# LEVERAGED FINANCE AND REGULATION

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A business of Marsh McLennan

# CONFIDENTIALITY

# ECB SCRUTINY REDUCES THE ATTRACTIVENESS OF LEVERAGED TRANSACTIONS RETAINED ON THE BANK'S BALANCE SHEET

Leveraged transactions[1] are regarded by the ECB as a "key vulnerability" and form part of the supervisory priorities for 2022-2024; the ECB suggests that the banks under its supervision hold €500 BN of these exposures

There are two areas of particular focus for the ECB, namely so-called Highly Leveraged Transactions (with Debt/EBITDA > 6.0) and covenant-lite structures

"Disappointed" with the "severely deficient" way banks have implemented the May 2017 guidance, the ECB has released the March 2022 "Dear CEO letter" which articulates extensive expectations around risk management practices such as a dedicated Risk Appetite Framework, specific metrics and adequate capture of all risks associated with these transactions

The ECB stresses the importance of their guidance by highlighting that failure to comply may lead to an increase of P2R: it has already acted on this by increasing capital requirements for BNP Paribas and Deutsche Bank and is conducting Onsite Inspections (OSIs) at other lenders

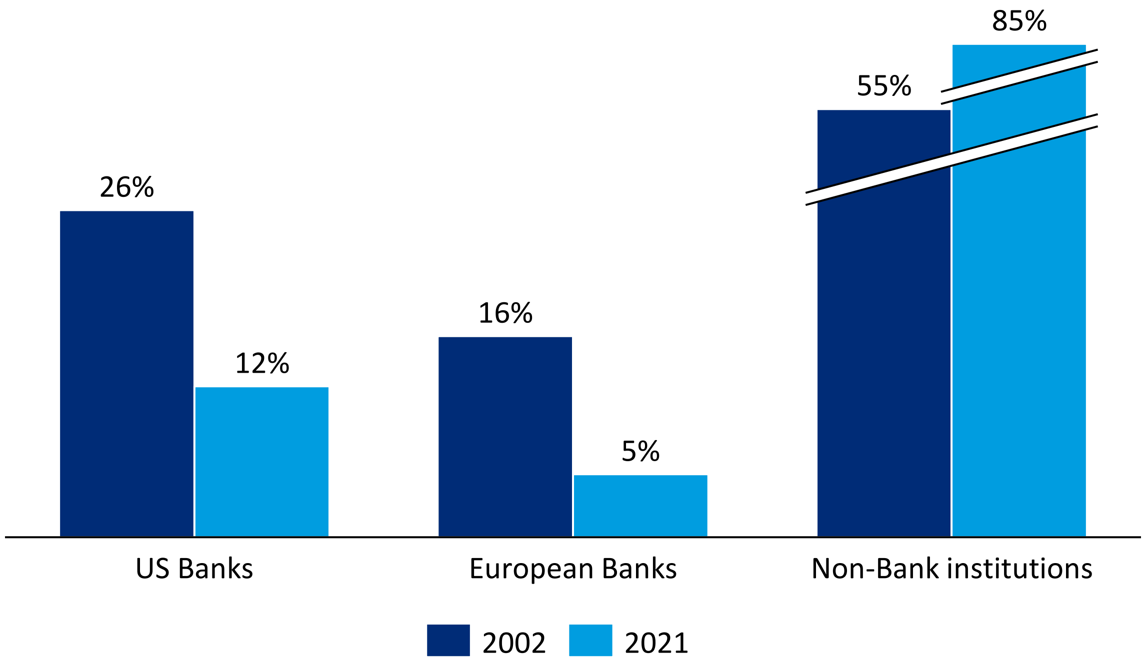
The increased regulatory focus is leading to a series of question marks across the European Banking industry

- There are still considerable uncertainties around the exact definition of Leveraged Transactions assets; practices for definition and identification vary across the industry
- The looming recession will lead to standard loans to corporates whose balance sheet is deteriorating to being classified as Leveraged Transactions ("Fallen Angels") alongside 'true' leveraged transactions. The regulatory awareness about these collateral effects is unclear

1. Lending transactions with Debt/EBITDA at group level > 4.0 (post financing) or with borrowers owned by PE firms with medium-term focus). Excl. investment-grade borrowers, SMEs/small exposures, trade finance/specialized lending. Designation at origination and modification.

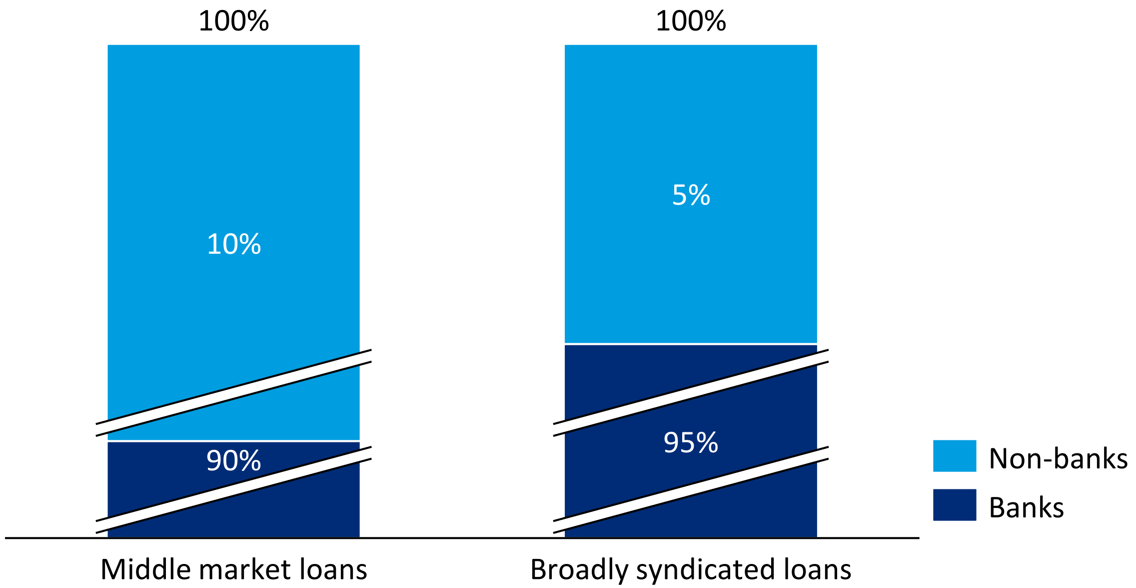
# BANKS HAD ALREADY LOST SUBSTANTIAL RELEVANCE AS INVESTORS IN LEVERAGED LOANS AND ARE NOW AT RISK TO ALSO BE CUT OUT AS ARRANGERS

**Significant decrease of banks' market share as investors in leveraged loans**




- Shift of market share are similar both for European and US leveraged loan markets
- Reflects a quadrupling in the AuM of private debt funds since the Financial Crisis to today > $1 trn

**Non-banks have also already captured between 5-10% of market share in arranging leveraged loans**



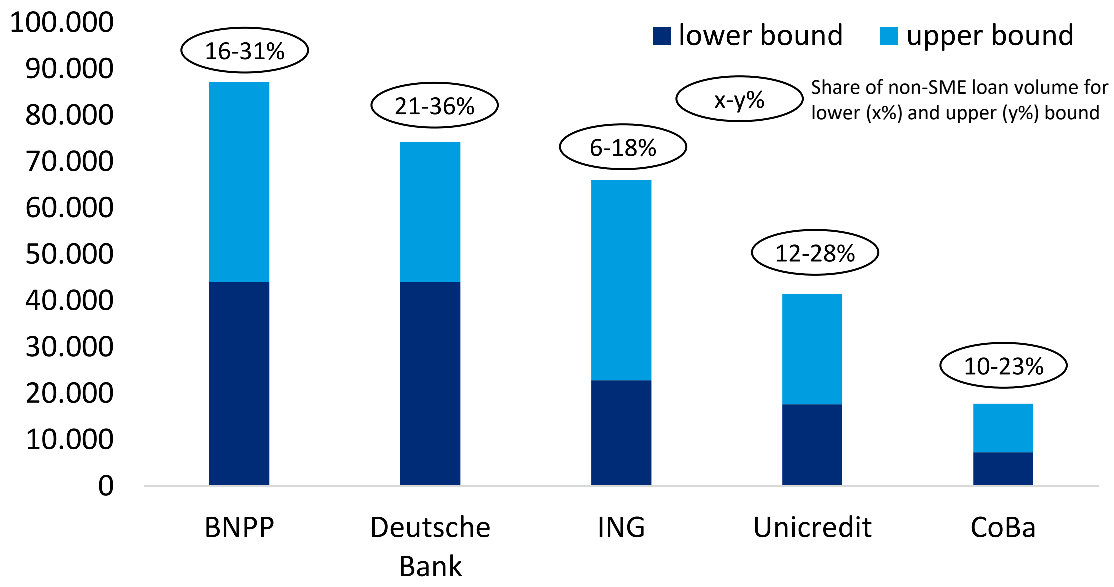

- Direct Lending by non-bank investors (i.e. debt funds) now makes up ca. 40% of all private debt activity (up from <5% in 2002
- Increasing relevance of (private) middle market loans, in which non-banks are more active compared to syndicated loans

Sources: Deutsche Bank, Ares Capital, LCD, Refinitiv, Oliver Wyman analysis

# GIVEN THE WIDE DEFINITION OF THE ECB AND THE INCREASE IN LEVERAGE, THE TOTAL POTENTIALLY AFFECTED VOLUME OF TRANSACTION COULD BE SUBSTANTIAL

**Wide definition of ECB will lead to potentially large parts of the banks' portfolio being caught in the "leveraged transaction" definition**

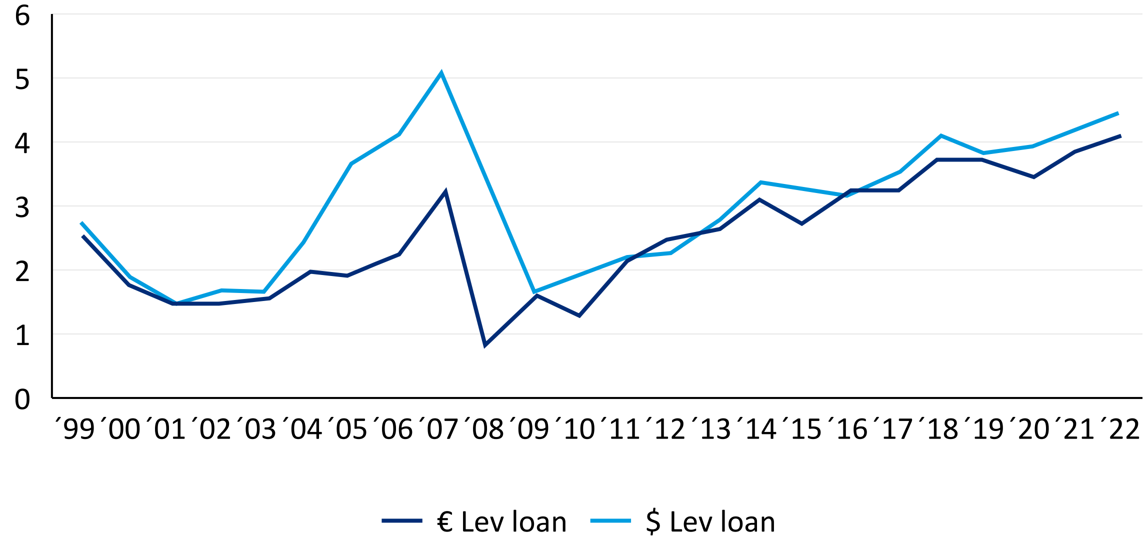
Exposures potentially to be classified as „Leveraged Transactions" for selected banks




- Lower bound is approximated as exposures with PD >2,5% (~rating worse than BB) higher bound as exposures with PD >0.75% (~all sub-investment grade) for non-SME corporate exposures

**Increasing leverage in "core" leveraged transactions increasing**

Average Debt/ BITDA




- Increasing levels of leverage will mean more transactions from core leveraged loans portfolio will be regarded as 'highly leveraged' transactions

Sources: Copmany information, Deutsche Bank, Oliver Wyman analysis

# BANK-INITIATED DEBT FUNDS – A WAY OUT?

***Structure visualisation***

**Sample Structure 1**


**Sample Structure 2**


| | Sample Structure 1 | Sample Structure 2 |
|---|---|---|
| ***Main Motivation*** | • Bank leverages O&D capabilities as well as housebank + sector knowhow to underwrite/acquire loans<br>• Syndication of loans to debt funds with 5% participation on each loan by bank balance sheet | • Bank underwrites loans as usual, but gives third party AM to participate in loans<br>• Bank retains small % of loans sold to AM |
| ***Key success factors/Pros*** | • 100% aligned interests between bank and AM, resolves concerns that bank offloads bad debt<br>• Close organizational proximity of AM business to bank (i.e. sitting within Corporate Bank) | • More flexibility for bank and AM to diverge in investment strategy<br>• AM fiduciary duty retained and opportunity to collaborate with more than one bank |
| ***Challenges*** | • Forced alignment of interests limits flexibility of both bank and AM<br>• Limited AM fiduciary duty („either you invest like our bank balance sheet or you don't invest“) | • Getting sufficient alignment on investment strategy in order to generate sufficient deal flow<br>• No ability to share capabilities with AM (or deep client insight via housebank relationship) |

Sources: Oliver Wyman analysis

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