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Leveraged Finance
Current Challenges and Future Evolution

Introduction
Currently Leveraged Finance (LF) is attracting considerable attention from both regulators and banking sector. The ECB has defined this topic as "key supervisory priority for 2022–2024" and has addressed the top management of the large financial institutions regarding the risks associated with Leveraged Transactions (LTs) and the regulator's expectations to manage them[1]. LTs are essentially financing arrangements to companies already deeply in debt. The ECB defines LTs as loan or credit exposure where the borrower's leverage ratio exceeds four, or any exposure where the borrower is owned by a financial sponsor[2].

European banks have significantly increased their exposure to LTs in recent years. Over the last four years, large banks (Significant Institutions according to the ECB, SI) increased leveraged loan exposure in their books from 40% to 60% approximately (CET1 capital). The trend has also been observed in the US market, and globally the issuance of leveraged loans has reached an all- time high[1,3]. Although in the past year issuance of leveraged loans declined in the European market due to inflation, rising interest rates, geopolitical uncertainty, and associated liquidity decline, the current LTs exposure remains very high[4].

At the same time, the evolution of LTs is broadly characterized as the deterioration of credit quality on the borrower side, predetermined by the long-lasting borrow-friendly environment and generally high demand on the investor side. This includes the rise in covenant-lite loans and the erosion of lender protections, the increasing complexity of LT documentation, increasing acceptance of high leverage ratios, and application of overly optimistic credit adjustments[3].

MAKING AN IMPACT THAT MATTERS since 1845

In European SIs, highly leveraged transactions (HLTs) thus comprise approximately half of new LT volume in recent years, according to the ECB[1]. At the same time, there has been a clear growth trend in European default rates for LTs, showing a rapid increase since 2022 (from 1.2% to 4.5% according to Fitch Rating[5]).

Obviously, the risks associated with LTs require appropriate risk management standards and practices. However, recent analyses performed by the ECB and IOSCO have identified severe deficiencies in current risk management. Furthermore, good practices and regulatory expectations have been defined to manage the high risks associated with LTs[1, 3]. The responses from European banks to ECB expectations confirmed significant deficiencies "in both the robustness of overall bank risk appetite frameworks and their management of market risk", as reported by the ECB[6]. This year the ECB has begun sending operation act letters to banks, describing the gaps to be remediated and included in the Supervisory Review and Evaluation Process.

A combination of growing volume, deteriorating credit quality, and deficient risk management makes LF an "explosive mixture" that requires special attention from both banks and regulators, especially given the current rise in interest rates and the uncertain economic situation. This also makes LF an actively developing field, with the banking sector facing a broad range of challenges to be addressed urgently. In this paper we describe those challenges with respect to European banks, consider existing solutions, and outline possible future developments.

Current challenges

Holistic group-wide (GW) risk management framework.

The ECB has emphasized the importance of establishing a GW level framework that covers all leveraged transactions across a bank. The core reason is that different LTs have common risk drivers and represent a distinctive asset class that requires appropriate holistic risk management. Such risk management should include an overall LT Risk Appetite Framework (LT RAF) that can capture all the relevant risks including concentration risk (implying a GW holistic approach). Such LT RAF should enable a system of limits to control the risks stemming from LTs and allow to efficiently control the entire LT exposure. Furthermore, it should quantify risks in both usual and stressed conditions[1,2].

For the banks implementation of LT RAF and more generally a holistic LT risk management approach rises a whole range of challenges. First, the definition LTs and HLTs should follow the regulator's expectations[1], and detailed classification should be established and where necessary discussed with the ECB (e.g. leveraged ratios used for HLT definition are subject for debates and may require adjustment due to uncertain economic conditions). The methods and metrics applied at different levels must be worked out and made uniform, achieving consistency between the levels (individual LT risk metrics should match GW metrics). The metrics should be able to consider risks in both the hold book and in the underwriting portfolio (the complete list of the ECB expectations is given in[1]). All this implies an ongoing transformation in the banks' risk management frameworks, which requires time, resources, and discussions with the ECB. This transformation should consider not only the regulator expectations, but also the current economic conditions. Thus, development and use of the forward-looking metrics may be challenging due to interest rate rise, inflation, and increasing default rates. This will obviously trigger further discussions between the ECB and the banking sector.

Market risks due to syndication.

The banks arranging syndicated loans are exposed to market risk, as they underwrite loans to be subsequently sold to third party investors. The ECB has emphasized the importance of methods to mark to market the so-called pipeline positions (the transactions that are in the process of syndication). Timeliness and ability to always reflect the realistic prices are set as crucial properties expected from the risk management. Motreover, stress tests including various scenarios and integrated into the overarching LT RAF are also considered a priority in establishing a realistic risk management framework[1].

In essence, a bank underwriting syndicated loans faces a demand-discovery problem, implying not only the risk on prices (and associated mark to marked loses), but also the risk on quantity (and associated hanging positions that have to be retained and transferred to the banking book with subsequent effects on the book and the capital requirements). Such risk due to its complexity was termed as pipeline risk[7].

The ECB has identified severe deficiencies in current risk management frameworks and provided detailed expectations for the timeliness and accuracy of mark-to-market activity and stress tests. These, among others include the need to back-test of the pricing models under COVID-19 conditions, a multitude of stress test scenarios ranging from stressed business as usual to the so-called very severe and extremely severe (including closed markets scenarios, implying that no transactions in the pipeline can be syndicated)[1].

Valuation of LTs. Realistic and precise valuation is a core topic in risk management and such key supervisory exercises as Asset Quality Review (AQR)[8]. Market prices of LTs are frequently unobservable, and therefore the valuation efforts often focus on the valuation inputs sources and the methods to derive the sensitivities to those inputs. Furthermore, the individual components of LTs should be evaluated separately, as some of the components may require specific non-standardized methods.

Market practices of LTs' fair and prudent valuation strongly depend on the data availability. The ECB documentation focused on AQR does not prescribe methods that should be specifically applied for LTs. The actual methodology must therefore follow the general recommendations for such financial health checks[8], documentation focused on LT management in general[1, 2], and concrete methods designed and discussed with the ECB. Basically, the approaches that can be applied can be divided into two categories: (i) discounted cash flows and (ii) bottom-up re-underwriting. The former approach is a main method for such valuations, and it should consider the risk-free rate, as well as the credit spread (client specific) and liquidity spread (e.g. refinancing costs, close-out costs). Bottom-up re-underwriting is helpful for specific deep-dive analyses, taking into consideration each corporate exposure, idiosyncratic risk, and the main industry and market level risks.

Prudent valuation of the fair-valued LTs may be challenging due to the data scarcity and low liquidity. Therefore, such valuation can mainly apply expert-based approaches based on proxy data or the so-called fall-back approach[9]. The latter approach does not require any data and is based on constant percentages (for loans the Additional Value Adjustment is derived as 100% of the net unrealised profit plus 25% of the absolute difference between the fair value and that unrealised profit)[9].

Interest rates rise and dynamic economic situation. Since September 2022 the ECB has raised the interest rates ten times with the last hike in September 2023 reaching a 22-year high of 4.5%, and the deposit facility rate reaching a new record of 4%. Remarkably, this increase was preceded by a nearly 10-year period of rates that were close, and even equal, to zero[10]. In parallel, leveraged loan default rates have increased dramatically and are projected to either remain high or further increase over the next year in both European and US markets[5,11].

As mentioned above, such long period of the low rates has resulted in deterioration of the credit quality on the borrower side, as well as rising risk-taking appetite on the lender side. Acceptance of high leverage ratios has gradually increased together with use of overly optimistic credit adjustments, development of covenant-lite loans and a general erosion of lender protections. Given the fact that large banks on average significantly increased their LT exposure over the past years, the current economic situation makes them vulnerable to current and upcoming shocks, including higher than expected interest payment on outstanding loans, increasing defaults due to economic slowdown, and larger than expected market risk in the syndication process. Improvements in the banks' risk management expected by the ECB (GW approach, LT RAF, market risk stress tests, etc[1]) should mitigate the risks explained above. However, this transformation towards the robust LT risk management is still to be completed.

In the current situation the secondary LT market is gaining importance as a determinant of the entire LT landscape[4]. The secondary market LTs remains more attractive to investors, and this affects the ability of the primary lenders to initiate new transactions that are to be syndicated. Besides, the secondary LT market can pose systematic risks, as rapid and simultaneous sales-off in the rising interest rate environment may potentially lead to a crisis scenario.

Future

The future of LTs in Europe and globally will apparently depend on the general economic situation and market development, as well as the interplay between regulators and banks. Meeting the expectations set by the ECB will of course strengthen the risk management and mitigate certain systemic risks. However, it will not facilitate the primary LT market development, as the lenders will set tighter limits on their LT and specifically HLT exposures. In turn, this potentially may cause certain economic slowdowns that are difficult to forecast. As mentioned above, the secondary LT market may increasingly play a more important role as a determinant of the entire LT market, and its economic effects are to be monitored and analysed. Decrease in LTs volumes, restructuring and amend-and-extend deals, and high borrowing costs may be further expected. All this indicates that LTs as a product flourishing in the low interest rate period is and will be posing difficulties for both lender and borrower sides in the new economic situation. Obviously, this will trigger further evolution of the leveraged finance, in which LTs may increasingly resemble non-leveraged transactions (lower acceptable leverage ratios, modest interest rates, standardized documentation, clear regulation and risk management).

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