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Leveraged Lending: Summary of ECB Guidance compared to US Guidance

In May 2017, the European Central Bank published its final Guidance on Leveraged Transactions (the “ECB Guidance”)¹. The ECB Guidance will come into effect six months after publication and will apply to all “significant credit institutions” supervised by the ECB. As we discussed in our previous note², when drafting its guidance the ECB took into account comments from market participants, many of which focused on aligning the ECB Guidance with the Interagency Guidance on Leveraged Lending (the “US Guidance”)³ promulgated by the several departments of the United States government in March 2013. In this note, we give a more specific comparison of significant points-to-note in the ECB Guidance and the US Guidance.

	ECB Guidance	US Guidance
Scope of application – affected institutions	<ul style="list-style-type: none"> (a) Applies to “significant” credit institutions based in member states participating in the single supervisory mechanism (“SSM”)⁴. Categorisation as “significant” depends on a number of criteria, including size and cross-border activities. (b) Subject to the principle of proportionality — i.e. consistent with the size and risk profile of each institution’s leveraged lending activities. (c) Each “significant” institution has a dedicated Joint Supervisory Team comprising staff of the ECB and national supervisors. 	<ul style="list-style-type: none"> (a) Wider reaching than the ECB Guidance: applies to all federally regulated financial institutions, including non-banking subsidiaries of bank-holding companies and US branches of non-US banks, regardless of booking location. (b) Implementation should be consistent with the size and risk profile of an institution’s leveraged activities relative to its assets, earnings, liquidity and capital. (c) Financial institutions engaged in leveraged lending should adopt risk management framework with an intensive and frequent review and monitoring process based on written objectives, acceptance criteria and controls for risk.

¹ [The European Central Bank’s Final Guidance on Leveraged Transactions](#) (May 16, 2017), to be read in conjunction with the ECB’s [Feedback Statement](#).

² [ECB Publishes Final Guidance on Leveraged Transactions - what this means for banks](#) (Shearman & Sterling, May 22, 2017).

³ [Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17,766](#) (March 22, 2013).

⁴ The SSM is one of the parts of the EU banking union and functions in conjunction with the Single Resolution Mechanism. As the UK chose not to participate in the SSM, credit institutions established in the UK are not supervised by the ECB and so the starting point is that they will not be subject to the ECB Guidance. However, since branches of UK credit institutions also fall within the ECB’s remit, it is possible that a branch of a UK credit institution may be supervised by the ECB if that branch is based in a country to which the SSM applies and that branch is deemed ‘significant’.

	ECB Guidance	US Guidance
	(d) The ECB Guidance does not apply to non-bank lenders.	(d) Does not apply to unregulated entities such as hedge funds, private equity sponsors, mezzanine funds and unregulated commercial lenders.
Scope of application – affected transactions	All leveraged transactions (unless exempt), including at origination, refinancing and modification. This includes all syndicated loans, including underwritten and “best efforts” transactions, as well as “club deals” and bilateral loans.	All leveraged transactions (unless exempt), including at origination, modification, extension or refinancing. This includes “best efforts” transactions and fully committed facilities (with no express exceptions for “club deals” or bilateral loans).
Definition of “leveraged transaction”	<p>(a) Any transaction meeting at least one of the following tests:</p> <ul style="list-style-type: none"> • <i>Sponsor test</i>: all types of loan or credit exposure, regardless of the actual leverage of the transaction, if one or more financial sponsors⁵ controls or owns more than 50% of a borrower’s equity; or • <i>Leverage test</i>: the borrower’s post-financing leverage exceeds a Total Debt to EBITDA ratio of 4.0 times (calculated at the consolidated borrower level⁶). <p>This is a hard test, unlike the US Guidance, which provides for a more holistic view based on transaction characteristics.</p> <p>(b) Applies to transactions regardless of leverage levels where a financial sponsor has a controlling stake in the borrower.</p> <p>(c) Scope and implementation of the definition of a “leveraged transaction” by each institution should be regularly reviewed by an appropriate independent audit department to ensure that no undue exclusion has been made.</p>	<p>(a) While there is no “bright line” test, leveraged loans would commonly contain some combination of the following characteristics:</p> <ul style="list-style-type: none"> • loan proceeds are used for buyouts, acquisitions or capital distributions; • the borrower is recognised in the market as highly leveraged; • the borrower’s post-financing leverage significantly exceeds industry norms or historical levels; and • the borrower’s post-financing leverage exceeds a total debt to EBITDA leverage ratio of 4.0 times <i>or</i> a senior debt to EBITDA leverage ratio of 3.0 times. <p>(b) A financial sponsor’s control of the borrower is not a factor in defining leveraged loans.</p> <p>(c) Financial institutions’ policies should include criteria to define leveraged lending that are appropriate for that institution.</p>
Total Debt	<p>(a) Applies to total committed debt (drawn and undrawn) – including, for example, subordinated shareholder or vendor financing and PIK instruments, even if they exhibit equity-like features.</p> <p>(b) Includes “any additional debt that loan agreements may permit”. For example, (uncommitted) incremental or accordion facilities, even if they are never actually used.</p>	<p>(a) Based on total committed debt, including subordinated debt and equity holdings (no express exception for PIK instruments or debt with equity-like features) and net hedging exposure.</p> <p>(b) Similar to ECB Guidance.</p>

⁵ 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.

⁶ Unless group financial support cannot be assumed in case the borrowing entity is experiencing financial difficulties and every deviation is to be justified and documented at the time of origination, modification or refinancing.

	ECB Guidance	US Guidance
	<p>(c) Excludes committed undrawn backstop liquidity facilities meeting the requirements of the Basel III liquidity standards (for example, common in commercial paper programmes).</p> <p>(d) Cash cannot be netted against debt.</p>	<p>(c) No express exceptions for backstop liquidity facilities.</p> <p>(d) Cash cannot be netted against debt.</p>
EBITDA	Permits EBITDA enhancements, which must be duly justified and reviewed by a function at the bank that is independent of the front office.	Does not define EBITDA, but acknowledges enhancements may be made ⁷ . EBITDA enhancements should be supported by third-party due diligence, and “large percentage” adjustments to EBITDA are viewed as a red flag ⁸ .
Transaction leverage levels	<p>(a) Highly leveraged transactions — those with a leverage ratio exceeding 6.0 times EBITDA — should remain “exceptional” and be “duly justified.”</p> <p>(b) Additional evidence of the involvement of senior management and the risk function is required above this threshold.</p>	Transactions exceeding the 6.0 times EBITDA threshold raise concerns for most industries, and may receive additional scrutiny.
Treatment of “fallen angels”⁹	“Fallen angels” are within scope; so no special dispensation if their loan is modified, extended or refinanced. No explicit allowance for workout or rescue financing.	Also applies to “fallen angels,” but only if the original loan is subsequently modified, extended or refinanced. However, standards are not intended to discourage lenders from providing workout financing in connection with bankruptcies.
Exempted transactions	<p>(a) Loans to natural persons, credit institutions, investment firms, public sector entities and financial sector entities.</p> <p>(b) Loans where consolidated exposure is below EUR5 million.</p> <p>(c) Loans to SMEs (except where owned by financial sponsors).</p> <p>(d) “Specialised lending” comprising project finance, real estate, asset and commodities financing.</p> <p>(e) Trade finance.</p> <p>(f) Loans to investment-grade borrowers¹⁰.</p>	<p>(a) No express exception for loans to natural persons, credit institutions, investment firms, public sector entities and financial sector entities.</p> <p>(b) Not addressed in US Guidance.</p> <p>(c) Small portfolio commercial and industrial loans.</p> <p>(d) No express exception for project finance or real estate. Traditional asset-based loans that are not part of the larger debt structure of the borrower are excluded from the US Guidance.</p> <p>(e) No express exception for trade finance.</p> <p>(f) No exemptions due to financial strength of the borrower — US Guidance expressly includes loans to even “the most creditworthy borrowers”.</p>

⁷ Federal Deposit Insurance Corporation et al., [Frequently Asked Questions for Implementing March 2013 Interagency Guidance on Leveraged Lending](#) (FIL-53-2014) (November 7, 2014).

⁸ [Gillian Tan, Regulators on Leveraged Lending: A Cheat Sheet](#), WALL ST. J. MONEYBEAT BLOG (Feb. 26, 2015, 5:40 PM).

⁹ Borrowers whose financial performance deteriorates significantly after loan inception.

¹⁰ Borrowers with a rating equivalent to or higher than BBB- (S&P) / BBB- (Fitch) / Baa3 (Moody's).

	ECB Guidance	US Guidance
	(g) Bonds and high-yield bonds held by bank and non-bank investors.	(g) The US Guidance does not impose substantive limits with respect to bonds or loans, but financial institutions engaged in leveraged transactions including for bonds and loans are expected to take the US Guidance into account.
Underwriting and syndication risk	Each leveraged transaction posing underwriting or syndication risks requires prior approval and detailed analysis of the market’s ability to absorb issuance and related pricing risk.	Financial institutions should have clear underwriting standards with set limits that accurately reflect the institution’s risk appetite. The standards should consider various risks including those related to the borrower’s capital structure and repayment capacity and effect of market disruptions.
Failed syndications / “hung transactions”	Syndication fails if not completed within 90 days following the commitment date. Such “hung transactions” should be moved to the “hold book” to reflect long-term risk positions, rather than the trading book. No flexibility for acquisition financing timetables, e.g. need for competition clearance or other structural reorganisations before syndication.	A transaction becomes a “hung” deal if not sold down within a reasonable period — generally 90 days from closing. Where a hung deal is reclassified as a hold-to-maturity loan, it should be reported to management and the board of directors.
Repayment capacity	“Adequate” repayment capacity is defined as the ability to fully amortise senior secured debt, or repay at least 50% of a borrower’s Total Debt over a 5–7 year period.	Borrower should be able to de-lever to a sustainable level within a reasonable period of time — characterized as the ability to repay at least 50% of total debt over 5–7 years.
Transaction terms	Detailed due diligence of the structure and terms of the transaction, including consideration of covenants, leverage levels and capex is required.	Financial institutions should have credit and underwriting authorities to approve structure and terms of the transaction, including evaluating various types of collateral.
Pricing	Syndication units should perform detailed analyses to price leveraged loans, to be verified independently.	US Guidance does not provide standards for pricing loans.
Risk appetite / governance	Senior management to have comprehensive and consistent oversight of all leveraged transactions originated, syndicated or purchased.	Financial institutions engaged in leveraged lending should adopt risk management framework with appropriate oversight by senior management and timely reporting to the board of directors.
Stress-testing framework	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. Additional stress-testing of “hold book” exposures.	Financial institutions should develop and implement guidelines for conducting period on loans (whether intending to hold or syndicate) and sensitivity analyses to quantify the impact of changes in economic and market conditions.
Credit approvals	Institutions are to have in place a credit approval process for all leveraged transactions, to comprise in-depth due diligence by the originating function and a critical review by an independent risk function. Diligence requirements are to include (in addition to assessments of repayment capacity): <ul style="list-style-type: none"> • business plan and projections in “base case” and “stress case” scenario; 	Financial institutions should have an independent, internal credit review process able to assess portfolio risk and escalate inappropriate risks and other findings to senior management. The credit review should: <ul style="list-style-type: none"> • evaluate level of risk, risk rating integrity, valuation methodologies and quality of risk management;

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	<ul style="list-style-type: none"> • enterprise valuation of the borrower (where applicable), reviewed and validated by a unit other than the originating unit; and • assessment of the structure of the transaction and related term sheets (see above in “<i>Transaction terms</i>”). 	<ul style="list-style-type: none"> • review leveraged lending policies to ensure compliance with regulatory guidance; and • conduct its reviews at least annually; for some institutions the risk characteristics of its leveraged portfolios may dictate more frequent reviews.
<p>Ongoing monitoring and reporting of “hold book” exposures</p>	<p>Ongoing monitoring of the portfolio to encompass all relevant risks for leveraged transactions held for the longer term. In addition to updates of the diligence requirements referred to above in “<i>Credit approvals</i>”, specific ongoing reporting requirements to cover:</p> <ul style="list-style-type: none"> • review of “hold book” exposures to occur at least once a year, but more targeted and frequent reviews of deteriorated exposures; • defined internal criteria to identify indicators of a borrower’s unlikelihood to pay; • alignment of internal criteria for classifying non-performing exposures, default and impairment with regulatory, legal and accounting requirements; • impairment tests in the event of covenant breaches and refinancings, or if there are justified concerns about a borrower’s ability to generate cash in “base case” and “stress case” conditions; • secondary market leveraged transaction exposures to ensure proper adherence with regulations on market conduct and treatment of privileged information; and • market trends, leveraged transactions across business units, concentrations of facility type, geography and sector, quality and profitability of transactions and exposure to weak covenant features. <p>Sophisticated Management Information Systems are expected to be sufficiently granular and sound to enable management to identify, aggregate and monitor leveraged transactions and capture all relevant aspects of the ECB Guidance.</p> <p>Institutions’ internal audit functions are expected to review their leveraged transactions and compliance with the ECB Guidance at least every three years.</p>	<p>Financial institutions should monitor leveraged loans and report to management at least quarterly regarding characteristics and trends of their exposures, which reports may include the following:</p> <ul style="list-style-type: none"> • individual and portfolio exposures within and across all businesses and legal vehicles, including the pipeline; • risk rating distribution and migration analysis, including maintaining list of non-leveraged borrowers that were removed from the leveraged portfolio because of improvement of financial risk and profile; • industry mix and maturities; • default and loss probability metrics; • portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs; • amount of impaired assets, nature of impairment and amount of allowance for loan and lease losses attributable to leveraged lending; • policy exceptions and its respective portfolio performance; • exposure by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment; • secondary market pricing data and trading volume; • exposures and performance by deal sponsors, noting that deals introduced by sponsors could relate to borrower exposure; • gross and net exposures, hedge counterparty concentrations and policy exceptions; • actual versus projected pipeline performance;

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		<ul style="list-style-type: none"> total and segmented leveraged lending exposures, including subordinated debt and equity holdings; and borrower and counterparty leveraged lending reporting considering exposures booked through other business units (default swaps, total return swaps and repo). <p>US Guidance does not specify reporting of “hold book” procedures (but see discussion of “<i>Failed syndication / hung transactions</i>”, which must be reported as hold-to-maturity loans).</p>
Effect of non-compliance	Not binding law and the consequences of non-compliance are not currently clear. At a minimum, non-compliant institutions face the risk of public censure by regulators and significant reputational damage.	The agencies are adopting an increasingly aggressive enforcement position. There have been reports of regulatory actions to privately reprimand banks for failure to comply.
Future developments	<p>In March 2017, Senator Pat Toomey (R-Pennsylvania) sent a letter to the US Government Accountability Office (GAO) asking whether the US Guidance constitutes a “rule” for purposes of the Congressional Review Act (CRA). If the GAO determines that the US Guidance is a “rule,” it would position opponents to argue that the US Guidance was improperly adopted because it was not submitted to Congressional review prior to being finalized. Such a determination could potentially (i) result in the US Guidance being unenforceable, and (ii) allow Congressional opponents to scuttle (or substantively change) the US Guidance to the extent it is re-submitted for review in compliance with the CRA. Additionally, the US Department of Treasury issued a report, <i>A Financial System That Creates Economic Opportunities</i>, on June 12, 2017, which proposes potentially broad changes with respect to the US Guidance. The report called for the US Guidance to be re-issued for public comment, and further suggested that the re-issued US Guidance focus on reducing ambiguity around the definition of leveraged lending and creating a consistent approach in supervision, examination and enforcement among the various US banking regulators. The report further encourages banks to use a clear and robust underwriting standard, instead of relying solely on the current 6.0x leverage ratio. As of today, no formal statements have been made regarding an update or a re-issuance of the US Guidance. If any of these developments proceeds, the result could be further disparate treatment of leveraged lending between the US Guidance and the ECB Guidance.</p>	

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