The syndication unit should perform a detailed analysis to help price the loan; the price should be verified, prior to the granting of credit, by a function independent of the syndication unit.
- Each leveraged 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. Syndicating transactions presenting high levels of leverage – defined as the ratio of Total Debt<sup>19</sup> to EBITDA<sup>20</sup> exceeding 6.0 times at deal inception – should remain exceptional (and a potential exception should be duly justified) and form part of the credit delegation and risk management escalation framework of the credit institution<sup>21</sup>. 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. An independent risk function should be involved in the monitoring of the risks related to the credit institution's syndication activities.
- 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<sup>22</sup>. 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.

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<sup>19</sup> As defined above.

<sup>20</sup> As defined above.

<sup>21</sup> Supervisory expectations relating to the risk management of transactions that present high levels of leverage also apply to "club deals" and bilateral loan structures.

<sup>22</sup> E.g. collateralised loan obligation funds, pension funds, insurers, loan funds, hedge funds or distressed funds, banks, other institutional investors.



- 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 commitment date<sup>23</sup>. 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<sup>24</sup> and subsequent capital requirements calculation.
- Credit institutions should have policies and procedures in place for reclassifying leveraged 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 of interest when syndicating and distributing leveraged transactions.

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<sup>23</sup> This date should be defined as the date on which the credit institution enters into a legally binding commitment vis-à-vis the counterparty to lend by virtue of an executed loan agreement; any exception to this timeline should be justified as part of the credit institution's internal policies and procedures.

<sup>24</sup> 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.

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

### 6.1 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.

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 has the capacity to repay a significant share of its debt or de-lever to a sustainable level within a reasonable time frame. An adequate repayment capacity is defined as the ability of the leveraged borrower to fully amortise senior secured debt or repay at least 50% of Total Debt over a period of five to seven years.
- 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 "base case" and "stress case" scenarios. The latter should be sufficiently conservative, capturing tail-end market events and idiosyncratic events throughout the life cycle of the transaction.
- An enterprise valuation of the borrower, where applicable, to be 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 the presence of 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<sup>25</sup>. 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 consider only 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).

## 6.2 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"<sup>26</sup> 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 and/or borrower is demonstrating indicators of financial difficulties or unlikelihood to pay (UTP) criteria.

In this regard, it is necessary for credit institutions to have clearly defined internal criteria to identify indicators of UTP. These indicators should refer to clearly defined situations (UTP events). Credit institutions should ensure that their internal criteria in respect of non-performing exposures (NPE), default and impairment classification are fully aligned with all relevant regulatory, legal and accounting requirements<sup>27</sup> and the specificities of leveraged transactions (covenant breach, increase of leverage).

Credit institutions are expected to assess the borrower for financial difficulty and conduct an impairment test in each of the following situations:

- breach of a material financial covenant or non-remediation of a covenant breach;

<sup>25</sup> 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).

<sup>26</sup> "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.

<sup>27</sup> See the EBA's Implementing Technical Standard on Supervisory Reporting (Forbearance and non-performing exposures), under Article 99(4) of the CRR; the EBA's Guidelines on the application of the definition of default, under Article 178 of the CRR; and the ECB's Guidance to banks on non-performing loans.

- where the transaction is a refinancing of an existing 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 owing to financial difficulties or when it is expected that a bullet loan cannot be refinanced at current market conditions;
- there are justified concerns about a borrower's future ability to generate stable and sufficient cash flows as part of the "base case" and "stress case" scenarios outlined above.

The monitoring of exposures should be complemented by a stress-testing framework that comprises severe but plausible scenarios leading to significant changes in risk drivers, 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 above for the underwriting and syndication pipeline.

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 appropriate 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 below.

## 8 Reporting requirements and Management Information Systems (MIS)

Regular comprehensive reports<sup>28</sup> about trends in the leveraged markets and characteristics of a credit institution's leveraged transactions should be sent to the senior management of each credit institution, including information about both the syndication pipeline and a credit institution's "hold book".

The reports should cover at least the following aspects:

- key markets trends;
- information on 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<sup>29</sup> and the outcome of the stress scenarios performed as per sections 5 and 6 above;
- 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).

MIS should be sufficiently granular and sound enough to enable management to identify, aggregate and monitor leveraged transactions and capture all the relevant aspects of this guidance.

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<sup>28</sup> Regular reports may form part of a broader reporting to senior management on credit and pipeline risks.

<sup>29</sup> Including, but not restricted to, the positioning of the underwriting and syndication pipeline compared with the limit referred to in section 5 above.

## 9 Requirements following release of the ECB guidance

This guidance enters into force six months after its publication. Eighteen months after publication an internal audit report shall be drawn up and submitted to the joint supervisory team, detailing how the expectations expressed in this guidance have been implemented by the credit institutions in their procedures.

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