Leveraged Loans and CLOs

Good Practices for Consideration

Consultation Report

The Board

OF THE

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Board or any of its members.

Foreword

The Board of the International Organization of Securities Commissions (IOSCO) has published this Consultation Report with a view to proposing a set of good practices for LL and CLO industry participants to consider.

How to Submit Comments

IOSCO welcomes input from all stakeholders as part of this consultation process.

Please submit consultation responses to LL-CLOconsultation@iosco.org by 15 December 2023.

Your comment letter should indicate prominently that it is a *'Public Comment on Leveraged Loans and CLOs – Good Practices for Consideration."*

All comments will be made available publicly unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

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1. Executive summary

The Leveraged Loan (LL) and Collateralized Loan Obligation (CLO) markets have historically had low default rates and performed well during the Global Financial Crisis (GFC). However, the structure of LLs and the LL market itself have evolved markedly since the GFC and globally both LL and CLO markets have experienced significant growth driven by an expanding economy and the low interest rate environment which characterised the post-GFC period until early 2022.

The LL market has experienced an evolution in both the characteristics of the borrowers and in the investor base. The former has partially shifted from traditional industrial sectors towards technology and healthcare, and on average, the credit quality of corporate borrowers has deteriorated. Meanwhile, the investor base has shifted from banks to non-banks (especially CLOs) and has diversified across a large number of CLO managers. These changes in the market participants combined with a prolonged borrower-friendly environment have led to significant developments in market practices including the rise in covenant-lite LLs, increasing complexity of LL documentation and the use of EBITDA[1] adjustments which are often shown to be overly optimistic.[2]

IOSCO has been following the evolution of the LL and CLO markets and examining the impact of fewer and looser covenants on investor protections, whether there is adequate transparency in the LL and CLO markets and whether potential conduct-related issues have arisen as a result of recent market developments. IOSCO's analysis is based on extensive engagement with market participants, credit rating agencies, academics and legal professionals, as well as a review of relevant research and literature. It also draws on input from a survey of IOSCO members as well as public surveys of industry participants. IOSCO identified some vulnerabilities in the LL and CLO markets which may be exacerbated by the behavior of certain participants and market practices.

This consultation report:

- Provides an overview of the LL and CLO markets and their evolution since the GFC;
- Explains why the vulnerabilities identified in the LL and CLO markets could impact IOSCO's objectives of (i) protecting investors, (ii) ensuring that markets are fair, efficient and transparent, and (iii) reducing systemic risk;
- Describes in detail the following twelve proposed good practices grouped into five themes: i) Origination and refinancing based on a sound business premise; ii) EBITDA and loan documentation transparency; iii) Strengthening alignment of interest from loan origination to end investors; iv) Addressing interests of different market participants throughout the intermediation chain; and v) Disclosure of information on an ongoing basis.
- Seeks feedback on the proposed good practices and the consultation questions, as set out in the report.

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[1] Earnings before interest, taxes, depreciation and amortization

[2] S&P (2023) Leveraged Finance: Fifth Annual Study Of EBITDA Addbacks Finds Management Continues To Regularly Miss Projections: https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170

This consultation report offers a set of good practices for the consideration of market participants. This is in line with IOSCO's objectives. While the good practices do not comprise either standards or recommendations as per IOSCO's taxonomy, they are designed to support market participants in their decision making when operating in the LL and CLO markets.

Theme A	**Origination and refinancing based on sound business premise**
Measure 1	**Debt repayment capacity test** Leveraged loans offered to the market in both new originations, debt refinancings and debt restructurings should be underpinned by sound business and financial risk assumptions. Borrowers should be able to demonstrate sufficient debt repayment capacity. An adequate debt repayment capacity is considered the ability to repay 100% of senior debt or 50% of total debt over the medium term. For example, some regulatory agencies and other market practitioners measure the debt repayment capacity test over a 5 to 7 year period. Where this is not evident, a credible explanation should be provided. It is also considered good practice to disclose debt repayment capacity in term sheets and supporting documentation at the time of debt offering and refinancing. A robust assessment of cash flows including stress testing should inform debt repayment capacity assessments.
Measure 2	**Dividend Recaps** Dividend recapitalisations should be considered with reference to the level of remaining equity support, degree of leverage and debt repayment capacity. The use of incremental debt to affect a dividend recapitalisation should be limited. In addition, borrowers are encouraged to clearly disclose dividend distribution policy and strategy.
Measure 3	**Enterprise Values (EVs)** The calculation of EVs which support the capitalisation structures of LBOs should be based on a well-constructed financial model. Underwriting entities are encouraged to clearly disclose the key assumptions underpinning the financial model. It is good practice that any EV model (DCF[3] or otherwise) is reviewed and validated by a function independent of the origination unit. Where possible, the basis for EV should be under-pinned by multi-year forecasted cashflows and not based only on comparable multiples of EBITDA derived from other LBO transactions. It is good practice that DCF valuations which are heavily influenced by terminal values extrapolated from final year forecasted cashflows be credible and challenged.
Theme B	**EBITDA and loan documentation transparency**
Measure 4	**EBITDA complexity and opacity** EBITDA definitions should avoid unnecessary complexity. Pro-forma EBITDA adjustments based on future synergies, earnings and asset

[3] Discounted cash flow (DCF) modelling is one methodology used to calculate EVs

	disposals should be made on a reasonable basis and borrowers are encouraged to provide clear justifications of these adjustments to investors. Borrowers are encouraged to subject forecasted cost savings and synergies to prudent time horizons and caps. Underwriting entities are encouraged to subject all EBITDA adjustments to independent review by an appropriate second line control function as part of the underwriting process with periodic back-testing thereafter.
Measure 5	**Transparency on covenants' limitations** It is good practice for material covenants and associated terms contained in term sheets and loan documentation to be written and presented in a clear, concise and effective manner that can be readily understood by the contracting parties, including under what circumstances covenants can be triggered. Where relevant, industry participants are encouraged to consider best practice guidance for transparency when drafting key marketing materials (e.g., term sheets). It is good practice for borrowers and underwriting entities to provide marketing materials that clearly disclose key terms that could materially impact a borrower's credit risk, including terms that could result in subordination, structural or otherwise, of lenders. In this regard, it is considered good practice to provide clear disclosures of the quantity of incremental debt and associated baskets that can be raised and the ability to move assets beyond the reach of the lender group. Detailed disclosures of key risks including documentation risk, through a risk factors disclosure, could be provided in a loan document.
Theme C	**Strengthening alignment of interest from loan origination to end investors**
Measure 6	**Transparency and fairness during underwriting and syndication** Underwriting entities are encouraged to: • provide sufficient and clear information to investors early in the syndication process with the aim of achieving a fair and efficient market in which investors have sufficient time and a fair opportunity to negotiate and to make well-informed investment decisions. • review the full loan documentation thoroughly before signing the commitment letter and engage in negotiation so that they are satisfied that the risk posed by a failed syndication is within their risk appetite. • provide anonymised feedback on investors' documentation points to all investors in a transparent way. • highlight to investors new flexibilities built into loan documentation as well as those which have previously faced opposition from the investor base.

Measure 7	**Alignment of interest between underwriting entities and investors** Underwriting entities are encouraged to demonstrate how they have aligned their interests with LL investors, through risk retention or other means. Implementation of robust risk management of leveraged lending activities can strengthen alignment of interests as well as prevent the build-up of systemic risks. Underwriting entities and LL investors are encouraged to obtain independent and impartial legal advice which represents their interests and strengthens their ability to negotiate loan terms and influence market evolution.
Theme D	**Addressing interests of different market participants throughout the intermediation chain**
Measure 8	**Reducing restrictions on transferability of loans** Transferability of loans within a pool of potential investors should be as broad as possible to support a liquid secondary market. It is considered good practice that where lists of approved and disqualified lenders are used, they should only be created based on clear and documented reasons. It is expected that investors be provided with transparency early in the syndication process on transferability restrictions and how these might evolve during the life of the loan. In particular, it is expected that investors are provided with sufficient clarity on the precise definition of an event of default, which will cause limitations on transferability to no longer apply.
Measure 9	**Managing conflicts of interest where PE sponsors also act as lenders** Conflicts of interest which can arise from a group's investments in different parts of a borrower's capital structure, should be appropriately identified and managed. It is expected that participants in a syndication and LL investors be properly informed of the instances where a group is acquiring the debt of a borrower while also acting as the borrower's sponsor or holding other classes of debt of that borrower. In such cases, the use of a sponsor disenfranchisement clause or similar clause is encouraged.
Measure 10	**Managing conflicts of interest in management of CLOs** Potential conflicts of interest in the management of CLOs should be appropriately identified and managed. It is expected that policies governing the purchase of distressed assets, cross-sales and trading / valuation of CCC/Caa rated loans and the related policies be clearly set out in a CLO indenture to enable investors to make an informed investment decision. It is considered good practice that trustee reports regularly disclose the trading activity and valuation of assets of a CLO to enhance transparency to investors. It is considered good practice that investors are provided with sufficient opportunity to conduct due diligence on the valuation methodology and results produced by the CLO manager and assess the strategy and rationale for management of assets when performance tests are at risk of being breached.

Theme E	Disclosure of information on an ongoing basis
Measure 11	**Disclosure in CLOs** CLO investors should be provided with all materially relevant information on the valuation, credit quality and performance of the portfolio of a CLO, consistent with jurisdictional regulatory requirements. It is expected that such data is made available on a regular basis (e.g., monthly) to CLO investors in order for them to make an informed judgement of their investment decisions and that potential CLO investors be provided access to such information upon request.
Measure 12	**Disclosure on underlying loans** LL borrowers are encouraged to provide their investors on a timely basis with their latest financial information and status, for example, the audited financial statements, periodic management financial information and financial forecast and budget in relation to its business plan. LL borrowers are also encouraged to inform their investors within a reasonable timeframe of occurrence of any events that may invalidate any assumptions originally applied in the EBITDA addbacks (including any activities that are outside the normal course of business) and potential implications and impact on the projected EBITDA.

We invite comments generally on the proposed good practices, as well as views regarding the consultation questions set out in Section 3 on each of the measures (see also Appendix 2 for the full list of consultation questions). Following the public consultation period, IOSCO will develop a final good practices report for publication.

2. Introduction

2.1 Mandate from IOSCO Board

2.1.1 Original mandate

IOSCO has been monitoring the growth in the closely inter-connected LL and CLO markets and their marked evolution over the years since the Global Financial Crisis ('GFC').[4] In March 2020 the IOSCO Board mandated a review of potential conduct-related issues in the LL and CLO markets and any impacts on IOSCO's objectives of (i) protecting investors, (ii) ensuring that markets are fair, efficient and transparent, and (iii) reducing systemic risk.

To conduct this assessment, IOSCO's Committee 3 on Regulation of Market Intermediaries and Committee 5 on Investment Management delegated the work to a working group ('WG') composed of market expert representatives from both Committees.

The purpose of the mandate was to review intermediation chains and origination practices in LL and CLO markets, including the transmission of risk along the intermediation chain from LL origination to sale of CLOs. Specific areas identified for further analysis included the impact of fewer and looser covenants on investor protections, whether there is adequate transparency in the LL and CLO markets and whether potential conduct-related issues have arisen because of recent market developments.

2.1.2 Phase 1 – Exploratory Analysis

The WG undertook an exploratory analysis in 2021 and presented an internal report to the IOSCO board in March 2022 based on surveys to IOSCO members and LL and CLO industry participants, industry roundtables and academic research.

This report highlighted a number of possible vulnerabilities in both the LL and CLO markets which could impact IOSCO's objectives. Among these were the potentially increased risk of default in the LL sector due to the large and growing proportion of lower-rated borrowers, a situation which could be exacerbated by the recent changes in monetary policy in key LL and CLO market jurisdictions. The report also highlighted a potentially increased risk of loss given default that may stem from a shift in loan contract terms in favour of the borrowers over the last decade (through so-called covenant-lite loans).

The report also suggested that these vulnerabilities may be exacerbated by the behaviour of certain participants and market practices. In particular, the potentially aggressive use of EBITDA adjustments and permissive contract clauses may provide private equity ('PE') sponsors and corporate borrowers with increased flexibility in periods of stress that may work to the detriment of LL investors. Further to this, the potential misalignment of interests between bank lenders and LL investors raises further concerns, especially if it results in an imbalance in negotiating powers between borrowers and lenders. Finally, it was highlighted that certain CLO managers may have an incentive to manage their CLOs to maximise return on equity rather than protect debt investors in periods of stress.

2.1.3 Phase 2 – Development of a Consultation Report on Good Practices

Based on the report from the Phase 1 exploratory analysis, in June 2022 the IOSCO Board approved a second mandate for the WG to develop a public consultation report on "good

[4] The Global Financial Crisis of 2007 - 2008

practices" for market participants to consider implementing in the LL and CLO markets which would seek to mitigate some of the vulnerabilities identified.

Examples of areas to be addressed at the outset of Phase 2 were the accurate use of EBITDA add-backs and other contractual terms of LL agreements, conflicts of interest management across market participants throughout the intermediation chain, greater and clearer disclosure of certain key financial terms in the LL contracts, and improvements in on-going disclosure to investors of financial information on corporate borrowers.

The WG complemented the Phase 1 exploratory analysis with a second outreach programme which included (i) review of existing regulatory guidance for leveraged finance markets and engagement with the responsible regulators, (ii) engagement with trade bodies on existing guides for LL term sheet completeness, and (iii) further industry roundtables with representation from banks, credit rating agencies, CLO managers, CLO investors, academia and law firms. This second round of industry roundtables provided a valuable opportunity to gain feedback about potential good practices.

This consultation report is the output from this second part of the WG's mandate from the IOSCO Board.

2.2 Markets Overview of LL and CLO markets

2.2.1 LL markets

Broadly speaking, LLs are loans to highly indebted, non-investment grade, non-financial corporate issuers. LLs are commonly used to fund mergers and acquisitions (M&A), for capital distributions and/or dividend recapitalization, to refinance prior loans, or to fund general corporate purposes. LLs also commonly finance leveraged buyouts (LBOs), which may involve one or more financial firms that sponsor the loan. LLs usually carry a floating rate of interest and, in contrast to high yield bonds, are secured by the borrower's assets.[5]

LLs are typically structured as a debt package that includes a revolving loan with traditional financial covenants (revolving credit facility or RCF) and a longer term, bullet repayment loan referred to as "Term Loan B" (TLB).[6] In some cases a short-term amortising loan often referred to as "Term Loan A" (TLA) is also part of the debt package, but this became less common in recent years. Typically, bank lenders keep the RCF and TLA loans on their balance sheet and distribute part or all of the TLB to institutional investors including CLOs, insurance companies and other banks.

Broadly syndicated loans (BSL) have tended to be the most common type of LL, but in the past few years LL funding has increasingly come from private credit.[7] BSL are typically underwritten by banks but widely distributed across various institutional investors, while private credit investors, such as credit-focused private or public funds, make loans directly to a borrower without any intermediation from banks.

[5] In contrast to high-yield bonds, leveraged loans are usually secured with a first lien against the corporates' assets and are characterized by a floating interest rate. Because most high-yield bonds are unsecured, they are subordinated to leveraged loans within the borrower's capital structure.

[6] Frederick Tung (2021). "*Do Lenders Still Monitor - Leveraged Lending and the Search for Covenants*"

[7] Credit Markets Update Q4 2022, KPMG Corporate Finance

There is no agreed upon standardised definition for a LL, and this leads to differing estimates and characteristics of the market even within the same jurisdictions. Based on the methodology used by the FSB, the global LL market estimated size was $4.6 trillion at the end of 2022.[8]

2.2.2 CLO markets

CLOs are a type of securitisation in which a portfolio of LL assets is typically bought by a bankruptcy remote special purpose vehicle (SPV) that finances the portfolio by the issuance of financial instruments in the form of bonds. These financial instruments are 'tranched', which means that they carry different levels of risk and return to suit the appetite of different investors. Cash received from interest and principal payments on the underlying LLs is paid to investors in order of priority (senior investors first, then mezzanine and any cash left to the equity). The order of payment and allocation of cash received are determined by what is commonly known as a "waterfall".

CLOs are managed by an investment management firm (typically called the CLO manager). CLO managers select the LLs to be included in the portfolio and can actively manage the loan portfolio during the reinvestment period. CLO structures are subject to contractual rules described in the CLO indenture, which ensure minimum credit quality of the portfolio. CLO structures also include performance tests which, if breached, divert cash to the most senior noteholders.

Within the last few years, CLOs have been increasingly allocated within institutional investment portfolios by asset/portfolio managers. This is due to CLOs offering higher returns than similarly rated corporate bonds and other structured products, in addition to their resilience through multiple market cycles.[9] The amount outstanding of CLOs globally at the end of 2022 stood at around $1.3 trillion.[10]

CLOs are the largest purchasers of broadly-syndicated LLs. CLOs purchased nearly 65% of all institutional LLs that were syndicated in 2021 and held 25% of global outstanding LLs in 2020.[11]

The issuance of a LL as well as the structuring, distribution and management of a CLO involve many different market participants, including private equity (PE) sponsors, bank lenders / bank arrangers, CLO managers, CLO investors and Credit Rating Agencies (CRA). The roles of these key participants are explained in more detail in **Appendix 3**.

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8 Based on Bloomberg data and applying the FSB's approach taken in this 2019 publication: "FSB report assesses vulnerabilities of leveraged loans and CLOs". The $4.6 trillion estimate includes institutional loans (Term Loan Bs), Term Loan As and Revolving Credit Facilities, but excludes private debt as per the FSB's top of the range estimate.

9 Frederick Tung (2021). "*Do Lenders Still Monitor - Leveraged Lending and the Search for Covenants*"

10 Based on data from BoA Global Research

11 S&P (2019) "Leveraged Commentary and Data", International Monetary Fund (2020) "Risky Credit Markets: Interconnecting the Dots".

2.3 Market Developments

2.3.1 Growth in the LL and CLO markets

At around $4.6 trillion outstanding, the current size of the global LL market is close to record high levels.[12] Since the GFC, the US LL market has grown almost 130%, twice the rate of GDP in the same period[13] and similar growth has been observed in Europe. Other regions have smaller but growing LL markets.[14] The global CLO market has grown in parallel with the LL market, and the total amount of outstanding CLOs globally has more than doubled since 2010. The growth of the LL market has predominantly been driven by an expanding economy since the GFC and the low interest rate environment which prevailed until 2022.[15]

These market conditions have driven activity on two different fronts. Firstly, low interest rates have encouraged institutional investors to chase higher yields, causing an increased demand for riskier investment products, and thus enabling companies to become further leveraged. Secondly, accommodative monetary policies have increased liquidity available in the financial system, allowing PE firms to increase their M&A activity and demand for LLs. LLs and CLOs are particularly attractive as floating rate instruments in a rising interest rate environment.

2021 was a record year for new LL and CLO issuance,[16] but higher borrowing costs and increased recessionary risks to the economy since early 2022 have driven a significant reduction in volumes since.[17]

2.3.2 Evolution of the type of LL borrowers

LL borrowers have increased in numbers while decreasing in size, and the average credit quality of corporate borrowers has deteriorated with the number in the B/B- rated categories exceeding those in the BB-rated category.[18] Since 2008 the share of the US LL index rated BB has declined from 49% to 24%, while the share rated B has doubled from approx. 30% to over 60% today.[19] Moreover, the sectors to which these corporate borrowers belong has shifted over time, from traditional industrial sectors to technology, software and healthcare, providing higher returns but lower tangible collateral.

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12 Based on Bloomberg data and applying the FSB's approach taken in this 2019 publication: "FSB report assesses vulnerabilities of leveraged loans and CLOs". The $4.6 trillion estimate includes institutional loans (Term Loan Bs), Term Loan As and Revolving Credit Facilities, but excludes private debt as per the FSB's top of the range estimate.

13 S&P Global Market Intelligence: *"Leveraged loan market continues to shatter records amid hunt for yield"*

14 Bloomberg Markets (2022): "Asia's Fledgling Leveraged Loan Market is Doing Just Fine"

15 Reuters: 2021Mid Year trend in large cap & mid-market loans

16 Credit Markets Update Q4 2021, KPMG Corporate Finance

17 Credit Markets Update Q4 2022, KPMG Corporate Finance

18 S&P Global Ratings: "How Weakening Debt Structures and Loan Terms Diluted First-Lien Credit Quality"

19 Pitchbook LCD data: Morningstar LSTA US Leveraged Loan Index

2.3.3 Evolution of the LL investor base

Post GFC, and in part due to prudential constraints on their balance sheets and tighter risk management/allocation of their capital, banks have moved towards a business model where they underwrite the LLs and distribute them almost entirely to other institutional investors, only keeping the less risky and less capital-intensive revolving credit facility (RCF) and short-term amortising loans (TLA) on their balance sheets. Some market participants have argued, during industry roundtables with IOSCO, that this may have lowered the alignment of interests between banks and non-bank-investors in contract term negotiations.

Stepping into their place, CLOs have grown to be the largest investor group in the broadly-syndicated LL market. At the same time, direct lending by credit funds has also grown rapidly, providing financing to borrowers seeking quick execution. The rise of institutional investors has led to greater demand for non-amortising bullet loans (TLB) which allow funds to be fully invested at relatively high yields for longer.

Overall, the growth and diversification of the investor base seems to have improved the liquidity of the LL secondary market while decreasing the individual bargaining power of investors in the terms of the LL.

2.3.4 LLs emulating High Yield Bonds

LL borrowers, especially those backed by a PE sponsor,[20] have taken advantage of robust demand for LLs and an accommodative credit environment to issue loans that are increasingly structured like high yield debt. This is not just in terms of the characteristics of the loan itself (weaker covenants, bullet maturity and lower collateral backing) but the structures have also evolved from LLs being typically supported by a debt cushion (often in the form of a concomitant issuance of high yield debt ranking subordinated to the lenders of the LL) to loan-only issuances.

2.3.5 Erosion of lender protections and the rise in covenant-lite LLs

Strong investor demand has also resulted in the terms of the loans moving markedly in favour of borrowers. This is evident through the increased issuance of covenant-lite loans, which now make up 90% of LL market share up from 1% in 2000.[21] Covenant-lite loans are loan agreements that often do not contain any financial covenants or contain much weaker financial covenants that are put in place to protect lenders.[22] Although each LL is structured differently, covenant-lite loans generally offer few financial covenant protections, including relaxing constraints on certain financial ratios and imposing fewer restrictions on the borrower's ability to: transfer collateral beyond the reach of the lender, use asset sale proceeds to pay down second lien debt ahead of first lien debt, and/or to issue new *pari-passu* debt secured on the same collateral as the existing LL investors, thereby potentially diluting investors' rights to the collateral.[23]

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[20] Moody's – convergence of bonds and loans sets the stage for worse recoveries in the next downturn, 16 August 2018. The trend cited in this Moody's research from 2018 was confirmed in the IOSCO roundtables as being still current.

[21] *S&P Global Market Intelligence. "Covenant-lite deals exceed 90% of leveraged loan issuance, setting new high"*

[22] Shohini Kundu (2021). "*The Anatomy of Collateralized Loan Obligations: On the Origins of Covenants and Contract Design*"

[23] See Bo Becker & Victoria Ivashina (2016) "*Covenant-Light Contracts and Creditor Coordination.*"- "Contrary to what their name might suggest, covenant-lite loans do not have fewer covenants. What

In favour of covenant-lite loans, some market participants noted that they offer the corporate borrower flexibility to manage extreme financial stress situations, like the one seen during the COVID-19 pandemic. It may indeed be costly and time-consuming to agree to waivers of covenant breaches across a large number of investors in a stress situation, which could arguably increase the likelihood of pushing corporate borrowers into insolvency.

However, the removal of lender protections has the effect of potentially lowering the amount of assets available to secure the lenders in the event of a default and is likely to result in lower recovery rates.

There are several explanations for the rise of covenant-lite issuance including the imbalance between the supply and demand for LLs, pushing terms in favour of the borrowers. Such imbalance is in part driven by the strong demand by CLOs and other institutional investors in search of yield in a low interest rate environment. The diversification of the investor base makes the negotiation of covenants more difficult and may also have played a part in the increase of covenant-lite loans. But research[24] indicates that the most important factor explaining the dominance of covenant-lite loans is the shift in the LL investor base from banks to institutional investors including CLOs, credit-focused private and public funds, hedge funds, and securities firms, and to a lesser degree, insurance companies and pension funds. The investor base for LLs today looks more akin to the investor base for high-yield bonds, which typically have few covenants.

2.3.6 Complexity of LL documentation

The LL market is highly idiosyncratic and loan documentation is usually tailored for each transaction with varying degrees of investor protection. Covenant packages and leverage/EBITDA calculations (including addbacks) are typically disclosed in the loan documentation. However, loan documents are increasingly complex and lengthy, and relatedly, issues have been identified with respect to the clarity of drafting.

Market participants have reported that more flexible terms are negotiated by corporate borrowers' sponsors on stronger credits but may be used as precedent for other borrowers thereafter.

There is also a lack of standardisation of loan documents, with large variations reported to exist between each deal, making comparison challenging for investors. Equally, this makes it harder for lenders to identify new or relevant clauses which may further erode their protections.

differentiates these loans and makes them riskier is weaker covenant enforcement. A covenant-lite contract (equivalently, a contract with incurrence provisions) requires the firm to comply with its financial covenants only if a firm pursues (*incurs*) an active event, such as issuance of additional financing, sale of assets, or merger. In contrast, a "cov-heavy" contract (a contract with maintenance provisions) requires the issuer to *maintain* its compliance with contractual financial covenants at all points in time."

[24] Bo Becker and Victoria Ivashina (2016). *"Covenant-Light Contracts and Creditor Coordination"*

2.3.7 Higher Leverage Raised to Fund Buyout Valuations

The long run average Enterprise Value (EV)[25] to EBITDA multiples have risen from 8-10x to 11-12x in more recent years.[26] This was partly fuelled by lower interest rates and significant market demand. To fund these higher buyout multiples, more debt has been raised at greater than 6x total debt to EBITDA, i.e., beyond a leverage multiple which is already considered to represent a highly leveraged transaction (6x). For the reasons outlined under separate points, the inherent leverage and financial risk are even higher due to the sometimes aggressive assumptions under-pinning EBITDA and the flexibility to raise more debt due to covenant-lite transactions. A rising interest rate environment is likely to result in a correction in these buyout valuations. In the past year, there has already been media coverage of significant corrections in certain private equity valuations, particularly in the venture capital segment of the industry.

2.3.8 Increased use of EBITDA adjustments

Alongside looser covenants, there is evidence that headline debt-to-EBITDA may be understated. The rationale for M&A and private equity buyouts often includes synergies or operational improvements, and it is standard practice to recognise these as adjustments (add-backs) to EBITDA, which is used to measure compliance with incurrence covenants. These add-backs, however, are uncertain, both in magnitude and timing, and may overstate EBITDA and thus understate debt-to-EBITDA leverage multiples. There is also evidence that incurrence covenants have become less restrictive to borrowers and allow for greater flexibility on the inclusion of add-backs. Market estimates indicate that incurrence covenants in current[27] deals are subject to EBITDA adjustments of 15-30%. CRAs found that most borrowers in the US leveraged finance markets missed EBITDA and deleveraging projections[28] Thus, actual levels of debt-to-EBITDA ratios may be higher than covenants would otherwise imply. Indeed, CRAs found that for deals originated from 2015-2019, borrowers have under-projected leverage by an average of 2.2x EBITDA in the first year and 2.9x EBITDA in the second year.[29]

2.3.9 Sharp increase in borrowing costs since last year

Interest rates have increased sharply in many jurisdictions throughout 2022 and the first half of 2023 as many major central banks responded to high inflation. The average yield to maturity on US leveraged loans has more than doubled from 4.2% at the end of 2021 to 10% by the end of 2022.[30]

While interest rates were low there may have been an assumption that TLB bullet loans could be easily refinanced approaching maturity, but lower-rated borrowers are likely to struggle to

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25 Enterprise Value (EV) measures a company's total valuation which should equal a valuation of equity (private or public) plus total short- and long-term debt minus cash and cash equivalents. Adjustments may have to be made to account for other liabilities including unfunded pension liabilities or minority interest holdings in companies. EV is often represented as a multiple of EBITDA to summarise the purchase price for a business e.g., 10 times purchase multiple, and the degree of debt and equity used to finance the business is a key measure of financial risk.

26 Pitchbook LCD data

27 Discussion of "current" levels is based on year-end 2018 data.

28 S&P (2023) Leveraged Finance: Fifth Annual Study Of EBITDA Addbacks Finds Management Continues To Regularly Miss Projections,

https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170

29 Ibid

30 Pitchbook LCD data

refinance at the new higher borrowing costs.[31] Borrowers rated B- and lower are likely to show the most refinancing vulnerability. Many borrowers took advantage of favourable conditions to refinance in 2021, in which case refinancing is not yet needed but there will be growing demand for refinancing from 2024 onwards due to significant maturity walls.[32] [33]

Where refinancing is challenging some borrowers may be able to execute 'amend-and-extend' transactions allowing them to push out part of their loan maturities through an amendment, rather than a full-out refinancing. However, some of the weakest borrowers may not be able to execute an 'amend-and-extend' and ultimately fall into financial distress and enter a restructuring of their debt.[34] [35]

3. Proposed good practices

3.1 Theme A – Origination and refinancing based on a sound business premise

Credit risk in the LL market has increased over the last decade, marked by a shift towards lower rated and more highly leveraged borrowers. This has been supported by benign financing conditions, a decreased focus on borrowers' cash generation and debt repayment capacity and an increased reliance on borrowers' ability to refinance based on growth of EV and EBITDA. In some cases, increased leverage is used to fund dividends or to repay private equity sponsors. These developments pose an increased systemic risk to the LL market, particularly in the event of a prolonged period of tougher financing conditions.

3.1.1 Measure 1 - Debt repayment capacity

The LL market, as part of the wider leveraged finance (LF) market, plays a key role in supporting acquisition finance and LBOs by the private equity industry. The LF market has a good track record in terms of average default rates over the long term and even during the GFC demonstrated a degree of stability compared to other asset classes. However, in recent years, the LF market has evolved towards lower-rated borrowers, higher leverage and less protection for lenders, which combined with the significant growth of the sector, has raised concerns among regulators and has become the focus of IOSCO and other regulatory bodies.

Over the past decade, the LF market has become less focused on the fundamentals of demonstrable debt repayment capacity and on forward looking cashflows that can robustly under-pin an EV. During the same period, the investor base for LLs has shifted from banks to non-bank institutional investors (including CLO managers).[36] Meanwhile the LF market overall, and the LL market in particular, has transitioned to debt structures that rely almost entirely on interest only bullet loans and / or bond instruments that do not amortise but often

[31] Moody's Investor Services (November 2022): "Rising rates, refinancing needs will hit lower-rated companies hardest"

[32] S&P (2022) Credit Trends: Global Refinancing – Rising Rates and Slowing Issuance Drag on Corporate Funding Conditions

[33] There are approximately $640 billion in LLs due to mature in the US and Europe over 2024-2026 according to Pitchbook LCD data.

[34] White & Case (2023): Ready for Restructuring

[35] Moody's Investors Service (November 2022) "Rising rates, refinancing needs will hit lower-rated companies hardest"

[36] FSB (2019): Vulnerabilities associated with leveraged loans and collateralised loan obligations

rely on being refinanced in the medium to long term.[37] The rationale for a debt refinancing is that it will be supported by an expansion in the EV of the business and a rise in EBITDA, which implies "de-leveraging" or expansion in the value of the equity, without debt reduction. While borrowing costs remained very low, borrowers often effected refinancings with a higher leveraged debt structure after 3 to 5 years to either facilitate a further acquisition and/or to fund a dividend payout and/or to repay money to their PE sponsors.

Assessing debt repayment capacity of a borrower is important not only for newly originated loans, but also in refinancing transactions of existing debt structures. In some cases, debt refinancings known as "amend-and-extends", might more accurately be described as debt restructurings since amendments are made which suggest the borrower may have insufficient operating cash flow available to service and repay the debt. For example, some "amend-and-extend" refinancings include a combination of fresh equity injected by the PE sponsor in exchange for a conversion of cash interest to "payment in kind" (PIK)[38] and an extension of maturity.

Following IOSCO's roundtable engagement with market participants, the following concerns have been raised:

- In recent years, low interest rates and demand from investors looking for relatively higher yield has continued to support LBOs with greater than 5-6x leverage. Given the higher interest rate environment since last year there is a risk that some highly leveraged borrowers will be left with insufficient cashflow to sustainably repay their debt obligations.
- EBITDA is normally "proforma"[39] with adjustments and has limitations due to complex definitions and occasionally aggressive assumptions around synergies and cost deductions (see Theme B) emphasising the importance of focusing on cash flow available for debt service (CFADS).
- The market has grown to accept debt service cover being measured by EBITDA to interest cover, but EBITDA does not repay debt and may mask the real degree of financial risk. CFADS (where capex, tax and other key deductions are made to EBITDA) to interest / debt service cover is considered by many market practitioners as

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37 Ashurst (2018) *High yield bonds and leveraged loans: a convergence of terms,* Ashurst website. Available at: https://www.ashurst.com/en/news-and-insights/insights/high-yield-bonds-and-leveraged-loans-a-convergence-of-terms/

38 Payment In Kind (PIK) structures are debt where interest is "rolled-up" into the debt and is repaid at refinancing or maturity. Such structures provide borrowers with more financial flexibility. They are generally subordinated to senior secured / senior unsecured debt e.g., second lien, mezzanine, and are charged at a higher margin. But sometimes an "Amend and Extend" will seek to refinance and extend an existing senior secured / unsecured debt cash interest loan structure into a new debt structure and maturity where the cash interest is replaced with a "partial" or "full" PIK interest rate structure to provide further financial flexibility. Hence, sometimes these "Amend and Extends" are in reality distressed restructures.

39 Pro-forma EBITDA is a non-GAAP financial measure. It means EBITDA of the company adjusted to strip out the effects of non-recurring or extraordinary gains or losses, or to include projected future synergies or revenue gains associated with significant transactions that have occurred or are expected to occur, but which are not reflected in historical financial statements. For example, it can represent the combination of businesses that have been purchased or a stripping out of the effects of extraordinary or once off-costs, as some companies recently did in respect of some COVID-19 related costs. Often it is supported by financial due diligence assumptions. Measures such as pro-forma EBITDA may have names and meanings that differ from those provided here.

a more realistic assessment of financial risk. It is also used to assess debt service coverage ratios and loan life coverage ratios.[40]

- The reduction in the use of amortising terms loans can result in borrowers being less focused on debt repayment which could potentially lead to less financial discipline.
- Credit rating downgrades began to exceed upgrades in the US leveraged finance markets since May 2022. CRAs note that cash flow deficits are the most significant concern for borrowers rated B and lower.[41]
- As market conditions have tightened, there has been an increase in the use of preferred equity and PIK notes to support companies whose cash flows are under pressure.[42]
- The type of borrowers accessing the LL market has evolved and now includes companies with less predictable cashflow.

Proposed Good Practices

Measure 1	**Debt repayment capacity test** Leveraged loans offered to the market in both new originations, debt refinancings and debt restructurings should be underpinned by sound business and financial risk assumptions. Borrowers should be able to demonstrate sufficient debt repayment capacity. An adequate debt repayment capacity is considered the ability to repay 100% of senior debt or 50% of total debt over the medium term. For example, some regulatory agencies and other market practitioners measure the debt repayment capacity test over a 5 to 7 year period. Where this is not evident, a credible explanation should be provided. It is also considered good practice to disclose debt repayment capacity in term sheets and supporting documentation at the time of debt offering and refinancing. A robust assessment of cash flows including stress testing should inform debt repayment capacity assessments.

Existing regulatory guidance identifies debt repayment capacity as a critical element of the underwriting process.[43] The Board of Governors of the Federal Reserve System (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and European Central Bank (ECB) have issued leveraged lending guidance, in their respective jurisdictions which identifies a debt repayment test of 5-7 years.[44] In the US the FRB, OCC and FDIC issued their Interagency Guidance on Leveraged Lending in 2013 (“**US Interagency Guidance”)**. The guidance identifies the ability to fully amortize senior secured debt or the ability to repay at least 50% of total debt over a 5-7 year period as representing an adequate

[40] Debt service coverage ratio measures a company’s available cash flow to pay current debt obligations while loan life coverage ratio is used to estimate the ability of a borrowing company to repay an outstanding loan by dividing the net present value of the money available for debt repayment by the amount of outstanding debt.

[41] S&P Global Ratings: ‘US BSL CLO and Leveraged Finance Quarterly: Navigating the Rough ‘CCCs’ Q1 2023

[42] Pitchbook (2023): “Private credit borrowers turn to structured capital, PIK with debt costs on the rise”

[43] Debt repayment capacity guidance is set out as part of the US Interagency guidance on leveraged lending (2013) and the ECB’s Guidance on Leveraged Transactions (2017)

[44] The ability to fully amortize senior secured debt and repay at least 50% of total debt over a 5–7-year period is identified as an adequate repayment capacity in both the US Interagency guidance and the ECB’s Guidance on Leveraged Transactions.

repayment capacity.[45] The ECB's 2017 Guidance on Leveraged Transactions ("**ECB guidance"**) also identified the ability to fully amortise senior secured debt or repay at least 50% of total debt over a period of 5-7 years as an adequate repayment capacity.[46]

This type of debt repayment capacity test is employed by underwriting entities as a common risk management tool, where transactions are considered to be highly leveraged. For instance, where gross leverage of a transaction (i.e., based on total committed debt to EBITDA) exceeds 6 times, then key risk mitigations based on the strength and predictability of cash flow are often assessed. Many investors believe a further key risk analysis is to assess the capacity of a business to repay 100% of the senior debt or 50% of the total debt over a 7 year period.[47]

Many loan investors build their own base case cash flow model to assess debt repayment capacity and deleveraging over a 7 year or longer period. In addition, varying cash flow modelling scenarios and sensitivities are applied (i.e., interest rate increases, incremental debt raised, revenue and profit sensitivities). When a debt investor does not have access to the cash flow model, they have to make an estimate of future cash flow by examining historic cash flow statements and then estimating base, upside and downside scenarios to assess debt repayment capacity.

As such, it is considered good practice to clearly disclose the borrower's ability to repay its debt based on projected free cash-flows available to service debt after cash interest has been paid.[48] Given the increasing prevalence of bullet loan structures and limited / no amortising loans, the following may be explicitly disclosed in the term sheet:

<u>Total Committed Debt Repayment Test</u>

- By year 7, the percentage of <u>total committed drawn and undrawn debt</u>[49] that can be repaid from base case[50] free cash flows projections after interest.
- By year 7, what percentage of <u>total committed drawn and undrawn senior debt</u> can be repaid from base case free cash flows projections after interest.

<u>Total Funded Debt Repayment Test</u>

- By year 7, the percentage of <u>total funded drawn debt</u> that can be repaid from base case free cash flows projections after interest.
- By year 7, what percentage of <u>total funded senior debt</u> can be repaid from base case free cash flows projections after interest.

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[45] Board of Governors of the Federal Reserve System, Federal Deposit Insurance & Corporation Office of the Comptroller of the Currency (2013) *Interagency Guidance on Leveraged Lending*

[46] ECB (2017) *Guidance on Leveraged Transactions*

[47] Based on observations of IOSCO members during supervisory reviews of LL lenders/investors

[48] Free Cash flow projections should capture refinancing risk and not assume favourable refinancing conditions going forward. Facilities with balloon payment features such as bullet loans, should be considered to be fully due on the maturity date.

[49] Total debt refers to total committed debt including all drawn and undrawn debt and any additional debt the loan agreements may permit. Committed undrawn liquidity facilities, according to the Basel Committee on Banking Supervision's Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (BCBS 238), are excluded. Cash should not be netted against debt. Drawn portions of uncommitted facilities are also included in the calculation of total debt.

[50] Based on underwriting bank base case cash flow modelled projections. In either case the methodology should be clearly disclosed.

It is considered good practice for base case free cash flow projections to be supported by analysis of historic cash flow statements; forward looking adjustments which are credible and justifiable; multi-year forecasts including their assumptions that can then be stress tested under different scenarios. Leveraged finance is often underpinned by a forward looking estimate of deleveraging[51] by maturity date which will then support a debt refinance at that date or an earlier date. Some market participants only focus on funded debt and not gross drawn and undrawn debt, but it is critical to assess the potential for committed debt to be drawn and incremental debt to be raised. A sale of assets can also be assessed in addition to cash flow forecasting, but if an asset is sold it is considered good practice to assess the impact on future cash flow generating capacity.

The importance of being transparent on debt repayment capacity is that it clearly puts the focus on cash generative capacity rather than EBITDA which is typically subject to multiple add-backs and adjustments that often prove to be overly optimistic.[52]

Question 1
Would a consistent debt sustainability disclosure within the term sheet based on the borrowers' base case cash flow modelled projections assist investors during the negotiation and investor assessment phase? Should this debt repayment capacity test disclosure be based on 2 measures: both total committed and total funded debt?

Question 2
Should there be a further debt repayment capacity test based on permissible incremental debt and if so, should incremental cash flow generated from the incremental debt (if applicable as some incremental debt is used to pay out a dividend) also be included?

Question 3
To what extent should debt repayment capacity be linked to a financial covenant in a loan document and how should this be constructed? Does a debt service ratio covenant need to be reintroduced into loan documentation or adapted to measure debt repayment capacity test?

3.1.2 Measure 2 – Dividend recaps

In recent years, numerous refinancing transactions with high leverage were completed to allow for dividend payment or capital distribution.[53] This is to take advantage of value generated by the business, for example from an increase in underlying cashflows arising from business growth, synergies achieved or cost savings. But market stakeholders have raised concerns that in some cases these synergies and cost savings do not materialise[54] (See Theme B), and higher

[51] Deleveraging can mean actual de-leveraging i.e., debt repaid, or implied based on an estimate of future debt as a multiple of EBITDA e.g., leverage has improved from 6x in 2023 to 4x at maturity in 2028. The problem with only looking at leverage using EBITDA is that there may not be sufficient cash flow to sustainably repay debt, which is why the debt repayment test at origination and ongoing during the life of the deal is essential.

[52] S&P (2023) Leveraged Finance: Fifth Annual Study Of EBITDA Addbacks Finds Management Continues To Regularly Miss Projections, https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170

[53] In particular, 2017 and 2021 were particularly active years in the European LL market for dividend recapitalisations with approximately €15 – 20 billion of those transactions in each year which accounted for ~15% of total loan volume in each of those years. Based on data from Pitchbook LCD

[54] S&P (2023) Leveraged Finance: Fifth Annual Study Of EBITDA Addbacks Finds Management Continues To Regularly Miss Projections, https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170

EV to EBITDA multiples may have been fuelled by lower interest rates and easy financing conditions.

PE sponsors and borrowers have in some cases sought flexibility to make dividend payments ahead of senior loan holders' repayment using dedicated incremental debt baskets. There have also been some cases where litigation has been brought by lenders who are contesting the legality of such a transfer as well as disputing the appropriateness of EBITDA add-backs used to size the debt capacity under covenant baskets.

Proposed Good Practices

Measure 2	<u>**Dividend Recaps**</u> Dividend recapitalisations should be considered with reference to the level of remaining equity support, degree of leverage and debt repayment capacity. The use of incremental debt to affect a dividend recapitalisation should be limited. In addition, borrowers are encouraged to clearly disclose dividend distribution policy and strategy.

The following practices are encouraged in respect of dividend recapitalisations:

- It is considered good practice to avoid dividend recapitalisations in circumstances where equity is less than 40%[55] of the total capital structure, total committed leverage is greater than 6x or the debt repayment test is not met.
- The use of incremental debt facilities to support dividend recapitalisations should be discouraged, as existing leveraged finance investors may not wish to participate in the incremental facilities. Consideration could be given to limiting dividend recapitalisations to the time of an initial origination or a full debt refinancing.
- Borrowers are encouraged to provide clear disclosures with regards to dividend distribution policy and strategy at the time of the initial origination of the transaction.

Question 4
Should limitations be placed on the ability to effect debt-financed dividend recapitalisations e.g., based on minimum equity, total leverage, debt repayment test?

Question 5
Should dividend recapitalisations only be permitted based on an initial origination or full debt refinancing (and not be permitted using incremental facilities in which all existing loan investors may not wish to participate)?

3.1.3 <u>Measure 3 – Enterprise Values</u>
Buyout multiples, typically represented as EV as a multiple of EBITDA, have trended upwards in recent years to average levels of 11-12x (compared to the long run average of 8-10x) for

[55] Equity contribution in US LBOs has ranged between 30% and 47% over the period from 2005 to 2020. From 2005 to 2007 lower equity contribution of 30% to 32% was typical, but since 2008 equity contribution has generally been higher and ranged between 37% and 51%. In LBOs since 2015 the average equity contribution has ranged between 42% and 47%. In both 2019 and 2020 the average equity contribution was 47%.
Source: S&P Global (2021) "As LBOs surged in Q4'20, US purchase price multiples hit new heights"

both the large corporate and middle market leveraged loan sectors.[56] Higher EV multiples have been supported by higher levels of debt above 5-6x[57] (excluding additional leverage from incremental debt capacity), lower interest rates and easy financing conditions.
Valuation through use of EVs is an established practice which provides benchmark multiples to compare buyouts in similar industries. But EVs need to be supported by a credible forward-looking financial cash flow model. The ability of a business to service the interest and sustainably repay debt is a critical consideration. Some roundtable participants identified insufficient cash flow and debt service capacity as an area of concern for the most highly leveraged borrowers, given increased borrowing costs and general market conditions since 2022. An argument could be made that some market participants have relied on an assumption that the EV can cover debt based on a forward-looking EV / EBITDA multiple, when a detailed cash flow model might show a lack of debt repayment capacity. Even so, discounted cash flow ('DCF') models may also be subject to optimistic assumptions, for example including a terminal value using the perpetual growth methodology based on inappropriate forecasts of final year unlevered free cash flows or discounting with an inappropriate weighted average cost of capital.

Proposed Good Practices

Measure 3	**<u>Enterprise Values</u>** The calculation of EVs which support the capitalisation structures of LBOs should be based on a well-constructed financial model. Underwriting entities are encouraged to clearly disclose the key assumptions underpinning the financial model. It is good practice that any EV model (DCF or otherwise) is reviewed and validated by a function independent of the origination unit. Where possible, the basis for EV should be under-pinned by multi-year forecasted cashflows and not based only on comparable multiples of EBITDA derived from other LBO transactions. It is good practice that DCF valuations which are heavily influenced by terminal values extrapolated from final year forecasted cashflows be credible and challenged.

EV is a widely used metric for valuing a company and as a proxy for determining debt sustainability in leveraged finance transactions. Underwriting entities are encouraged to disclose the EV calculation for all originations, debt refinancings, "amend-and-extends" and raising of incremental debt. Regarding EV calculations, the following are considered good practices:

- Market participants should review and challenge the EV calculation methodology (i.e., Discounted Cash Flows / Income Method, Asset Valuation, Market Based, etc.).[58]

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56 Pitchbook LCD

57 Ibid

58 EVs are commonly calculated using a number of different methodologies including the discounted cash flow method which calculates value based on future unlevered free cash flows or market-based approaches which rely on prices of comparable enterprises.

- Disclosure of the key underlying assumptions, including any adjustments to EBITDA and calculations of total debt, if not the same as used for the debt sustainability or leverage multiple calculations.

- For EV calculations based on DCF models, market participants are encouraged to scrutinise the unlevered free cash flow forecasts for the initial years and the final year, which forms the basis of the terminal value under the perpetual growth methodology. Appropriate discount and growth rates should be applied to the assessment of perpetuity cashflows. If the debt repayment test cannot be met and other indictors of default are evident, then a terminal value based on an assumption of perpetual growth may not be relevant and instead a limited multiple of final year cash flow may be more appropriate. It may also be appropriate to include no multiple of final year cash flow (year 5/6/7) in the assessment of EV where no confidence can be instilled in the long term cash generative capacity of the business.

- It is good practice for underwriting entities to prepare a weighted average upside, base and downside calculation of EVs compared to the relevant debt structure to measure a potential credit loss, assuming the borrower is deemed to be a going concern. This analysis may highlight that in some cases a right-sizing of debt may be required based on the debt repayment capacity of the borrower and a realistic assessment of future debt servicing costs.

- US Interagency and ECB guidance state that EVs should be calculated or validated by a team independent of the loan origination team[59]

Question 6
Would a clearer disclosure of the arranging banks' calculation of the borrower's EV,[60] including high level methodology (i.e., Discounted Cash Flows / Income Method, Asset Valuation, Market Based etc.) and key underlying assumptions (i.e., EBITDA adjustment and total debt) assist investors to make more informed decisions?

Question 7
Should EV to EBITDA multiples be highlighted in term sheets and on which basis of EBITDA i.e., proforma, adjusted,[61] historic or forward looking?

Question 8
Do you agree that the basis for EVs should be under-pinned by multi-year forecast cashflows and not simply based only on multiples of EBITDA comparable in other acquisitions or buyouts?

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59 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency: "Interagency Guidance on Leveraged Lending", March 21, 2013 & ECB (2017) *Guidance on Leveraged Transactions*

60 Typically, the arranging banks include an EV of the borrower in the Information Memorandum shared early in the syndication process with potential investors

61 Adjusted EBITDA is a form of EBITDA that includes adjustments for amounts in the historical financial statements beyond those related to interest, taxes, depreciation, and amortization. Pro forma EBITDA is a form of EBITDA that includes adjustments for significant transactions that have occurred or are expected to occur but are not reflected in the historical financial statements. .

3.2 Theme B – EBITDA and loan documentation transparency

Increased use of EBITDA adjustments coupled with the opacity and complexity of loan documentation may be undermining investors' ability to assess credit risk in LLs. It has been widely acknowledged by market participants, in industry roundtables with IOSCO, that EBITDA marketed by borrowers may significantly underestimate leverage at deal inception due to inappropriate EBITDA adjustments. This issue may be exacerbated by the increasing complexity of loan documentation, which has made it more difficult for investors to assess lender protections. These developments could potentially undermine the principle of fair, efficient and transparent markets and expose the market to increased systemic risk.

3.2.1 Measure 4 – EBITDA complexity and opacity

EBITDA is a gross proxy for cash flows and is commonly used to assess the ability of the borrower to service its debt. However, EBITDA is generally not subject to strict accountancy rules and commonly accepted definitions and as such is more exposed to the potential for inappropriate adjustments.

There have been growing concerns among market stakeholders that EBITDA projections marketed at deal inception may have disguised the inherent credit risk of borrowers in the LL market. As previously noted, the significant growth in reported leverage multiples, while concerning, also likely underestimate total leverage as marketed EBITDA is often based on overly optimistic assumptions.

EBITDA is a concept that can be defined in numerous ways and is often based on a diverse and esoteric range of add-backs or adjustments defined by borrowers. These adjustments are intended to strip out the effects of non-recurring or extraordinary gains or losses but also to include projected future synergies associated with M&A activity and LBOs. While these add-backs can account for up to a third of EBITDA borrower projections in larger M&A and LBO deals,[62] they generally prove to be overly optimistic, as evidenced below.

Since 2018, S&P has conducted annual studies on the accuracy of US speculative grade borrowers' EBITDA projections. The studies have tracked EBITDA performance for deals originated from 2015-2019 and found that 66% and 61% of borrowers missed EBITDA projections by at least 25% in year 1 and year 2 post inception, respectively.[63] In addition, borrowers failed to meet deleveraging projections. For deals originated from 2015-2017, 75% of borrowers missed debt projections, while for deals originated in 2018 and 2019, 67% of borrowers missed debt reduction projections.[64] This underperformance has significant implications for leverage multiples. S&P has found that for deals originated from 2015-2019, borrowers have under projected leverage by an average of 2.2 times EBITDA in the first year and 2.9 times EBITDA in the second year.[65]

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[62] S&P (2023) Leveraged Finance: Fifth Annual Study Of EBITDA Addbacks Finds Management Continues To Regularly Miss Projections, https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170

[63] Ibid. The study compared marketing EBITDA at deal inception versus actual reported EBITDA in year 1 and year 2 post inception.

[64] Ibid: S&P explain that the improvement in the 2018 and 2019 vintage was a result of companies hoarding cash during the COVID-19 pandemic. This had an effect of reducing net debt which was used as the basis of S&P's debt definition.

[65] Ibid

EBITDA and leverage misses are often caused by the inaccuracies associated with synergy and cost saving projections, which account for approximately a third of total add-backs.[66] However, these items are considered among the most difficult add-backs to accurately predict. In addition, S&P found a positive correlation between the magnitude of EBITDA add-backs and the size of management projection misses. It was found that for deals with the largest projected leverage misses, add-backs were approximately double those of the best performing deals.[67] This longitudinal study indicated that marketing EBITDA is an inaccurate proxy for future profitability and cash flows, which at deal inception can significantly disguise a borrowers' credit risk.

These findings were echoed by feedback received from industry stakeholders as part of roundtable discussions. Marketed EBITDA was considered to be an inaccurate indicator of future revenues and cash flows. While private side LL investors relied on their own EBITDA projections based on financial data provided by the borrower, there was agreement that additional transparency would support the development of more informed and accurate forecasts and increased market efficiency.[68]

Proposed good practices

Measure 4 – EBITDA complexity and opacity
EBITDA definitions should avoid unnecessary complexity. Pro-forma EBITDA adjustments based on future synergies, earnings and asset disposals should be made on a reasonable basis and borrowers are encouraged to provide clear justifications of these adjustments to investors. Borrowers are encouraged to subject forecasted cost savings and synergies to prudent time horizons and caps.

Underwriting entities are encouraged to subject all EBITDA adjustments to independent review by an appropriate second line control function as part of the underwriting process with periodic back-testing thereafter.

EBITDA calculations

Existing regulatory guidance emphasises the importance of closely scrutinising EBITDA calculations and associated adjustments. For instance, the ECB Guidance states that any enhancements to EBITDA should be duly justified and reviewed by a function independent of the front office function.
These principles are commonly observed in bank underwriting policies, which generally include provisions for assessing EBITDA and associated pro-forma adjustments. These include requirements for pro-forma EBITDA adjustments to be scrutinised by the leveraged finance syndication desk' with independent review by risk management. Other good practices observed include establishing time horizons for EBITDA calculations such as the most recent 12-months

[66] Ibid

[67] Ibid

[68] Loan markets rely on both public and private buy-side participants. Investors participating on the private side receive additional financial information from the borrower including management projections during the syndication process. Separate marketing materials are prepared for public side investors which exclude management projections. Private side investors also receive enhanced on-going reporting including monthly or quarterly financial reporting, financial projections, covenant compliance reports and plans for acquisitions and disposals. Such information is subject to confidentiality agreements.

(TTL[69] or LTM[70]) and requiring additional scrutiny to be applied to add-backs associated with cost-savings and synergies that are forecast to occur beyond 12-months.

Bank underwriting standards also generally include provisions to remove adjustments based on assets sales / disposals where these sales / disposals are not legally contracted or not due to occur within a reasonable timeframe (i.e., 12-months).

Many banks also include provisions whereby borrowers can be designated as a weak credit where a certain percentage of EBITDA (i.e., 20%) is based on synergies and cost saving not yet realised or other inappropriate add-backs based on cash costs.

In this regard, the following practices are encouraged in relation to EBITDA calculation methodologies:

Where pro forma EBITDA is based on asset sales or disposals these be based on legal contracts or similar arrangements that provide reasonable assurances on asset values and be forecast to occur in reasonable timeframe (i.e., within the next 12-months).

- Pro-forma EBITDA based on future synergies or future earnings should be based on reasonable assumptions and borrowers are encouraged to disclose these key assumptions to investors.
- Where projected synergies and cost savings are included in pro-forma EBITDA, it is considered good practice that these be subject to clearly defined and prudent caps set as a percentage of trailing EBITDA (i.e., last four quarters summed or trailing 12-months summed, as sourced from the borrower's financial statements / earnings results). Historically add-backs for synergies and cost savings were capped at between 5% and 25% of EBITDA.[71] While appropriate caps should be set in the context of each deal, caps above this range are not considered prudent and for many deals prudent caps may be set at lower levels. In all cases caps should be supported by appropriate assumptions.
- Inclusion of add-backs associated with restructuring costs should be treated in a prudent manner and the borrower should be able to demonstrate that these restructuring costs do not relate to a company's normal operations, strategy, or industry and regulatory environment. It is good practice that restructuring costs which could be reasonably expected to be included in operational costs (i.e., those needed to restructure operations to remain competitive) are not included in add-backs.
- Borrowers are encouraged not to include cost saving or synergies forecast to occur beyond 24-months in pro-forma EBITDA marketed at deal inception.[72]
- It is considered good practice that underwriting entities subject any cost saving or synergies forecast to occur beyond 12-months to enhanced scrutiny.

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[69] Trailing twelve months

[70] Last twelve months

[71] Historically loan or bond documentation would cap EBITDA add-backs / adjustments between 5%-25% of the previous 12-months EBITDA. However, according to research from Fitch, among others, there has been a trend towards eliminating EBITDA add-back caps from loan documentation.
https://www.fitchratings.com/research/corporate-finance/coronavirus-related-ebitda-addbacksenhance-flexibility-adjustments-increase-covenant-cushion-add-extra-financial-flexibility-for-issuers-18-11-2021

[72] It is common practice for loan documents to include cut-offs of 12-24 months for add-backs to be realised. Add-backs forecast beyond this threshold are not included. White & Case (2019) 'Synergising synergies' https://www.whitecase.com/insight-alert/synergising-synergies

- Any pro-forma adjustments included in EBITDA to produce an updated normalised EBITDA should be closely scrutinised. It is considered good practice that enhancements to EBITDA be reviewed by a function independent of the front office function (i.e., risk function) of the underwriting banks.

EBITDA Disclosures

Adequate disclosure of EBITDA definitions and assumptions is a critical factor in ensuring investors have sufficient information to make informed investment decisions. In this regard, trade bodies, the European Leveraged Finance Association (ELFA) and the Loan Market Association (LMA) published a best practice guide for loan term sheet completeness in 2022, hereafter referred to as the **ELFA/LMA best practice guide.**[73] The guide calls for clear disclosures on EBITDA including: (i) full definitions of consolidated EBITDA and Consolidated Net Income, (ii) full details of any add backs, run rate adjustments or similar as well as cap levels, (iii) presentation of add backs / run rate adjustments in the borrower Base Case Model and (iv) clarification of whether EBITDA has been adjusted for IFRS 16 and its impact on consolidated indebtedness.[74]

The following practices are encouraged in relation to EBITDA disclosures:

- Borrowers are encouraged to disclose full details of any add-backs, run-rate adjustments, or similar, with cap levels as part of a financial calculations covenant and in the loan term-sheets. EBITDA definitions should avoid unnecessary complexity.
- To support more prudent investment decisions, borrowers are encouraged to also disclose a more prudent pro-forma EBITDA in marketing materials based on a more prudent adjustment basis (i.e., removal of add-backs associated with synergies and cost savings and supported by historic EBITDA actuals).

Question 9
What key disclosures would assist market participants to come to a more accurate view of pro-forma EBITDA and projected leverage (e.g., what key assumptions should be disclosed in relation to pro-forma adjustments, should there be a disclosure of a more prudent pro-forma adjusted EBITDA with the exclusion of synergies and costs savings)?

Question 10
Is a 25% cap based trailing EBITDA or previous year EBITDA an appropriate cap for add-backs based on cost savings and synergies? It was noted that historically it was common practice for caps to be set at between 10%-15%.

Question 11
Is 24-months an appropriate threshold for the exclusion of add-backs based on cost savings and synergies? It was noted that it is a common practice for deals to include 12-24 months thresholds.

[73] European Leveraged Finance Association and the Loan Market Association (2022) *Best Practice Guide for Term Sheet Completeness*

[74] European Leveraged Finance Association and the Loan Market Association (2022) *Best Practice Guide for Term Sheet Completeness*

3.2.2 Measure 5 - Transparency on covenants' limitations

Covenant Limitations and Loan Documentation Transparency

Over the past decade there has been a steady reduction in the credit protections available in loan documentation as leveraged loans increasingly adopted features typical of the high yield bond market. As a result, there has been a move away from more standardised loan documentation based on the LMA style documentation and terms towards covenant-lite structures associated with the high yield bond market. Traditionally term loans were amortizing facilities that included financial maintenance covenants, designed to ensure that the debtor maintained agreed financial ratios. However, in recent years the covenants have been gradually replaced with incurrence covenants associated with high yield bonds, which provide borrowers with greater flexibility. For instance, covenant-lite facilities have grown from approximately 32% of the US LSTA Leveraged Loan Index in 2013 to almost 90% of the index by the end of 2022.[75] The change has been even more profound in Europe where covenant-lite facilities have grown from approximately 6% of the European Leveraged Loan Index in 2013, to almost 95% of the index by the end of 2022.[76]

As previously discussed, macro-economic factors have played a significant role in this transition. The prolonged period of low interest rates and the resulting search for yield increased risk appetites and drove supply-demand imbalances that have contributed to more borrower friendly terms. This has been coupled with the change in the LL investor base, from banks to institutional investors, the associated move from a lend-to-hold to an originate-to-sell origination model and the rising influence of PE sponsors.[77]

This change has seen the proliferation of terms that offer borrowers significant additional flexibility to raise incremental debt; make significant adjustments to pro-forma EBITDA; reduce the collateral available to lenders through the exclusion of key subsidiaries' assets from the reach of lenders as well as to allow for greater flexibility on restricted payments. In addition, loan documents now allow for greater flexibility for borrowers in the event of default. In some cases, grace periods have been extended for missed interest payments to 30 calendar days, while covenant breaches have been extended to 60 days.[78]

Incremental debt

Incurrence terms now generally allow issuers to incur incremental debt subject to a financial ratio test plus free and clear baskets (incremental debt facilities that do not require compliance with pro-forma financial ratio) that often allow for additional debt based on a full turn of the borrower's EBITDA.[79] Traditionally debt covenants restricted debt incurrence to 2x Fixed Cost Coverage Ratio (FCCR) plus some additional baskets such as revolving credit facilities and

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[75] Pitchbook Leveraged Commentary & Data, 2023, LLI Factsheet, https://www.lcdcomps.com/lcd/idx/index.html?rid=10

[76] Pitchbook Leveraged Commentary & Data, 2023, ELLI Factsheet, https://www.lcdcomps.com/lcd/idx/index.html?rid=20

[77] Ashurst (2018) *High yield bonds and leveraged loans: a convergence of terms,* Ashurst website. Available at: https://www.ashurst.com/en/news-and-insights/insights/high-yield-bonds-and-leveraged-loans-a-convergence-of-terms/

[78] Ibid

[79] Ibid

limited general permitted debt baskets.[80] As part of industry engagement, IOSCO found that in some cases incremental debt could be raised at up to 9x total debt to EBITDA.

Concerns associated with borrowers' ability to raise incremental debt are exacerbated by additional flexibilities now afforded to borrowers when calculating pro-forma EBITDA. Term loans place only limited restrictions on the inclusion of EBITDA add-backs that strip out the effects of extraordinary or unusual items as well as adjustments that account for projected synergies and savings[81]. Research suggests that these pro-forma adjustments are often missed, this can lead to uncertainty regarding leverage ratios and debt sustainability.[82] This can be further compounded when incremental debt is raised based on pro-forma compliance with a financial ratio, generally a leverage ratio. An inappropriately elevated EBITDA figure may ensure compliance with the ratio, while disguising true leverage multiples and credit risk.[83]

Asset stripping

The flexibilities associated with the current covenant-lite structures have gained industry and media attention in the wake of a series of high profile cases, which have illustrated the potential weaknesses in the credit protections available to investors. In particular, liability management techniques such as 'trap doors' and 'up-tiering' have gained widespread attention as a result of the potential significant structural subordination imposed on senior lenders. 'Trap door' or 'asset stripping' manoeuvres have become well known following a series of high profile cases whereby borrowers moved key assets outside the guarantor group to an unrestricted non-guarantor subsidiary, resulting in a structural subordination of the restricted group lenders. Similarly, 'up-tiering' or 'priming' are manoeuvres can result in material contractual subordination for existing senior lenders, when super-senior debt is raised without the consent of many of the senior lenders.

Document opacity

The risks highlighted above have been further exacerbated by a lack of transparency in the loan documents and key marketing materials such as term sheets, which further undermines the efficient functioning of the market. In particular, investors have pointed out that term sheets lack sufficient standardisation in terms of content and sufficiency of disclosures in respect of material terms investors rely on to make investment decisions.[84]

According to research carried out by trade bodies ELFA and LMA, not only is there a lack of detail on disclosed terms but in some cases some material terms are omitted and subsequently

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80 Ibid. FCCR is a measure of a company's ability to meet fixed charges out of cash flows generated. It is expressed as a ratio of cash flows to fixed charges (i.e., interest and principal costs, leases / rent, capital expenses, etc.)

81 Ibid

82 S&P (2023) Leveraged Finance: Fifth Annual Study Of EBITDA Addbacks Finds Management Continues To Regularly Miss Projections, https://www.spglobal.com/ratings/en/research/articles/230216-leveraged-finance-fifth-annual-study-of-ebitda-addbacks-finds-management-continues-to-regularly-miss-project-12643170

83 Ibid. S&P research has shown widespread underperformance against marketing EBITDA, across the US speculative grade market. This has resulted in leverage multiples being on average almost 3 turns greater than forecasted when the deal was marketed.

84 European Leveraged Finance Association and the Loan Market Association (2022) *Best Practice Guide for Term Sheet Completeness*

included in the loan documentation. ELFA and the LMA have confirmed that these practices are impacting investors' ability to appropriately assess risk during the syndication process and are undermining the proper functioning of the loan market.[85] Much of these concerns were echoed by industry participants as part of IOSCO's industry engagement. LL and CLO investors were supportive of increased transparency in respect of key loan terms including debt incurrence covenants and associated financial ratio tests, permitted debt baskets as well as covenant terms that enable liability management manoeuvres such as 'priming' or 'asset stripping'.

The material dilution in lender protections coupled with increased leverage at origination are likely to have an impact on future recovery rates and result in increased systemic risk. A 2020 study by S&P, found that recovery rates were materially lower for US covenant-lite loan facilities compared to non-covenant-lite facilities emerging from bankruptcy between 2014 and 2020. The average and median recovery rates for covenant-lite US leveraged loans were 11% and 34% lower than non-covenant-lite facilities, respectively.[86]

Furthermore, the lack of transparency on key terms of covenant-lite loan facilities may be undermining investors' ability to assess the inherent credit risk associated with the loans, which in turn undermines investors' ability to accurately price credit risk.

Proposed good practices

Measure 5: Transparency on covenants' limitations

It is good practice for material covenants and associated terms contained in term sheets and loan documentation to be written and presented in a clear, concise and effective manner that can be readily understood by the contracting parties, including under what circumstances covenants can be triggered.

Where relevant, industry participants are encouraged to consider best practice guidance for transparency when drafting key marketing materials (e.g., term sheets). It is good practice for borrowers and underwriting entities to provide marketing materials that clearly disclose key terms that could materially impact a borrower's credit risk, including terms that could result in subordination, structural or otherwise, of lenders. In this regard, it is considered good practice to provide clear disclosures of the quantity of incremental debt and associated baskets that can be raised and the ability to move assets beyond the reach of the lender group.

Detailed disclosures of key risks including documentation risk, through a risk factors disclosure, could be provided in a loan document.

Transparency on key loan provisions is considered critical in ensuring that investors have the necessary information to effectively analyse the risk associated with a transaction and its

[85] Ibid

[86] The research captured 67 credits which exited chapter 11 bankruptcy between 2014 and H1 2020. It found the average recovery rate was 78.5% for non-covenant-lite loans compared to 67.5% for covenant-lite loans. Median recovery rates for non-covenant-lite loans was 98.7% compared with 64.8% for covenant-lite loans. Source: S&P Global Ratings (2020) 'Settling for less: Covenant-lite loans have lower recoveries, higher event and pricing risk'. Available at: https://www.spglobal.com/ratings/en/research/articles/201013-settling-for-less-covenant-lite-loans-have-lower-recoveries-higher-event-and-pricing-risks-11687612.

material covenants. Given loan term sheets are provided early in the syndication process, additional clarity on terms strengthens investors' ability to challenge those that materially weaken lender protections.

In recent years there have been industry led initiatives aimed at increasing transparency in the LL syndication process, resulting in the development of the ELFA/LMA best practice guide.[87] The guide calls for clearer disclosures on material covenants and terms such as: (i) debt incurrence, (ii) incremental facilities, (iii) clear definitions of key financial ratios components including potential exclusions of certain debt baskets, (iv) the ability of non-guarantor subsidiaries to incur debt, (v) asset sales and transfer covenants, (vi) restricted payments and (vii) EBITDA margin ratchets and associated reporting.
In this regard, it is good practice that material covenant and associated terms contained in term sheets and loan documentation are written and presented in a clear, concise and effective manner that can be readily understood by the contracting parties, including under what circumstances covenants can be triggered.

In addition, the following practices are encouraged in relation to disclosures in loan documentation and marketing materials:

- Where available and applicable to a jurisdiction, industry participants are encouraged to have regards to relevant best practice guidelines, for example the ELFA/LMA best practice guide.
- Material covenant terms in loan term sheets should be clearly disclosed. It is good practice that such disclosures capture material terms including but not limited to:
    - The quantity of incremental debt that can be raised
    - Calculation of debt baskets including relevant caps
    - Definition of restricted payments and retained cash. Restricted payment disclosures should capture any flexibilities afforded to the borrower to use available debt bucket capacity for restricted payments
    - Debt incurrence provisions and calculation of associated financial covenants including the leverage ratio
    - Existence of 'trap door' or 'asset stripping' clauses
    - Existence of 'up-tiering' or 'priming' clauses
- It is considered good practice that material terms of the debt incurrence covenant, including but not limited to the following, be clearly disclosed:
    - Existence of clauses allowing the borrower to use available restricted payment capacity to incur incremental debt. Where these clauses exist, borrowers are encouraged to disclose the ratio at which this debt can be incurred.
    - Existence of clauses allowing the borrower to incur additional debt based on equity contributions. Where these clauses exist, borrowers are encouraged to disclose the ratio at which this debt can be incurred.
- Borrowers are encouraged to disclose clauses imposing a cap on overall non-guarantor debt incurrence.
- Where a ratio debt basket is based on a leverage ratio, it is considered a prudent approach to calculate the leverage ratio on both a steady state EBITDA and base case pro-forma EBITDA.
- Risk factor disclosures could be considered for inclusion in loan documentation as a method to support increased transparency. It is considered good practice for such risk

[87] Ibid

factor disclosures to capture all the risks that could conceivably occur. Borrowers are encouraged to capture documentation risk and subordination risk associated with incremental debt facilities.[88]

Question 12
Would a disclosure of the calculation of the marketed leverage ratio assist investors in analysing borrower credit risk?

Question 13
Do you agree with the Measure 5 good practice, and what are the other key term-sheet disclosures that would enhance investor analysis of borrower credit risk?

3.3 Theme C – Strengthening alignment of interest from loan origination to end investors

As the LL investor base has shifted from banks towards non-banks, there has arguably been a concurrent shift towards an 'originate-to-distribute' model and a weakening of the alignment of interests between the intermediary banks and the LL lender syndicate. It is good practice for banks to be able to demonstrate that they have aligned their interest with end investors, through risk retention or other means, such as robust risk management and reference to independent and impartial legal advice.

3.3.1 Measure 6 – Transparency and fairness during underwriting and syndication

Background on the syndication process

A borrower or potential acquirer in an LBO solicits bids from potential arranging banks and awards a mandate to the preferred syndicate. Negotiation between the borrower and the banks on terms, fees and pricing feed into this decision.

The arranging banks sign the commitment letter, in advance of any investor engagement, from which point they are committed to underwriting the debt on the agreed terms and become exposed to the risk of failed syndication, i.e., market conditions in which they struggle to sell the loans into the market. It is therefore in their interests for the book-building, pricing and final allocation to be completed quickly to minimise their exposure to underwriting risk.

The arranging banks prepare the information memorandum (IM) or lender presentation describing the terms of the transaction. This typically includes an executive summary, investment considerations, a list of terms and conditions (i.e., a preliminary term sheet), an industry overview, and a financial model. For investors who wish to have the option to invest in public securities of the same issuer, if any, a public version of the IM is produced which strips out private information such as the financial model and financial projections.

CRAs receive transaction information early on, generally ahead of investors, to provide their rating to the transaction. They generally receive the term sheet in advance of the 'bank meeting'[89] with investors and receive the full loan documentation around 10 days in advance of the rating committee meeting.

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[88] Clarity should be provided on covenants that allow non-guarantors of the restricted group to incur incremental debt. In many cases this debt is considered senior to the parent credit facility.

[89] The syndication process proper begins with a 'bank meeting', 'management meeting' or 'lender presentation' at which the borrower (and sponsor, if applicable) present the transaction to potential lenders.

While the IM is being prepared, the syndicate will look for informal feedback from potential investors on their appetite to invest and the price at which they are willing to invest in the loan. This could be through a pre-launch ('early bird') marketing phase in which some larger potential investors are asked to provide feedback on the structure, pricing and potentially some of the terms of the deal. Taking into account the feedback received, the syndicate will formally market the deal to potential investors. This usually begins with a 'bank meeting' or 'management meeting' at which the borrower (and sponsor, if any) present the transaction to potential investors. Usually, the potential investors receive the term sheet 2 to 4 days following the bank meeting.

Allocation and final pricing of the loan is determined through a 'book-building' process which allows for pricing of the loan to increase or decrease depending on investor demand. A loan will be launched to market at a target spread or range of spreads referred to as 'price talk'. Investors can then make commitments to invest in certain amounts at a certain spread; these commitments can be made contingent on changes being made to certain documentation points but at the risk of receiving no allocation if the deal is over-subscribed by investors who accept the original terms as they understand them. At the end of the process the arrangers will determine the final allocation and pricing based on the amounts committed and associated spread levels as well as the level of over- or under- subscription.

Draft full loan documentation is typically shared with investors close to the deal close. Once the loan is closed, the final terms are then documented in detailed credit and security agreements which are distributed to the investors. Between the bank meeting and deal close, the syndication process typically lasts around 2 weeks.

Timing of term sheet

There is variability in the timing at which investors receive a term sheet and in the level of detail provided in that term sheet. When the term sheet is received later in the syndication timeline or lacks sufficient detail, investors' opportunity to make a well-informed investment decision is sometimes squeezed into an unmanageable timeframe. For example, investors are sometimes waiting as long as four days after the bank meeting to view an initial term sheet.

Negotiation power and documentation points

The final loan agreement should reflect a negotiation on price and terms between the borrower and the ultimate investors in the loan, mediated by the bank syndicate. Through industry outreach, IOSCO learned that investors find it difficult to know whether other investors share common concerns about the introduction of specific terms and conditions which are more borrower-friendly or erode their protections. Investors further explained that because loans are syndicated to a broad range of investors, each individual investor has a small marginal power of negotiation. Rules against market collusion and the risk of a breach limit the ability for investors to discuss their opposition to certain terms or to negotiate jointly. IOSCO was also informed that there was a lack of transparency on how investor opposition to certain terms is considered by the bank syndicate where common concerns emerge.

Some market participants indicated to IOSCO that the bank syndicate is in a better position to negotiate the terms with the borrower before the syndication process even begins, because by the time syndication starts the banks have already signed off on the terms and agreed to the underwriting risk associated with those.

On occasion, there have been reports of LBO transactions where investors have achieved changes in terms by pushing back against the flexibility given to the borrower where

particularly egregious terms have been introduced allowing the borrower to raise extra debt and to shift assets beyond the reach of lenders. However, such instances have been rare.

Supply and demand and the wider macroeconomic backdrop feed into the negotiation and pricing considerations. During the long period of very low interest rates which prevailed until 2022 there was strong demand for investments with a relatively high yield and this demand contributed to the ease with which more borrower-friendly terms could be introduced. However, this dynamic changed in 2022 when central banks started to increase interest rates sharply to tackle high inflation, credit spreads widened, and underwriting banks dealt with several high profile 'hung' transactions staying on their balance sheets

Timing and complexity of full documentation

Before the syndication commences, banks sign the commitment letter based on a term sheet and full suite of documentation. IOSCO received feedback during industry roundtables indicating that banks typically have 24-36 hours in which to provide comments and 5 or 6 days overall to review these documents which may run to 1000 or 2000 pages. This contrasts with the longer time period of approximately 6 weeks which used to be typical twenty years ago and which allowed for a more thorough analysis of the underwriting risk and a greater opportunity for negotiation between the banks and the borrower.

Full loan documentation is typically shared with investors close to the deal close, sometimes only 24 hours prior to commitments being due. This short time window as well as the length and complexity of the loan documentation means that in practice investors may not have adequate time to read the full documentation but rely instead on the term sheet circulated earlier. Some investors employ third party legal (covenant review) services to review the full documentation and provide feedback.

Prevention of using third party

In some instances, particularly in the US, examples were mentioned where sponsors inserted clauses into documentation to prohibit sharing documents with third parties (e.g., covenant review services) even when those third parties would be bound by strict non-disclosure agreements.

Proposed good practices

Measure 6 – Transparency and fairness during underwriting and syndication

Underwriting entities are encouraged to:

- provide sufficient and clear information to investors early in the syndication process with the aim of achieving a fair and efficient market in which investors have sufficient time and a fair opportunity to negotiate and to make well-informed investment decisions.
- review the full loan documentation thoroughly before signing the commitment letter and engage in negotiation so that they are satisfied that the risk posed by a failed syndication is within their risk appetite.
- provide anonymised feedback on investors' documentation points to all investors in a transparent way.
- highlight to investors new flexibilities built into loan documentation as well as those which have previously faced opposition from the investor base.

Timing of term sheet
The underwriting entity is encouraged to allow a reasonable amount of time for potential investors to review term sheets early in the syndication and as it evolves during the syndication process. Potential investors should be provided with a comprehensive draft term sheet and the information memorandum (lender presentation) no less than 48 hours before the bank meeting. The underwriting entity is encouraged to promptly provide redline updated versions of the term sheet to investors and allow adequate time for them to review the proposed changes.

Negotiation power and documentation points
Underwriting entities should review the full loan documentation thoroughly before signing the commitment letter and engage in negotiation so that they are satisfied that the risk posed by a failed syndication is within their risk appetite. Underwriting entities are encouraged to highlight to investors new flexibilities built into loan documentation as well as those which have previously faced opposition from the investor base.

Responsible underwriting banks are encouraged to address investors' documentation points fairly and transparently during book-building, particularly where there are shared concerns among several investors. This could be achieved by disclosure by the underwriting syndicate, on an anonymised basis, to investors of any material investor feedback on the draft Senior Facilities Agreement and Intercreditor Agreement (where available) at least 24 hours prior to commitments being due. Material investors' feedback may include points that were raised by multiple investors. Transparency on these lines could help the investor base to form a stronger negotiation position.

Timing and complexity of full documentation
Underwriting entities are expected to build in a reasonable amount of time (e.g., minimum 2 weeks[90]) for review by a function independent of the first line (i.e., risk management function) of loan documentation prior to signing the commitment letter.
Investors are expected to be given a reasonable amount of time (e.g., minimum 5 days[91]) to review and consider the full loan documentation.
Borrowers, underwriting banks and their legal counsel are encouraged to work towards simpler and more standardised covenants and loan documents.

Use of third party services
Investors should not be prevented from employing third party legal services to support them in reviewing and understanding loan documentation provided there are arrangements in place to protect private and confidential information about the borrower.

Question 14
Do you agree with the proposed good practices outlined in Measure 6 regarding circulation of a comprehensive term sheet no less than 48 hours before the bank meeting?

Question 15
Do you agree with the proposed good practices regarding time for underwriting entities (minimum 2 weeks) and investors (minimum 5 days) to review the full loan documentation?

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[90] Timing based on feedback from IOSCO's roundtable engagement with industry participants

[91] Ibid

Question 16
What other good practices have been or could be put in place to provide transparency and fairness to investors during underwriting and syndication?

3.3.2 Measure 7 - Alignment of interests between underwriting entities and investors

Shift from 'Originate-to-retain' to 'Originate-to-distribute'
Prior to the GFC, banks tended to retain on their balance sheet the credit exposure to the LLs they originated. However, post GFC, and in part due to prudential constraints on their balance sheets and tighter risk management/allocation of their capital, banks have moved towards a business model where they underwrite the LLs and aim to distribute them almost entirely to other institutional investors, only keeping the less capital-intensive revolving credit facility and short-term amortising loans on their balance sheets, where applicable. Some market participants have argued that this may have lowered the alignment of interests between banks and non-bank-investors which may have resulted in a lack of incentive to negotiate more lender-friendly loan terms. Furthermore, institutional investors raised concerns that banks' interest may be more aligned with the PE sponsor on the grounds that they generate fees from a finite cohort of PE sponsors.

It is important to note that banks typically underwrite the entire LL, on a firm commitment basis, and therefore are exposed to the risk of not being able to distribute it to other institutional investors or to distribute it at a lower price. It is arguable whether the risk of hung transactions has been a strong incentive in aligning interests between banks and investors during the period of low interest rates and high demand for LLs which prevailed for a long period until early 2022. Some underwriting banks which had arranged transactions in benign conditions found themselves with hung debt and have since realised losses on the sale of loans at discounted prices. While this risk was a possibility in the years leading up to 2022 when interest rates were very low, there may have been a sense of complacency around the possibility of interest rates rising given the prolonged period during which central banks pursued low interest rate policies. CLOs were in high demand due to their relatively high yield and seemingly strong track record.

Risk retention
'Alignment of interests' has a specific meaning in the context of securitisation markets including the CLO market. In the wake of the GFC which was caused in part by high risk 'originate to distribute' residential mortgages packaged into RMBS[92], some jurisdictions introduced risk retention obligations whereby originators or sponsors are required to retain a 5% exposure to the credit risk of the securitisation or underlying loans for the life of the securitisation. This is designed to ensure that they are exposed to the performance of the loans alongside the securitisation investors, thereby aligning the interests of the originators or sponsors with the securitisation investors.

The way in which this risk retention requirement has been implemented varies depending on jurisdiction. In the EU and UK, securitisation regulations impose a 5% risk retention requirement on original lenders or on CLO managers. In practice, typically the CLO manager or a so-called 'third party originator' fulfils the role of the risk retention holder rather than the original lenders. In the US, following the GFC, regulators adopted risk retention requirements that applied to CLOs and other asset-backed securities. The risk retention rule in the US as applied to open-market CLOs was, however, successfully challenged in court, and since April

[92] Residential mortgage-backed securities

2018 open-market CLOs (which form the majority of CLOs) no longer have to comply with US risk retention requirements.

Alignment of interest may also be achieved through other means including management fees linked to the performance of the portfolio.

Designated counsel

Designated counsel is a practice, prevalent mostly in the European market, where the PE sponsor selects the law firm on behalf of the bank lenders. The law firm is selected often even before the lenders are themselves selected by the PE sponsor. In the European market the sponsor typically pays the legal fees on behalf of the banks. This contrasts with the US market where the banks in the syndicate choose their own legal counsel, pay their own legal fees and are usually represented by separate law firms or at least separate legal teams from the same firm.

The justification for the designated counsel approach is that it allows the PE sponsor to rely on law firms that are familiar with their LL structure and documentation, thereby facilitating a faster and smoother syndication. Through industry roundtables, IOSCO heard concerns from some market participants that this practice limits their choice of legal counsel and may not serve to ensure that the advice they receive is independent. Further concerns were raised that conflicts of interest may arise whereby lawyers representing the banks might be reluctant to push back against sponsor lawyers due to the risk they could be excluded from the market for lender-side work.

In 2022 it was reported that some lenders in the direct lending portion of the market have started to appoint their own 'shadow' legal counsel alongside the counsel designated by the sponsor because they had concerns about the independence of the designated representation.

Proposed good practices

Measure 7 – Alignment of interest between underwriting entities and investors
Underwriting entities are encouraged to demonstrate how they have aligned their interests with LL investors, through risk retention or other means. Implementation of robust risk management of leveraged lending activities can strengthen alignment of interests as well as prevent the build-up of systemic risks. Underwriting entities and LL investors are encouraged to obtain independent and impartial legal advice which represents their interests and strengthens their ability to negotiate loan terms and influence market evolution.

Risk management within banks

Both US interagency guidance[93] and ECB guidance[94] include key elements which banks need to incorporate into the management of risks arising from their leveraged lending activities. Adopting robust risk management around leveraged lending helps to align interests between banks and investors as well as preventing a build-up of systemic risks in the economy.

According to the existing US interagency guidance and ECB guidance, some of the key elements which underpin robust risk management in leveraged lending include:

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93 Board of Governors of the Federal Reserve System, Federal Deposit Insurance & Corporation Office of the Comptroller of the Currency (2013) *Interagency Guidance on Leveraged Lending*

94 ECB (2017) *Guidance on Leveraged Transactions*

- A clear and consistent definition of leveraged lending.
- A sound governance structure which enables senior management to have a comprehensive and consistent oversight of all leveraged lending.
- Sound management information systems which allow accurate and timely aggregation of leveraged loan exposures.
- Well-defined risk appetite and strategy for leveraged lending which is subject to regular review.
- Well-defined underwriting standards which are applied uniformly whether the loans are underwritten to hold or to distribute.
- Review and approval of all transactions by an independent risk function to ensure transactions are in line with risk appetite. Sufficient time should be permitted for this review (minimum 2 weeks).
- A stress-testing approach which captures the impact of market disruption on transactions in the pipeline as well as policies and procedures for defining and managing 'hung' transactions.
- Dedicated procedures and confidentiality requirements to ensure that potential conflicts of interest are identified and managed and that private information is kept confidential.

Risk retention
Market participants (as originators, sponsors or original lenders) are encouraged to make adequate disclosures on retained credit risk exposures (either voluntarily or as meaningful compliance with risk retention requirements where applicable), to allow investors to assess the alignment of interest and whether the method chosen actually aligns interests as intended.

Independence of legal advice
Underwriting entities and LL investors are encouraged to obtain independent and impartial legal advice which represents their interests and strengthens their ability to negotiate loan terms on individual transactions and to influence the overall evolution of the market, both on documentation and processes. In doing so, they will be in a better position to shape the risks they could be exposed to in the event of failed syndications or a market downturn, and also strengthen their alignment of interest with the ultimate LL investors who will be exposed to the credit risk of the loans for the long term.

Question 17
Do the considerations as set out above accurately reflect the key issues regarding alignment of interests between the underwriting banks and investors?

Question 18
Do you agree with the measures proposed to help strengthen the alignment of interest between underwriting entities and investors?

Question 19
What other good practices have been or could be put in place to strengthen risk management of leveraged lending activities by underwriting entities?

Question 20
Do the considerations as set out above accurately reflect the key issues regarding the practice of designated counsel being chosen by the sponsor?

3.4 Theme D – Addressing interests of different market participants throughout the intermediation chain

A long and complex intermediation chain, coupled with a complex design and distribution process for securitised assets, create potential for heightened conflicts of interest in LL and CLO markets. Furthermore, market participants raised concerns during industry roundtables about current market practice in LL transfer provisions which could be seen as harmful to secondary market liquidity. It is important that market participants identify, disclose and manage conflicts of interest which can arise from their activities in these markets, for example PE groups investing in equity and debt (or in different classes of debt) of the same borrower or CLO managers holding certain tranches of a CLO. Market participants should also make efforts to support LL secondary market liquidity by reducing transferability restrictions.

3.4.1 Measure 8 - Reducing restrictions on transferability of loans

Transfer provisions in LLs
Prior to the GFC, leveraged loans were typically originated as 'lend to hold' investments retained by the underwriting banks with limited occasion to transfer the loans. In the period following the GFC, when banks began to distribute more loans to a non-bank investor base, some standard transfer provisions emerged.

In the European market, borrower consent to a transfer is generally required subject to a set of exceptions. Borrowers are not permitted to withhold consent unreasonably and consent is deemed given after a certain number of business days. Transfers between affiliates, existing lenders and related funds is a common exception where borrower consent is not required. European loans typically include an **agreed list** (or approved list) of lenders that can buy the loans without borrower consent. Often the borrower can update the agreed list throughout the life of the loan and remove a certain number of names per year. A further exception where borrower consent to a transfer is not usually required is if the transfer is made while an event of default is continuing.

The US market differs in that it usually relies on a **disqualified lender list**, which expressly sets out those institutions that cannot become lenders even during an event of a default. As a general rule, borrower consent is required, unless an event of default is occurring, and borrower consent is deemed given after a certain number of business days.

Agreed and disqualified lender lists impinge on not only the lenders who can participate in the primary loan market, but also the pool of lenders who might acquire loans in the secondary market.

In contrast with the LL transfer provisions, the only restrictive transfer provision which generally applies in the HY bond market relates to the transfer of the bond to an investor who holds a net short position, i.e., a short position in a credit derivative exceeding any long position held in the bond.

Impact on liquidity
During engagement with industry participants, IOSCO heard that the use of agreed lists may restrict the ability of investors to find liquidity when they need it, especially in a period of market stress. Some market participants expressed a view that the use of agreed lists amounts to market collusion and could not see a justification for the practice. There were also concerns

that this practice is sometimes used to coerce investors into accepting borrower-friendly loan terms at the risk of being taken off agreed lists on future transactions.

The types of lenders that may be omitted or removed from the agreed list or included in the disqualified lender list include industry competitors[95] or distressed debt[96] funds (including those who might pursue loan-to-own[97] strategies). These restrictions are sometimes expressed in overly expansive definitions which further limit the pool of potential lenders.

During IOSCO's engagement with industry participants, some participants indicated that it is often the case that the agreed list is not available at the launch of the syndication which means that investors may lack transparency and the opportunity to negotiate on transferability of the loans.

In more recent years the borrower-friendly market dynamic has led to borrowers seeking to take and retain even greater control over the composition of the lenders by introducing further restrictions on loan transferability, particularly in the European market, such as:

- Limitations on transfers staying in place even in an event of default or only falling away upon certain specified material events of default, namely non-payment and insolvency defaults;
- Restrictions on a new lender and its affiliates from holding more than a certain amount (e.g., 10%) of the total commitments, to prevent a single lender from acquiring a blocking minority;
- No overall cap on the number of names that can be removed from the agreed list during the life of the loan and no requirement to attempt to insert replacement names;
- Blanket carve-outs to any entity on the agreed list that is a distressed debt fund, loan-to-own investor or industry competitor;
- Requirements for lenders to notify a borrower prior to any transfer, even if the transferee is on the agreed list; and,
- Requirement for the borrower to act reasonably on any consent request for transfer is often no longer included and when it is, the period for deemed consent is longer (e.g., 10 instead of 5 business days).

While such restrictions are favourable to the borrower, they may detract further from liquidity in the secondary market for LLs.

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[95] Sponsors are keen to ensure a competitor sponsor is not able to acquire debt in its investee company, to avoid the risk that the competitor may gain a potentially valuable insight into the terms of the borrower's debt and the company's performance.

[96] Distressed debt investors aim to identify debt securities trading at a larger discount than is justified given the potential for a turnaround. The investor acquires a stake in the debt to gain influence in the reorganisation of the borrower. Distressed debt investors have the potential to generate strong returns via short-term price recovery or through 'loan-to-own" strategies.

[97] Loan-to-own strategies are used by lenders seeking to take control of a borrower by converting debt obligations into an equity stake in a post-restructured entity. Typically, the intention is to de-lever the company in question, strengthen its financial resilience and realise value in a subsequent sale of its equity. A loan-to-own transaction usually occurs when a borrower company is, or is expected to be, highly leveraged, experiencing financial distress, or is considering undergoing a refinancing or filing for bankruptcy.

Measure 8 – Reducing restrictions on transferability of loans

Transferability of loans within a pool of potential investors should be as broad as possible to support a liquid secondary market. It is considered good practice that where lists of approved and disqualified lenders are used, they should only be created based on clear and documented reasons. It is expected that investors be provided with transparency early in the syndication process on transferability restrictions and how these might evolve during the life of the loan. It is expected that investors are provided with sufficient clarity on the precise definition of an event of default, which will cause limitations on transferability to no longer apply.

Supporting a liquid secondary market

The LL market has evolved from its origins and exhibits more liquidity in a secondary market than in the past. Given these developments, some of the current restrictions on loan transferability no longer appear congruent with IOSCO's objectives of reducing systemic risk, protecting investors and ensuring that markets are fair, efficient and transparent.

As a general principle, it is good practice that the potential pool of investors who are able to participate in the secondary markets for LLs be as broad as possible to support market liquidity and efficiency. This principle also has a bearing on transparency of loan pricing since prices can only be observed when transactions actually occur.

The use of borrower consent and lists of approved or disqualified lenders is discouraged. It is suggested they only be used in a limited context to exclude particular types of investors based on clear and documented reasons. As such it is considered good practice that any such lists are created and updated based on a defined set of criteria supported by a documented rationale. An effort needs to be made to avoid overly expansive definitions which limit the investor pool unnecessarily.

Underwriting entities and borrowers are encouraged to provide investors with transparency early in the syndication on transferability restrictions, including the precise definition of an event of default which will cause limitations on transferability to fall away (e.g., the agreed list). Underwriting entities and borrowers are encouraged to provide investors with any agreed list or disqualified lender list at an early stage of the syndication, for example in the term sheet circulated around the time of the bank meeting, and at least annually thereafter if there is a possibility of the list changing.

The removal of names from the initial agreed list is discouraged. Where names are removed it is considered good practice that these be subject to an annual cap (e.g., 3 per annum). Such removals should refer to those same clear and documented reasons used to prepare the initial list and be notified to investors. Where names have been removed, borrowers are encouraged to add replacement names to the agreed list to support secondary market liquidity. Where agreed lists are used, it is suggested to eliminate restrictions during an event of default.

Where a period for borrower deemed consent exists, it is considered good practice that this period be as short as reasonably possible. A period of 3 business days is considered adequate.

Question 21

Do the considerations as set out above accurately reflect the issues surrounding transfer provisions in the LL market?

Question 22
Do you agree with the proposed good practice to ease restrictions on the transferability of LLs to support liquidity in the secondary market? Is there a justification for transferability to be more limited in the LL market as compared to the HY bond market?

3.4.2 Measure 9 - Managing conflicts of interest where PE sponsors also act as lenders
Several private equity (PE) groups have expanded into the business of private debt investing either by setting up funds to provide direct lending to highly leveraged borrowers or by managing CLOs or other types of investment vehicles focusing on LLs. Such activities have grown substantially over the past few years.

Where PE groups are invested in different parts of the borrower's capital structure, there are potential conflicts of interest which could arise through the exercise of voting rights against the interests of other lenders or through leakage of confidential information within the group. In practice the sponsor lender's interests may be more likely to be aligned with the borrower's than a third-party lender's would be.

The LMA leveraged facilities agreement includes a "sponsor disenfranchisement" clause. This provision is designed to allow a "sponsor affiliate" to acquire the debt, but to prevent it from then being classed as a lender for the purpose of voting on amendments and waivers, attending lender meetings or receiving information sent to lenders.

Through IOSCO's engagement with market participants, IOSCO received feedback indicating that when such situations arose in the past, the potential conflict of interest was managed using the "sponsor disenfranchisement" clause, but that this is no longer widespread practice in recent years and this protection for lenders has been eroded away as part of the general trend towards more borrower-friendly terms. In contrast, it is still normal in the HY bond market that an affiliate of the borrower who purchases the debt of the borrower will be subject to disenfranchisement.

Some market participants noted the potential benefits of sponsors having the ability to purchase debt and reduce the borrower's leverage, for example at times when loans were trading at discounted levels in secondary markets.

Proposed good practices

Measure 9 – Managing conflicts of interest where PE sponsors also act as lenders
Conflicts of interest which can arise from a group's investments in different parts of a borrower's capital structure, should be appropriately identified and managed. It is expected that participants in a syndication and LL investors be properly informed of the instances where a group is acquiring the debt of a borrower while also acting as the borrower's sponsor or holding other classes of debt of that borrower. In such cases, the use of a sponsor disenfranchisement clause or similar clause is encouraged.

PE groups should identify the conflicts of interest arising from different arms of their group investing in different parts of a borrower's capital structure including the equity and various classes of debt which may have been issued by the borrower. Arrangements to manage those conflicts of interest appropriately should then be put in place.

Conflicts of interest should be clearly disclosed to LL market participants as well as to the investors of funds managed by those PE groups. If instances arise where a PE group is investing in debt and equity of the same borrower or in different classes of debt of the same borrower, appropriate disclosures should be made. Such an instance might arise, for example, if a CLO manager which is part of a PE group is purchasing the debt of a borrower where the same PE group is the sponsor to that borrower or owns a different class of debt issued by that borrower.

The use of the sponsor disenfranchisement clause is encouraged to better manage the potential conflicts of interest arising when PE groups hold both the debt and equity of a borrower. Where no such clause is applied, third party lenders need to carefully consider the associated risks which will depend on the proportion of total debt commitments held by the sponsor group, or which could be held by the sponsor group in the future.

Question 23
Do you agree with the proposed good practice to mitigate conflicts of interest which may arise from PE groups investing in the debt and equity of the same borrower?

Question 24
What other good practices have been or could be put in place to help manage conflicts of interest arising for the reason described here?

3.4.3 Measure 10 - Managing conflicts of interest in management of CLOs

CLO managers, acting on behalf of the CLO, arrange the purchase of LLs from originating banks and sell the CLO tranches to a range of investors. Depending on the jurisdiction, CLO managers may be regulated firms or not. For example, in the EU/UK, the majority of CLO managers have a MiFID II authorisation, although not all.

Alignment of interest
CLO managers owe a standard of care[98] to the CLO investors requiring them to manage the CLO with reasonable care and in good faith in the best interests of all the investors. They therefore must consider how they can balance the competing incentives and interests of the multiple investors in each of the tranches of risk, including the equity piece.

Post-GFC reforms have imposed a level of risk retention in some jurisdictions – whereby the original lender or CLO manager is obligated to retain a net economic interest in the transaction - to better align its interests with those of the investors. Often this results in the CLO manager retaining exposure to the equity tranche, aligning their interest more with those of the equity holders than the debt holders.

Separately, the fee structure is also a mechanism to better align interests between the CLO manager and the investors. CLO managers typically earn three types of management fees: (i) senior management fees paid near the top of the waterfall, (ii) subordinated management fees paid near the bottom of the waterfall, and (iii) performance fees[99] which are only paid if the equity tranche reaches a specified internal rate of return threshold. This fee structure is

[98] The standard of care is typically defined in the collateral management agreement entered into between the CLO and the collateral manager.

[99] Performance or incentive fees are more typical in the US CLO market but not widely used in the European CLO market.

intended to incentivise the manager to manage the portfolio in a way that maximises the performance of the transaction.

Managing in favour of equity holders

Conflicts between equity and debt holders are not new in CLOs. The discussion existed prior to the GFC, particularly as to how CLO managers managed the conflicting interests, specifically, whether CLO managers managed the CLO so as to favour the equity holder by facilitating cash being paid down to the equity tranche and in subordinated fees.

CLO structures include performance tests and metrics (such as the overcollateralization (O/C), interest coverage (I/C) tests and CCC/Caa bucket threshold)[100] which, when breached, divert cash received from the underlying LLs to the senior debt holders instead of being paid through the waterfall to the equity holders.

Equity holders have a keen interest for the O/C tests to be maintained above the threshold, thereby allowing to maximise their return. O/C tests are measured using the notional amount of a loan even if it trades below par. It could be therefore in the interest of the equity holders for distressed assets to be bought at a price below par and yet valued at par against the O/C test. As CLO managers typically hold part of the equity, they may be incentivised to manage the LL portfolio using their ability to buy distressed assets to help pass O/C tests. However, it is acknowledged that this risk is reduced by the limits to the percentage of CCC/Caa or lower rated assets that can be held by the CLO. When these so-called CCC/Caa buckets are exceeded, the excess CCC/Caa rated assets are valued on a mark-to-market basis, which in turn erodes the O/C test.

IOSCO received feedback during industry roundtables indicating that market volatility sparked by the COVID-19 pandemic in 2020 highlighted the management style of CLO managers and allowed investors to differentiate among managers and identify those who managed the CLO to the benefit of all investors and those which seemed to have a bias in favour of the equity holders.

Valuation

The price at which a LL is either valued for purposes of the O/C tests (where relevant) or when sold is key to the performance of the CLO. IOSCO received feedback during industry roundtables indicating that CLO investors do not typically check every valuation and/or sale of a LL but rather focus on making sure, as part of their initial due diligence, that the CLO manager has policies and procedures in place, including for cross sales, i.e., sales between two CLOs (or funds) managed by the same CLO manager.
In addition, prices of LLs are normally published by third party vendors allowing investors to check for clear outliers. Investors also can ask questions to the CLO managers, particularly on cross sales.

Valuation of CCC/Caa assets is particularly key to the performance of O/C tests when the CCC/Caa bucket threshold is breached, which may happen in times of stress. It is particularly challenging to value a CCC/Caa asset in a market stress because it is highly dependent on the

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[100] Overcollateralization test (O/C) - being the par value of the loan portfolio divided by the principal amount of the outstanding CLO tranches. Interest coverage ratio (I/C) - being the income generated by the loan portfolio divided by the interest due on the outstanding CLO debt tranches. CCC/Caa bucket threshold – being the percentage of the CLO portfolio that can be rated CCC/Caa or below.

liquidity of the asset at that point. Although the valuation of an asset by a CLO manager is disclosed in the investor report, how the CLO manager arrived at this valuation is not required to be disclosed.

Proposed good practices

Measure 10 – Managing conflicts of interest in management of CLOs Potential conflicts of interest in the management of CLOs should be appropriately identified and managed. It is expected that policies governing the purchase of distressed assets, cross-sales and trading / valuation of CCC/Caa rated loans and the related policies be clearly set out in a CLO indenture to enable investors to make an informed investment decision. It is considered good practice that trustee reports regularly disclose the trading activity and valuation of assets of a CLO to enhance transparency to investors. It is considered good practice that investors are provided with sufficient opportunity to conduct due diligence on the valuation methodology and results produced by the CLO manager and assess the strategy and rationale for management of assets when performance tests are at risk of being breached.

Alignment of interest

CLO managers should identify and appropriately manage potential conflicts of interest to fulfil the standard of care they owe to all the CLO investors. In doing so they should consider the alignment of their own incentives with investors as a whole or with particular categories of investors and potential conflicts of interest this may cause. For example, if the CLO manager itself is an investor in some CLO tranches, either voluntarily or because of the applicable risk retention requirement, this might pose a conflict of interest which should not supersede the standard of care to the whole investor base.

The structure of CLO management and performance fees play an important role in incentivising the strategy of the CLO manager and should be designed to create an effective alignment of interest which incentivises the CLO manager to act in the best interest of the CLO investors as a whole.

Transparency on trading activity in distressed assets or CCC/Caa-rated assets

The purchase of distressed assets is typically constrained by the CLO structure to protect CLO note holders. Hence, investors' understanding and negotiation of the terms of the CLO structure is important to understand/limit the flexibility of CLO managers to hold and/or buy distressed obligations.

CLO managers are encouraged to disclose to investors how they manage the CLO's exposure to CCC/Caa-rated loans in relation to the CCC/Caa-bucket test and the rationale for trading activity in CCC/Caa-rated loans and how this activity serves the best interests of all CLO investors.

It is expected that the CLO manager disclose to investors policies governing its ability to engage in cross-sales of investments between the CLOs it manages and rationale for doing so. Existing good practice is to include information on individual purchases and sales in regular

trustee reports, including the purchase/sales prices and reasons for sale (if applicable) and highlighting any purchases/sales involving an affiliate (i.e., cross-sales).

Many CLO managers also explain in response to due diligence questionnaires[101] the policy they follow regarding cross trades and how they demonstrate adherence.

Transparency on valuation
It is good practice for CLO managers to have appropriate policies and procedures embedded in their operations which equips them to determine appropriate valuations of the individual assets in the CLO. Details of the valuation methodology should be made known to investors upon request. It is expected that these policies and procedures include specific approaches for the valuation of defaulted assets, illiquid assets and the assets in excess of the CCC/Caa bucket which must be carried at the mark-to-market value.

A good practice observed in trustee reports is including a market value report showing the current market value of assets alongside the original purchase price for all holdings as well as a valuation report on the CCC/Caa assets showing their current market value.

Investors should have the opportunity to perform their own due diligence upon initial investment and on an ongoing basis including (i) familiarizing themselves with the valuation policies of the CLO manager, (ii) using other pricing services to perform independent checks and identify any outliers in pricing, and (iii) understanding and questioning the valuation approach and outcomes for defaulted and illiquid assets where there is little or no trading activity.

Question 25
Have the considerations above captured the key considerations regarding potential conflicts of interest which may arise between the CLO manager and the CLO investors?

Question 26
Do you agree with the proposed good practices? What other good practices have been or could be put in place to help manage such conflicts of interest?

3.5 Theme E - Disclosure of information on an ongoing basis

Market participants expressed concerns, through industry roundtables with IOSCO, that deficiencies in transparency at LL deal inception may be exacerbated by insufficient on-going disclosure of key financial and management information to investors. In some cases, investors noted that critical information supporting key assumptions such as evolution of EBITDA and leverage ratios was not disclosed in a timely manner. Ongoing disclosure of such information to the lender syndicate is important in ensuring that investors have sufficient information to make informed investment decisions. Equally, ongoing disclosure to CLO investors via regular trustee reports is important for the same reason.

3.5.1 Measure 11 - Disclosure in CLOs
CLO investors normally have access to information about the composition of the portfolio and the underlying LLs. They do not, however, have detailed information about the credit of each

[101] It is typical for CLO investors to send due diligence questionnaires (DDQs) to CLO managers to gather information to feed into their due diligence assessment prior to investing.

underlying LL nor do they see the credit agreement for each loan. They explained that this is because, being exposed to a statistical risk rather than an idiosyncratic risk (except for the equity holder), they may not need to review the underlying loan documents themselves. Instead, they rely on the ratings of the individual loans, the structural protection of the CLO, and on the due diligence process, credit analysis and portfolio management carried out by the CLO manager. Some CLO investors in the roundtables looked at the information of the underlying LLs such as the prices, ratings, liquidity and industries for a high-level/tail risk assessment.

Some CLO investors noted that the most important consideration in investing in a CLO is not whether the loan agreements include financial covenants but whether the businesses are viable and the nuances of the loan documents in relation to collateral stripping. In this regard, CLO investors rely exclusively on the CLO managers to pay close attention to the relevant clauses.

The emphasis on the management style and skills of the CLO managers has increased recently and particularly through the COVID-19 crisis. Market participants in the roundtables however reported that COVID-19 had provided CLO investors with more channels and opportunities to interact with CLO managers. CLO investors could conduct virtual due diligence meetings with their managers to make instant queries, check and monitor the portfolio more closely, allowing more in depth understanding of their portfolio. Calls with CLO managers are the most common means to gather information. CLO managers were informally differentiated based on their responsiveness and preparation in meetings.

Measure 11 - Disclosure in CLOs

CLO investors should be provided with all materially relevant information on the valuation, credit quality and performance of the portfolio of a CLO, consistent with jurisdictional regulatory requirements. It is expected that such data is made available on a regular basis (e.g., monthly) to CLO investors in order for them to make an informed judgement of their investment decisions and that potential CLO investors be provided access to such information upon request.

In the EU and the UK, the securitisation regulation implemented in 2019 requires detailed disclosure to CLO investors about the portfolio and on-going performance, as well as CLO manager actions. This requirement applies whether the CLO is done through a public offering or is a private transaction.

To enable CLO investors to make an informed investment decision and continue to assess their investments, information on valuation, credit quality and performance of the loan portfolio in the CLO should be accessible by CLO investors on a regular basis. Also, it is encouraged to provide regular updates to investors on the following information concerning the underlying loans:

- Prices and liquidity status
- Leverage ratios
- Debt service coverage ratio and debt repayment capacity test

While the presentation of the above information may take different formats, it is expected that CLO managers present the above information in a manner that can facilitate the assessment by CLO investors and for their ease of understanding. CLO managers are encouraged to clearly

disclose signs of credit deterioration in the loan portfolio in monthly trustee reports shared with the CLO investors.

In addition, it is considered good practice to provide investors with timely updates on key performance tests and asset concentration limits, which are key structural protection features in CLOs. In making available the information to investors and potential investors, it is suggested to provide the following:

- The latest overcollateralization (O/C) ratio (being the par value of the loan portfolio divided by the principal amount of the outstanding CLO tranches), interest coverage (I/C) ratio (being the income generated by the loan portfolio divided by the interest due on the outstanding CLO debt tranches), and CCC/Caa concentration ratio (being the value of loan rated as CCC/Caa or below divided by the value of the loan portfolio).
- The underlying loan portfolio may be presented to the CLO investors in a manner that can help investors to understand whether the loan portfolio is in compliance with its limits as specified in the CLO documents (e.g., the percentage of second lien, covenant-lite, single issuer, industry, etc.)

Information on portfolio turnover, credit selection, portfolio liquidity etc. could also be included to facilitate CLO investors in understanding and evaluating the performance of a CLO manager.

Question 27
Have the above factors captured the necessary information that are important considerations to investors for their CLO investment decision and evaluation of CLO managers' performance?

Question 28
What additional good practices in disclosure can be put in place to help investors better understand and evaluate their CLO investments?

3.5.2 Measure 12 - Disclosure on underlying loans

Leveraged lending is a highly idiosyncratic market and loan documentation is usually tailored for each transaction with varying degrees of investor protection. Covenant packages and leverage/EBITDA calculations (including addbacks) are typically disclosed in the loan documentation but subject to interpretations and judgements.
During industry roundtables, some bank lenders reported that the amount and quality of information about the financial position of borrowers is deteriorating, particularly with respect to on-going performance, and that access to the management of the company is limited. As a result, investors are relying on third party documentation review providers and on the CRAs to conduct more detailed due diligence.

LL investors, primarily CLO managers, also noted the diminishing amount of information they receive about the business of the company, its financial strategy and on-going performance. They very rarely have access to the management of the company to ask relevant questions and increasingly rely on CRAs, who generally meet the management before the initial rating and periodically thereafter.

Measure 12 - Disclosure on underlying loans
LL borrowers are encouraged to provide their investors on a timely basis with their latest financial information and status, for example, the audited financial statements, periodic

management financial information and financial forecast and budget in relation to its business plan. LL borrowers are also encouraged to inform their investors within a reasonable timeframe of occurrence of any events that may invalidate any assumptions originally applied in the EBITDA addbacks (including any activities that are outside the normal course of business) and potential implications and impact on the projected EBITDA.

While LL investors in the roundtables mentioned that they have access to financial information of the LL borrowers, some LL investors express concern that because of the very private nature of the LL market, it is challenging to obtain information on the on-going performance of the credit (for example, how the leverage ratio has evolved over time).

In this case, it is suggested that:

- LL borrowers inform their lenders within a reasonable timeframe of occurrence of any events that may invalidate any assumptions originally applied in the EBITDA addbacks. The LL borrowers are also encouraged to indicate the likely impact of such event(s) on the projected EBITDA and their ability to pay interest and repay debt.
- In cases where the actual EBITDA may deviate significantly from the projected figures, LL borrowers inform their lenders as soon as practicable of the impact on the projected EBITDA and whether any material deviation from the projected EBITDA is expected. Such cases may occur when LL borrowers engage in activities outside their ordinary course of business that may have a financial impact on the projected figures.
- LL borrowers provide updates on the debt repayment capacity test and whether there is any deviation from what was disclosed in the loan document.

Some LL investors reported that the amount and quality of information about the financial position of borrowers is deteriorating, particularly with respect to business of the company, financial strategy and on-going performance, and that access to the management of the company is limited.
The following practices are encouraged in relation to disclosures:

- LL borrowers establish appropriate practices and communication channels with their lenders to provide regular updates on their financial position and an explanation of any material deviation from the projected EBITDA, if applicable.
- Whenever audited financial information is available, LL borrowers disseminate the same to their lenders to keep them abreast of their latest financial positions and conditions.
- LL borrowers share their budgeting information with the lenders with explanation on how such budgeting information may be understood in conjunction with the projected EBITDA, subject to applicable laws, regulations and rules in the disclosure of such information.

Question 29
Have the above practices captured the necessary information that are important considerations for investors to evaluate the on-going financial performance of LL borrowers?

Question 30
What additional good practices in disclosure can be put in place to help investors better understand the financial position and status of LL borrowers?

4. Conclusion

The proposed good practices are intended to guide market participants in their decision making when operating in the LL and CLO markets, as well as to encourage the development of these markets and the behaviour of market participants in ways which support the fulfilment of IOSCO's objectives.

The Consultation Report does not comprise either standards or recommendations as per IOSCO's taxonomy. Following the public consultation period, IOSCO will develop final good practices report for publication.

Appendices

Appendix 1: List of proposed good practices

Origination and refinancing based on sound business premise

Measure 1 **Debt repayment capacity test**

Leveraged loans offered to the market in both new originations, debt refinancings and debt restructurings should be underpinned by sound business and financial risk assumptions. Borrowers should be able to demonstrate sufficient debt repayment capacity. An adequate debt repayment capacity is considered the ability to repay 100% of senior debt or 50% of total debt over the medium term. For example, some regulatory agencies and other market practitioners measure the debt repayment capacity test over a 5 to 7 year period. Where this is not evident, a credible explanation should be provided. It is also considered good practice to disclose debt repayment capacity in term sheets and supporting documentation at the time of debt offering and refinancing. A robust assessment of cash flows including stress testing should inform debt repayment capacity assessments.

Measure 2 **Dividend Recaps**

Dividend recapitalisations should be considered with reference to the level of remaining equity support, degree of leverage and debt repayment capacity. The use of incremental debt to affect a dividend recapitalisation should be limited. In addition, borrowers are encouraged to clearly disclose dividend distribution policy and strategy.

Measure 3 **Enterprise Values (EVs)**

The calculation of EVs which support the capitalisation structures of LBOs should be based on a well-constructed financial model. Underwriting entities are encouraged to clearly disclose the key assumptions underpinning the financial model. It is good practice that any EV model (DCF or otherwise) is reviewed and validated by a function independent of the origination unit.

Where possible, the basis for EV should be under-pinned by multi-year forecasted cashflows and not based only on comparable multiples of EBITDA derived from other LBO transactions. It is good practice that DCF valuations which are heavily influenced by terminal values extrapolated from final year forecasted cashflows be credible and challenged.

EBITDA and loan documentation transparency

Measure 4 **EBITDA complexity and opacity**

EBITDA definitions should avoid unnecessary complexity. Pro-forma EBITDA adjustments based on future synergies, earnings and asset disposals should be made on a reasonable basis and borrowers are encouraged to provide clear justifications of these adjustments to investors. Borrowers are encouraged to subject forecasted cost savings and synergies to prudent time horizons and caps.

Underwriting entities are encouraged to subject all EBITDA adjustments to independent review by an appropriate second line control function as part of the underwriting process with periodic back-testing thereafter.

Measure 5 **Transparency on covenants' limitations**

It is good practice for material covenants and associated terms contained in term sheets and loan documentation to be written and presented in a clear, concise and effective manner that can be readily understood by the contracting parties, including under what circumstances covenants can be triggered.

Where relevant, industry participants are encouraged to consider best practice guidance for transparency when drafting key marketing materials (e.g., term sheets). It is good practice for borrowers and underwriting entities to provide marketing materials that clearly disclose key terms that could materially impact a borrower's credit risk, including terms that could result in subordination, structural or otherwise, of lenders. In this regard, it is considered good practice to provide clear disclosures of the quantity of incremental debt and associated baskets that can be raised and the ability to move assets beyond the reach of the lender group.

Detailed disclosures of key risks including documentation risk, through a risk factors disclosure, could be provided in a loan document.

Strengthening alignment of interest from loan origination to end investors

Measure 6 **Transparency and fairness during underwriting and syndication**

Underwriting entities are encouraged to:

- provide sufficient and clear information to investors early in the syndication process with the aim of achieving a fair and efficient market in which investors have sufficient time and a fair opportunity to negotiate and to make well-informed investment decisions.

- review the full loan documentation thoroughly before signing the commitment letter and engage in negotiation so that they are satisfied that the risk posed by a failed syndication is within their risk appetite.
- provide anonymised feedback on investors' documentation points to all investors in a transparent way.
- highlight to investors new flexibilities built into loan documentation as well as those which have previously faced opposition from the investor base.

Measure 7 **Alignment of interest between underwriting entities and investors**

Underwriting entities are encouraged to demonstrate how they have aligned their interests with LL investors, through risk retention or other means. Implementation of robust risk management of leveraged lending activities can strengthen alignment of interests as well as prevent the build-up of systemic risks. Underwriting entities and LL investors are encouraged to obtain independent and impartial legal advice which represents their interests and strengthens their ability to negotiate loan terms and influence market evolution.

Addressing interests of different market participants throughout the intermediation chain

Measure 8 **Reducing restrictions on transferability of loans**

Transferability of loans within a pool of potential investors should be as broad as possible to support a liquid secondary market. It is considered good practice that where lists of approved and disqualified lenders are used, they should only be created based on clear and documented reasons. It is expected that investors be provided with transparency early in the syndication process on transferability restrictions and how these might evolve during the life of the loan. investors are provided with sufficient clarity on the precise definition of an event of default, which will cause limitations on transferability to no longer apply.

Measure 9 **Managing conflicts of interest where PE sponsors also act as lenders**

Conflicts of interest which can arise from a group's investments in different parts of a borrower's capital structure, should be appropriately identified and managed. It is expected that participants in a syndication and LL investors be properly informed of the instances where a group is acquiring the debt of a borrower while also acting as the borrower's sponsor or holding other classes of debt of that borrower. In such cases, the use of a sponsor disenfranchisement clause or similar clause is encouraged.

Measure 10 **Managing conflicts of interest in management of CLOs**

Potential conflicts of interest in the management of CLOs should be appropriately identified and managed.

It is expected that policies governing the purchase of distressed assets, cross-sales and trading / valuation of CCC/Caa rated loans and the related policies be clearly set out in a CLO indenture to enable investors to make an informed investment decision. It is considered good practice that trustee reports regularly disclose the trading activity and valuation of assets of a CLO to enhance transparency to investors.

It is considered good practice that investors are provided with sufficient opportunity to conduct due diligence on the valuation methodology and results produced by the CLO manager and assess the strategy and rationale for management of assets when performance tests are at risk of being breached.

Disclosure of information on an ongoing basis

Measure 11 **Disclosure in CLOs**

CLO investors should be provided with all materially relevant information on the valuation, credit quality and performance of the portfolio of a CLO, consistent with jurisdictional regulatory requirements. It is expected that such data is made available on a regular basis (e.g., monthly) to CLO investors in order for them to make an informed judgement of their investment decisions and that potential CLO investors be provided access to such information upon request.

Measure 12 **Disclosure on underlying loans**

LL borrowers are encouraged to provide their investors on a timely basis with their latest financial information and status, for example, the audited financial statements, periodic management financial information and financial forecast and budget in relation to its business plan. LL borrowers are also encouraged to inform their investors within a reasonable timeframe of occurrence of any events that may invalidate any assumptions originally applied in the EBITDA addbacks (including any activities that are outside the normal course of business) and potential implications and impact on the projected EBITDA.

Appendix 2: List of consultation questions

Origination and refinancing based on sound business premise

Measure 1 **Debt repayment capacity test**

Question 1

- Would a consistent debt sustainability disclosure within the term sheet based on the borrowers' base case cash flow modelled projections assist investors during the negotiation and investor assessment phase? Should this debt repayment capacity test disclosure be based on 2 measures: both total committed and total funded debt?

Question 2

- Should there be a further debt repayment capacity test based on permissible incremental debt and if so, should incremental cash flow generated from the incremental debt (if applicable as some incremental debt is used to pay out a dividend) also be included?

Question 3

- To what extent should debt repayment capacity be linked to a financial covenant in a loan document and how should this be constructed? Does a debt service ratio covenant need to be reintroduced into loan documentation or adapted to measure debt repayment capacity test?

Measure 2 **Dividend Recaps**

Question 4

- Should limitations be placed on the ability to effect debt-financed dividend recapitalisations e.g., based on minimum equity, total leverage, debt repayment test?

Question 5

- Should dividend recapitalisations only be permitted based on an initial origination or full debt refinancing (and not be permitted using incremental facilities in which all existing loan investors may not wish to participate)?

Measure 3 **Enterprise Values (EVs)**

Question 6

- Would a clearer disclosure of the arranging banks' calculation of the borrower's EV, including high level methodology (i.e., Discounted Cash Flows / Income Method, Asset Valuation, Market Based etc.) and key underlying assumptions (i.e., EBITDA adjustment and total debt) assist investors to make more informed decisions?

Question 7

- Should EV to EBITDA multiples be highlighted in term sheets and on which basis of EBITDA i.e., proforma, adjusted, historic or forward looking?

Question 8

- Do you agree that the basis for EVs should be under-pinned by multi-year forecast cashflows and not simply based only on multiples of EBITDA comparable in other acquisitions or buyouts?

EBITDA and loan documentation transparency

Measure 4 **EBITDA complexity and opacity**

Question 9

- What key disclosures would assist market participants to come to a more accurate view of pro-forma EBITDA and projected leverage (e.g., what key assumptions should be disclosed in relation to pro-forma adjustments, should there be a disclosure of a more prudent pro-forma adjusted EBITDA with the exclusion of synergies and costs savings)?

Question 10

- Is a 25% cap based trailing EBITDA or previous year EBITDA an appropriate cap for add-backs based on cost savings and synergies?

Question 11

- Is 24-months an appropriate threshold for the exclusion of add-backs based on cost savings and synergies?

Measure 5 **Transparency on covenants' limitations**

Question 12

- Would a disclosure of the calculation of the marketed leverage ratio assist investors in analysing borrower credit risk?

Question 13

- Do you agree with the Measure 5 good practice, and what are the other key term-sheet disclosures that would enhance investor analysis of borrower credit risk?

Strengthening alignment of interest from loan origination to end investors

Measure 6 **Transparency and fairness during underwriting and syndication**

Question 14

- Do you agree with the proposed good practices outlined in Measure 6 regarding circulation of a comprehensive term sheet no less than 48 hours before the bank meeting?

Question 15

- Do you agree with the proposed good practices regarding time for underwriting entities (minimum 2 weeks) and investors (minimum 5 days) to review the full loan documentation?

Question 16

- What other good practices have been or could be put in place to provide transparency and fairness to investors during underwriting and syndication?

Measure 7 **Alignment of interest between underwriting entities and investors**

Question 17

- Do the considerations as set out above accurately reflect the key issues regarding alignment of interests between the underwriting banks and investors?

Question 18

- Do you agree with the measures proposed to help strengthen the alignment of interest between underwriting entities and investors?

Question 19

- What other good practices have been or could be put in place to strengthen risk management of leveraged lending activities by underwriting entities?

Question 20

- Do the considerations as set out above accurately reflect the key issues regarding the practice of designated counsel being chosen by the sponsor?

Addressing interests of different market participants throughout the intermediation

Measure 8 **Reducing restrictions on transferability of loans**

Question 21

- Do the considerations as set out above accurately reflect the issues surrounding transfer provisions in the LL market?

Question 22

- Do you agree with the proposed good practice to ease restrictions on the transferability of LLs to support liquidity in the secondary market? Is there a justification for transferability to be more limited in the LL market as compared to the HY bond market?

Measure 9 **Managing conflicts of interest where PE sponsors also act as lenders**

Question 23

- Do you agree with the proposed good practice to mitigate conflicts of interest which may arise from PE groups investing in the debt and equity of the same borrower?

Question 24

- What other good practices have been or could be put in place to help manage conflicts of interest arising for the reason described here?

Measure 10 **Managing conflicts of interest in management of CLOs**

Question 25

- Have the considerations above captured the key considerations regarding potential conflicts of interest which may arise between the CLO manager and the CLO investors?

Question 26

- Do you agree with the proposed good practices? What other good practices have been or could be put in place to help manage such conflicts of interest?

Disclosure of information on an ongoing basis

Measure 11 **Disclosure in CLOs**

Question 27

- Have the above factors captured the necessary information that are important considerations to investors for their CLO investment decision and evaluation of CLO managers' performance?

Question 28

- What additional good practices in disclosure can be put in place to help investors better understand and evaluate their CLO investments?

Measure 12 **Disclosure on underlying loans**

Question 29

- Have the above practices captured the necessary information that are important considerations for investors to evaluate the on-going financial performance of LL borrowers?

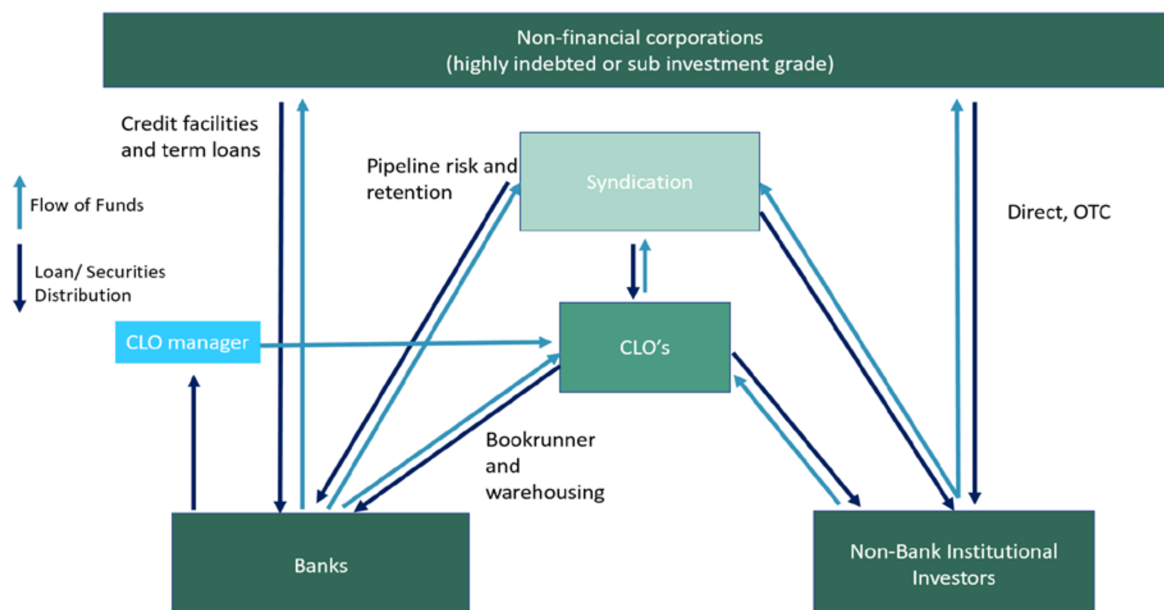
Question 30

- What additional good practices in disclosure can be put in place to help investors better understand the financial position and status of LL borrowers?

Appendix 3: Key market participants in LL and CLO markets

Figure 1 shows the interconnection between the LL and CLO markets.

Figure 1 – LL and CLO ecosystem



Source: Financial Stability Board & Shohini Kundu[102]

PE sponsors

Many leveraged companies are controlled by one or more private equity (PE) firms, or a fund managed by a PE firm.[103] A large part of the LLs are issued by corporate borrowers as a result of LBOs, and M&A activity more generally. An LBO is a type of acquisition whereby the cost of buying a company is financed primarily with borrowed funds. LBOs are often executed by PE firms which in addition to injecting equity into the company, raise funds by leveraging the company, i.e., having the company borrow through a LL. As such, a large proportion of broadly syndicated LLs are backed by a PE sponsor.

[102] Shohini Kundu (2021). "The Anatomy of Collateralized Loan Obligations: On the Origins of Covenants and Contract Design"

Pipeline risks - Banks may be left holding unsold leveraged loans (pipeline exposure) for long periods after a transaction's closing if investor interest in those loans dries up. This will not only increase the risk of their loan books, but also deplete part of their liquidity buffer to finance unsold loans.

Bookrunning warehousing risk - Banks may face delays in repayment on warehouse facilities extended to CLO issuers and may ultimately be forced to absorb loans residing in such facilities.

[103] "Many leveraged companies are owned by one or more private equity firms. These firms, such as Blackstone, KKR, or Carlyle Group, invest in companies that have leveraged capital structures. To the extent that the sponsor group has a strong following among loan investors, a loan will be easier to syndicate, and can therefore be priced lower."- S&P (2019) "Leveraged Commentary& Data (LCD): Leveraged Loan Primer"

Bank lenders/bank arrangers

Banks play various roles in the underwriting of LLs. One or a small number of banks arrange, lead the issuance of a LL, and then syndicate it to institutional investors such as CLOs, insurance companies and financial institutions. Together they play different roles in the syndication process such as administrative agent, syndication agent, documentation agent, agent, co-agent or managing agent, and lead arranger or bookrunner. Banks earn fees for arranging, underwriting and syndicating the LLs.

Banks also provide structuring and distribution services to CLO managers as well as financing the underlying loans during the warehouse period. They may also act as the initial purchaser of the notes and often serve as market makers in the CLO secondary market.

CLO managers

CLO managers purchase the LLs on behalf of the CLO SPV and actively manage the LLs on behalf of the CLO investors. They are responsible for meeting the CLO's portfolio tests which are designed to protect the senior noteholders. CLO managers are often regulated firms, especially where their investments comprise securities, though their regulatory status varies across jurisdictions.

Over the last decade, the number of CLO managers entering the market has increased and in 2021 around 135 managers have managed a CLO transaction.[104] According to Fitch Ratings' data, the largest 30 managers represented 60% of all CLO issuance. Many of the managers are affiliated with PE firms or investment banks.[105]

CLO investors

A wide range of financial institutions invest in CLOs. The IMF reports that 37% of CLO investors are banks, 17% are insurers, 10% are pension funds, 9% are mutual funds, 6% are hedge funds, 5% are CLO managers, and 15% are not identifiable as a group. In the US, banks primarily invest in AAA tranches, whereas insurance companies and asset managers invest across the capital structure and are most exposed to riskier tranches of CLOs.[106]

There are different reasons why investors are attracted by CLOs. One of the main drivers is that CLOs offer exposure to a diversified portfolio of loans with higher yield offerings relative to other financial products, while being perceived as more resilient, given historically low default rates.

Credit rating agencies (CRAs)

CRAs rate both the underlying LLs and the CLO notes. Most CLO notes, with the exception of the equity tranche, are rated by one or two agencies. CRAs monitor CLO performance over its lifetime and may, correspondingly, upgrade or downgrade the rating of notes. With respect to LLs, ratings are particularly important to measure the quality and concentration limits of the CLO.

104 *Based up data collected from: BofA Global Research, Bloomberg, S&P LCD, Intex, Markit*

105 See Fitch: *The Anatomy of Collateralized Loan Obligations: On the Origins of Covenants and Contract Design*

106 IMF (2020): Global Financial Stability Report, April 2020: Markets in the time of COVID-19