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US-Style Leveraged Lending Guidance Comes to Europe

The European Central Bank published draft guidance to banks on leveraged lending, launching a public consultation period that runs until 27 January 2017.

The draft guidance is very similar to leveraged lending guidance issued by the US federal banking agencies in 2013, which has had a significant impact on the leveraged lending market in the US. There are some significant differences between the ECB's guidance and the US guidance that could raise issues of competitive equality between US, European and other banks. Below we highlight some of the important differences between the US guidance and the ECB's draft guidance.

The issuance of the ECB's draft guidance follows a 2015 survey by the ECB of the leveraged finance activities of banks across the Euro area. According to the ECB, that survey highlighted a number of concerns relating to the leveraged finance market, including borrower-friendly conditions, the need for improvement in banks' monitoring practices, and significant discrepancies in individual institutions' approaches to defining, measuring and monitoring leveraged lending transactions. Through the guidance, the ECB is seeking to develop a clear and consistent definition of what constitutes leveraged transactions and to establish guidelines on how banks should measure and monitor such exposures. The guidance also sets out how the ECB expects banks to ensure credit quality in their leveraged lending transactions and monitor related risks to their balance sheets. The guidance is non-binding. However, the ECB expects the guidance to be translated into banks' internal policies and procedures, proportionally to the size and the risk profile of the institutions' leveraged lending transactions in relation to the institutions' assets, earnings and capital.

The ECB states that the goals of the draft guidance are aligned with those outlined in the US leveraged lending guidance. According to the ECB, the draft guidance aims to strengthen the level playing field for banks operating on a global basis by more closely aligning supervisory expectations and practices. Some of the key components of the ECB guidance, as well as key differences from the US leveraged lending guidance, include:

- **Institutions Covered** – The ECB guidance applies to all "significant credit institutions" supervised by the ECB under the Single Supervisory Mechanism (SSM) regulation. The categorization of a credit institution as "significant" depends on a number of criteria, including inter alia its size and its cross-border activities. Currently there are 127 institutions under the ECB's direct supervision. "Less significant" credit institutions (*i.e.* credit institutions not categorized as "significant") and credit institutions based in EU member states which do not participate in the SSM (*e.g.* UK) are outside the scope of the ECB guidance. The US leveraged lending guidance applies to federally regulated financial institutions, including US branches of non-US banks. For US banking organizations, the US guidance applies on an enterprise-wide basis, including bank holding companies and nonbank subsidiaries and affiliates of banks. The booking location of a leveraged loan by a US banking organization is irrelevant, as the guidance applies to leveraged lending activities by such organizations both inside and outside the US. For non-US institutions with US charters or licenses, the US guidance applies to all leveraged loans that are both originated and distributed in the United States. As drafted, the ECB guidance would apply to significant credit institutions also on an enterprise-wide basis.

- **Definition of Leveraged Lending** – Similar to the approach taken in the US leveraged lending guidance, institutions subject to the ECB guidance are expected to develop and implement a comprehensive, institution-specific internal definition of leveraged lending. Under the ECB guidance, an institution's definition of leveraged lending should include any loan or credit exposure that meets at least one of two conditions: (i) the borrower's post-financing leverage exceeds a total debt to EBITDA ratio of 4.0 times; or (ii) the borrower is owned by one or more financial sponsors (s) (*i.e.*, financial sponsor owns or controls more than 50% of borrower's equity). In contrast, the US leveraged lending guidance sets out four characteristics that, either separately or in combination, are common to leveraged lending transactions. The factors are quantitative (*i.e.*, the borrower's total debt to EBITDA ratio exceeds 4.0 times or its senior debt to EBITDA ratio exceeds 3.0 times) as well as qualitative (*i.e.*, the proceeds are used for buyouts, acquisitions, or capital distributions; the borrower is recognized in the debt markets as a highly-leveraged firm; and the borrower's post-transaction leverage significantly exceeds industry norms or historical levels). Unlike the ECB guidance, loans that meet any one of the four common characteristics under the US leveraged lending guidance are not automatically considered leveraged. Also, in a significant difference from the ECB guidance, control of the borrower by a financial sponsor is not included in the factors defining leveraged loans under the US guidance. However, under the US guidance, banks that rely on sponsor support for repayment of a leveraged loan are expected to have guidelines for evaluating and monitoring the financial condition of sponsors.
- **Transactions Covered** – Similar to the US leveraged lending guidance, the ECB guidance applies to all types of leveraged lending exposures, including drawn and undrawn facilities, term loans, bridge loans, revolving credit facilities, committed exposures not yet syndicated or distributed, and exposures being warehoused for later sale. While the US leveraged lending guidance specifically excludes bonds, it appears that the ECB guidance is intended to apply to non-investment grade bonds as well. The ECB guidance also applies to new loan originations, as well as any refinancing or material modification of an existing loan, which is consistent with the US guidance. While the US leveraged lending guidance specifically excludes asset-based loans that are not part of the debt structure of the borrower, the ECB guidance appears to exclude a broader range of asset-based loans. The ECB guidance also excludes other types of loans that are not specifically addressed in the US guidance, such as loans to natural persons, loans to credit institutions and investment firms, loans with a consolidated exposure for the institution less than €5 million, commercial real estate financing, project finance loans and trade finance).
- **Definition of EBITDA** – For purposes of the ECB guidance, EBITDA means realized EBITDA over the previous 12 months with no adjustments made for non-recurring expenses, exceptional items and other one-offs. This use of unadjusted EBITDA is a significant difference from the US leveraged lending guidance. While the US guidance does not contain any specific definition of EBITDA, the guidance does acknowledge adjustments to EBITDA. Additionally, in an industry conference call in 2015, the US federal banking agencies noted that adjustments to EBITDA should be supported by third-party due diligence and should come with appropriate documentation and "credible justification". However, the agencies also noted that a "large percentage" adjustment to EBITDA would be a red flag.
- **Total Debt** – Unlike the US leveraged lending guidance, the ECB guidance does not specifically address whether a gross or net measure should be applied in determining total debt for purposes of

leverage calculations. The US guidance requires the use of a gross measure, specifically providing that cash should not be netted against debt for purposes of calculating total debt.

On the other hand, the ECB guidance mirrors the US leveraged lending guidance in a number of additional key aspects. With respect to maximum leverage levels, both the ECB and the US guidance provide that a leverage level in excess of 6.0 times total debt to EBITDA raises concerns for most industries. Also, both the ECB guidance and the US guidance place significance on banks' assessment of a borrower's capacity to repay at least 50% of its total debt over a five to seven year period. Both the ECB guidance and the US guidance set out expectations for monitoring and reporting leveraged lending exposures across the institution, but the monitoring and reporting requirements under the US leveraged lending guidance appear to be somewhat more robust that those under the ECB guidance.

On a practical level, we note that as a matter of good practice, many credit institutions affected by the ECB guidance likely already follow many of the key aspects contained in the guidance. When conducting the survey in 2015, the ECB provided feedback to credit institutions on their leveraged lending activities and a similar exercise by the Bank of England in 2014 came to the conclusion that no action was required. In addition, some national supervisory authorities have issued guidelines (not specifically relating to leveraged lending) which provide for similar requirements (*e.g.* in Germany the circular by the Federal Financial Supervisory Authority (BaFin) on the minimum requirements for risk management).

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