Feature

KEY POINTS
- Notwithstanding the Guidelines, 2018 saw the share of 6.0 times leveraged loan transactions grow to 33% of the European leveraged loan market from 30% the year before.
- The Guidelines are not directly legally binding or rigorously enforced.
- The Guidelines do not in many cases reflect the commercial realities of leveraged lending.

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Easier said than done: the failure of the European Central Bank's Guidance on Leveraged Transactions

More than a year has now passed since the European Central Bank's (ECB) 'Guidance on Leveraged Transactions' (the Guidelines) came into force. The Guidelines require "significant credit institutions" under ECB supervision to implement internal frameworks to better manage and monitor the risks caused by leveraged transactions. This article explores the reasons why the Guidelines have so far largely failed to restrict leveraged lending activities in the way intended by the ECB.

In November 2016, the ECB finally followed its US counterpart, the Federal Reserve, to launch a public consultation relating to its key supervisory expectations for leveraged transactions. The ECB had for a long time been concerned by borrower-friendly loan market conditions, the weakening of leveraged transaction structures (particularly declining underwriting standards) and the wider potential consequences for the financial system.

The Guidelines were its much-heralded response to this perceived lack of discipline in standards in the European market.

The Guidelines define a "leveraged transaction" as one where:

- the borrower's post-financing level of leverage exceeds a Total Debt to EBITDA ratio of 4.0 times; and/or
- the borrower is owned by one or more financial sponsors (being 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).

Various exclusions were also provided to these criteria including loans to small and medium sized enterprises, certain limited recourse financings and trade finance.

Among the key controls the Guidelines recommended implementing were the following:

- transactions with a Total Debt to EBITDA ratio exceeding 6.0 times (at deal inception) should remain exceptional and any such exceptions should be duly justified;
- leveraged borrowers should be able to demonstrate an ability to amortise fully senior debt, or repay at least 50% of Total Debt over a period of five to seven years; and
- loans should be classified as "hung syndications" if not syndicated within 90 days of commitment.

Notwithstanding these Guidelines, 2018 saw the share of 6.0 times levered loan transactions grow to 33% of the European leveraged loan market from 30% the year before. The vast majority of all leveraged transactions were agreed on a covenant-lite basis (ie not including at least one financial maintenance covenant) and which offer far less protection to lenders.

FORCE OF LAW

One of the key reasons credit institutions have not, in all cases, adopted the Guidelines is that they are not directly legally binding or rigorously enforced. While there is an expectation that credit institutions may from time to time be called upon by the ECB to explain deviations from the Guidelines, they have nonetheless been treated by market participants as largely advisory in nature. Lessons learned from the implementation of the US leveraged lending guidelines highlight that full adherence can take time as the market practice adjusts to new norms. Some market participants in the US only began to focus their minds on full compliance when penalties were imposed for non-compliance. It remains to be seen whether the ECB will need to take similar actions.

It is also unclear to many whether the ECB has invested sufficient human capital in monitoring compliance of leveraged transactions given high levels of market activity across Europe. When you consider the complexities of the underlying documentation, it can be a near impossible task to monitor and establish the "true" leverage on some of these transactions, particularly once adjustments to EBITDA are included (see below). Moreover, the universe of 4.0 times levered transactions is broad and spans a number of different product areas not only financings backed by financial sponsors.

COMMERCIAL REALITIES

Feedback from market participants has also highlighted frustrations that the Guidelines do not in many cases reflect the commercial realities of leveraged lending and make compliance with them impractical.

The obvious example of this is the ECB's use (despite much opposition in the market consultation phase) of Total Debt (rather than Net Debt) as the numerator for the leverage ratio. Net Debt has historically been the formulation used by market participants and is contained in the vast majority of European leverage loan agreements. It follows intuitively that credit should be given to prudent borrowers which accumulate cash or cash equivalents in reserve for the repayment of debt if required.

Similarly, it is not clear why equity-like subordinated debt instruments (ie PIK facilities, shareholder loans and vendor loans) should be included in the formulation of Total Debt. Many financial sponsors contribute equity into their portfolio

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companies by way of shareholder loan for a variety of reasons, including the tax benefits which it can provide. In practice, those shareholder loans are viewed commercially as equity equivalents and are generally seen as a de-risking feature of a leveraged transaction rather than one that increases leverage.

Even more problematic is the requirement that Total Debt should cover both drawn and undrawn debt and any additional debt that the loan agreements permit. As a result, any permitted incremental, accordion or sidecar debt together with capacity under any permitted debt incurrence baskets is captured regardless of whether it is actually utilised. This appears to be an imbalanced viewpoint to take. For example, in the case of undrawn acquisition debt, whilst the debt capacity itself is included in the leverage ratio, no account can be taken of the additional EBITDA likely to be gained through the acquisition of the target company. Many leveraged companies put revolving credit lines in place as a backstop which are also included in Total Debt even though they may never be utilised. The analysis is further complicated by the fact that most indebtedness baskets are structured on a grower basis, such that the basket limit is the greater of a hard-cap amount and a percentage of prevailing EBITDA. The Guidelines contain no recommendations on how to treat this type of basket.

Another area where insufficient guidance has been provided relates to the loan syndication process. The Guidelines classify any transaction which has not been syndicated within 90 days of execution of the applicable loan agreement as a "hung transaction". Credit institutions are expected to establish a dedicated framework to deal with these "hung transactions" with a focus on a holding strategy, booking and accounting practices, regulatory classification and subsequent capital requirements. The likely reclassification of a hung transaction would typically require further capital to be allocated to the loan even though in practice there may be no greater risk to the lender. For a typical leveraged transaction, a period in excess of 90 days between signing and closing may simply be the result of a structural reorganisation of the group or an outstanding competition or regulatory clearance or other approval rather than being indicative of a risk with the underlying credit. A 90-day period from the transaction closing date may be a more achievable test and would tie in with market standard syndication periods.

The Guidelines' focus on assessing credit risk primarily on the basis of a leverage ratio also seems flawed when compared to market practice. The focus is on a borrower's earnings rather than its assets, even though those assets may be of very high value. In our view, the relative strength of the security package backing the leveraged transaction should be factored into the Guidelines. This would be particularly pertinent for businesses with large real estate portfolios or significant receivables or stock.

INTERPRETING THE RULES

As well as being divergent from market practice in certain respects, the Guidelines are also open to significant flexibility in terms of interpretation. The key example of this is the definition of EBITDA which can be adjusted to reflect the effects of non-recurring items. There has been a great deal of attention paid recently to aggressive EBITDA add-backs which can have the effect of materially increasing EBITDA on a number of market transactions. Sponsors have been able to add-back speculative costs and revenue synergies related to generic transactions such as restructurings and acquisitions. Often these synergies can be determined subjectively by the company CFO and do not need to be independently verified. Strong sponsors are also now able to account for such expected synergies over a 24-month period. While these add backs were historically subject to caps, the number of loan agreements with a cap on EBITDA add-backs has fallen significantly.

A generous EBITDA definition has further consequences within the loan agreement, particularly with regard to covenant general baskets which are increasingly sized on a proportion of prevailing EBITDA.

UNEVEN PLAYING FIELD

For many observers, the Guidelines have helped to foster an uneven playing field for leveraged loans within the wider leveraged finance marketplace. The Guidelines themselves only apply to leveraged loans provided by credit institutions and not to high yield bonds. Bonds have historically had even looser covenants than loans and attract a similar investor base. So, if the ECB's concern is to mitigate the systemic risk posed by the leveraged debt burden, why make a distinction between different types of secured leveraged debt instrument?

The Guidelines only cover participants in the Single Supervisory Mechanism Regulation, which notably does not include Swiss or UK banks. In addition, they also do not apply to the universe of alternate credit providers (ACPs) who have year on year increased their share of the leveraged lending market. The ACPs are technically unfettered in their ability to provide a high degree of leverage to the financial sponsor community. Hence the ACPs can provide the dry powder sponsors need to increase their purchasing power in competitive auction processes and ultimately enhance their return on equity.

If you couple the enormous competition in the market place with CLO investor demand for leveraged paper and the internal pressure faced by the leveraged loan community to deploy capital, the commercial pressure faced by the leveraged loan community is inescapable. It is unsurprising that many market participants have not been able to fully prioritise adherence to the Guidelines.

CONCLUSION

As we look ahead in 2019, we do not expect any material change in the approach of market participants to the Guidelines. All indications from the US are that the federal banking agencies are now relaxing rather than tightening restrictions on leveraged transactions. We think Europe will continue on the same path with the Guidelines remaining only advisory in nature. ■

Further Reading:

- Incremental facilities: another example of European and US loan market convergence (2017) 3 JIBFL 151.
- Current and anticipated trends in direct lending (2018) 3 JIBFL 173.
- LexisPSL: News analysis: Banking & Finance: Examining the latest draft guidance on leveraged transactions.