JONES DAY

COMMENTARY

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ECB Seeks to Curb Banks' Appetite for Leveraged Finance Risk

IN SHORT

The Situation: On May 16, 2017, the European Central Bank ("ECB") published guidance, which comes into force in November 2017, on leveraged transactions for credit institutions supervised by the ECB.

The Rationale: The ECB fears the weakening of credit quality due to borrower-friendly terms and high completion as a result of surplus liquidity in the leveraged finance markets, and it has identified areas for improvement.

Looking Ahead: ECB-supervised credit institutions are expected to implement comprehensive risk management and reporting requirements for leveraged transactions.

Subsequent to the close of the consultation period following the ECB's publication of the draft guidance, the ECB issued the final guidance to banks on leveraged transactions ("Guidance") on May 16, 2017. The Guidance applies to European credit institutions under direct supervision of the ECB ("Supervised Banks").

The Guidance's goals are to: (i) ease the identification of leveraged transactions by means of a unique definition; and (ii) establish a set of satisfactory standards for risk management and reporting requirements, with a view to ensuring harmonization across Supervised Banks in Europe when dealing with leveraged transactions. In its feedback statement and response to the public consultation, the ECB pointed out that the scope and purpose of the Guidance is aligned with the United States' 2013 Interagency Guidance on Leveraged Lending. However, there still are some inconsistencies between the two sets of guidelines.

CHANGES: DRAFT GUIDANCE VS. FINAL FORM

What changed

Although the Guidance's final form does not differ materially from the draft Guidance, the ECB has taken into account some comments made during the public consultation.

1. Definition of "earnings before interest, taxes, depreciation, and amortization," or "EBITDA," has been revised to include EBITDA adjustments, which need to be justified and internally reviewed.
2. Clarification of credit exposures outside of the Guidance's scope:
   - Financing where the principal source of debt repayment arises from the assets being financed (specialized lending)
   - Loans to investment-grade borrowers, small-to-medium enterprises, natural persons, credit institutions, investment firms, public sector entities, and financial sector entities
   - Loans below €5 million

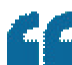
What has not

Some terms of the draft guidance were not amended.

1. The definition of "leveraged transaction" still covers all types of loan or credit exposures where the leverage ratio exceeds 4.0:1, or where the borrower is majority-owned by a private equity fund. (The ratio is calculated on a gross basis and encompasses all types of debt, including shareholder loans and payment-in-kind instruments, as well as any debt not yet incurred but permitted, thus any incremental facilities.)
2. Transactions with a leverage in excess of 6.0:1 should remain the exception and, in any event, be subject to more stringent risk management controls.

Next Steps for Supervised Banks

The ECB expects Supervised Banks to implement the Guidance in their internal policies. The Guidance will enter into effect six months after its publication, on November 16, 2017. Supervised Banks, within 18 months following the publication of the Guidance, should review their existing risk and internal policies to ensure that they are in compliance with the Guidance and must report to the joint supervisory team on the progress of their implementation.



Supervised Banks, within 18 months following the publication of the Guidance, should review their existing risk and internal policies to ensure that they are in compliance with the Guidance and must report to the joint supervisory team on the progress of their implementation.

To implement the Guidance, Supervised Banks must define clearly, for each stage of a leveraged transaction (origination, syndication, portfolio monitoring, secondary market activities, distress situation) appropriate internal policies. These policies will need to define which transactions are considered "leveraged transactions," the limits allocated to leveraged transactions, the reporting requirements to senior management on leveraged transactions, the tools and due diligence requirements to be used when assessing risk, and the criteria to identify distress scenarios.

Supervised Banks will also be required to implement independent risk analyses—whether at the origination stage, the syndication stage, or during the life of the transaction (e.g., in case of a recapitalization transaction). They will need to show that they have put in place specific controls, policies, and procedures when entering or participating in leveraged transactions.

It will be interesting to follow how the ECB will test compliance with the Guidance, particularly because the Guidance should be subject to the principle of proportionality (i.e., consistent with the size and risk profile of the leveraged transaction activities of a Supervised Bank compared to its assets, earnings, and capital). Also, the Guidance's aim is not to prevent Supervised Banks from lending to leveraged borrowers. One thing is reasonable certain, however—future correspondence between the Supervised Banks and the supervisor will be thorough.

THREE KEY TAKEAWAYS

1. Supervised Banks must assess their credit portfolio to determine which loans qualify as leveraged transactions within the meaning of the Guidance.
2. The assessment should be followed by a revision of their existing credit approval procedures for leveraged transactions.
3. Senior management is required to pay special attention to the quality and development of the leverage loan book with the support of specific reporting requirements.

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