ECB focuses on leveraged finance in times of Corona

For banks, leveraged transactions due to higher interest and fee income compared to ordinary corporate loans are an attractive market that offers additional opportunities in the secondary market. In view of the low level of interest rates and the good economic situation worldwide so far, in recent years, leveraged finance has experienced an enormous recovery since the financial crisis. However, the effects of the COVID 19 pandemic have also reached the leveraged loan market.

Impact of the COVID 19 pandemic on leveraged finance

The economic consequences of the COVID-19 pandemic led to a significant slow down of the primary market for leveraged loans in March 2020, resulting in a further decline in fee and interest income for banks. The secondary market is currently suffering from large scale sell-offs and price collapses, which are becoming particularly noticeable with a 14.78% decline in the S&P European Leveraged Loan Index in March.

While certain standards have been established in loan agreement documentation due to the borrower loan market in recent years, it is obvious that they are hardly tenable under current market conditions. This concerns, for example, loan agreements with covenant-lite / -loose, which reduce the level of protection of lenders. Furthermore, in the years 2018 and 2019 almost half of the borrowers had a comparatively high leverage of exceeding six times at the date of signing the loan agreements.

Also in the view of the ECB, especially in these times, loans with a high proportion of debt capital bear a special risk potential, which is a decisive factor for banks in their risk management activities in this market segment. New loan applications, utilisation of undrawn facilities, making use of increase and extension options and also applications for a temporary suspension of financial covenants and deferrals are challenging for banks. Not to mention the significantly increased insolvency risks for individual market participants and certain industries and sectors. Banks must carefully weigh up the risks of a new transaction or the further handling of existing loan agreements and also put them in the context of their existing portfolio. Failed syndications and the decline in loan transactions represent a particular risk in this context, which has a direct impact on the capital of the financial institution.

Guidelines and support from the European Central Bank

The ECB explicitly emphasises that the current situation in the loan markets is closely monitored, in particular with regard to the impact on institutions directly supervised by the ECB. Against this background, from the perspective of the ECB, its Guidance on leveraged transactions, published in May 2017, which aims to ensure sound lending and improve risk management, is becoming more important. These guidelines particularly require credit institutions to align their risk profile and risk strategy for leveraged transactions with the various business units involved in such transactions. To this end, the limits allocated to leveraged transactions, e.g. underwriting limits, should be defined and reviewed at least annually.

However, especially in such challenging times, shortcomings in the implementation of risk management guidelines become apparent. These concern, for example, the correct recording of risks, the adequate consideration of market conditions or the concrete design of the stress test systems. Last year, the banks already received recommendations as part of the Supervisory Review and Evaluation Process to remedy such deficiencies in risk management. It remains to be seen whether the ECB will consider supervisory measures necessary this year due to the acute conditions.

In any case, it gives institutions the “advice” (“there should be no doubt as to what banks need to do”) that they must continue to ensure the quality of existing and future risk and information processes related to leveraged lending and use the current situation to further improve lending and risk management.

Please click here for further finance insights:

[Privileging of loans under insolvency law due to Corona]

[Credit financing markets in times of Corona]

Please feel free to contact us!

Dr. Peter Seemann
Partner, Hamburg

T: +49 40 36803-122E
: p.seemann@taylorwessing.com

Dr. Jens WiesnerPartner
, Hamburg

T: +49 40 36803-320E:
j.wiesner@taylorwessing.com

Ulf Gosejacob
Partner, Frankfurt

T: +49 69 97130-144E:
u.gosejacob@taylorwessing.com

Hauke Bornschein
Partner, Hamburg

T: +49 40 36803-146E
: h.bornschein@taylorwessing.com

Sabine Schomaker
Partner, Frankfurt

T: +49 69 97130-137E
: s.schomaker@taylorwessing.com

Clemens Niedner
Partner, Frankfurt

T: +49 69 97130-142E
: c.niedner@taylorwessing.com

Claus Goedecke
Partner, Frankfurt

T: +49 69 97130-365E
: c.goedecke@taylorwessing.com

Dr. Michael Beyer
Salary Partner, Frankfurt

T: +49 69 97130-153E
: m.beyer@taylorwessing.com

Maike Schöber
Salary Partner, Frankfurt

T: +49 69 97130-248E
: m.schoeber@taylorwessing.com