RegCORE Client Alert

Financial Services: ECB-SSM publishes its supervisory expectations on use of leverage and high-levels of risk taking in the context of risk appetite frameworks

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Back in the supervisory spotlight – old weaknesses face new risks

The adverse effects posted by excessive use of both credit and financial instrument leverage were thrust into the spotlight during the 2008 global financial crisis. Financial services reforms that have been advanced by both global and EU policymakers since then have successively sought to make sure governance, risk management and systems and controls are robust. The European Central Bank (**ECB**), acting in its role at the head of the Banking Union's Single Supervisory Mechanism (**SSM**) has, at the end of March 2022, published two statements reminding financial services firms of the need to not lose sight of these principles and set out its supervisory expectations. This concerns specifically leveraged lending and prime brokerage activity – in particular when coupled with inadequate risk management.

The ECB-SSM has done this both in the form of a "Dear CEO" letter[1], dated 28 March 2022, addressed to Banking Union supervised institutions (**BUSI**s) setting out supervisory expectations (although exclusively on leveraged transactions as opposed to prime brokerage activity) as well as in a comparably rarer used form, a public opinion piece together with the UK's Bank of England as a "joint warning".[2]

In both publications, as reviewed in this Client Alert, the ECB-SSM warns against complacency in compliance with risk appetite frameworks (**RAF**) – this despite BUSIs having weathered the storm of a prolonged pandemic quite well, they are now faced with new risks relating from what the ECB-SSM warns in terms of a "…period of significant economic and geopolitical uncertainty, with inflation challenges" and ultimately slowed economic growth and increasing volatility warranting more vigilance and caution. The ECB-SSM has particularly warned that the deficiencies it has identified at BUSIs are often accentuated by completion risk to transactions, in particular due to delays and/or failures stemming from the closure of primary markets.

[1] Available here

[2] Available here.

Specifically, the ECB-SSM warns that while the global leveraged lending market was largely unscathed by the COVID-19 pandemic, BUSIs should conclude that current high levels of credit leverage and weak loan documentation are prudent. Notably given that with the widespread pandemic-related fiscal and other government sponsored afforded support being provided to the real economy now being in the process of refinanced, run-down or repealed over various different timelines and different financing conditions, what was previously put in place may run into problems. The ECB-SSM is particularly concerned about worsening loan origination, underwriting, syndication and lender protection standards – while this hints at increased supervisory scrutiny of BUSIs compliance with ECB-SSM rules but also those set by the EU and the European Banking Authority, it also hints at more fundamental changes expected of certain firms in respect of RAFs and an improvement of data capture for risk management purposes.

Furthermore, the ECB-SSM has also expressed concern in respect of liquidity runs on prime brokerage businesses, that while welcome measures have been put in place following the previous crises, the failure of (the family office/hedge fund) Archegos in March 2021 highlighted that liquidity risk is exacerbated when coupled with counterparty credit losses, notably when excessive uses of financial instrument leverage are used in a concentrated environment. The ECB-SSM has announced it will focus its efforts in this area through targeted reviews and on-site inspections covering credit risk governance and management including for prime brokerage activity (in particular since it now supervises large broker dealers so called Class 1 IFR/IFD firms).

Key takeaways from the Dear CEO Letter

The ECB-SSM's Dear CEO Letter is addressed to those BUSIs that are categorised as significant credit institutions (**SCI**s) and subject to direct ECB-SSM supervision. The content of the letter focuses on leveraged transactions and SCI's RAF generally as well as specific principles that they are expected to have in place in accordance with the ECB-SSM's 2017 Guidance on Leveraged Transactions[3] in the form of a more tailored RAF. This Guidance, while not setting quantitative limits, did however define what are "High Leveraged Transactions" (**HLT**s) i.e., those where the total debt is more than 6.0 times EBITDA at the time of the deal's origination.

The ECB-SSM's Joint Supervisory Teams (**JST**s) have been closely monitoring BUSI's practices on leveraged finance transactions since the new guidance entered into force in 2017. In November 2018 BUSIs were required to provide an internal assessment of how that guidance was put in place and the ECB-SSM began collecting quarterly data from originally the 18 and now 28 most actively supervised BUSIs to monitor their loan underwriting activity and the quality of newly originated loans.[4] A multi-annual programme of on-site inspections launched in January 2019 and will, now that the ECB-SSM is looking beyond the pandemic and to new risks, including worsening economic outlook and adverse impact on EBITDA, possibly pick up pace further.

In the strongest warning yet, the Dear CEO Letter on page 4 of 21 states that, in light of the risks from leveraged finance and HLTs:

> "…the ECB expects [SCIs] to reduce HLT origination as a share of total origination to low levels consistent with the prudent risk management described in the ECB Guidance, and it expects that lower level of HLT origination to be reflected in a decline in HLTs' share of the [leveraged transactions] hold book, thereby substantially reducing HLT concentration risk over time. Annex 1 provides more details regarding the sound risk identification and management practices that the ECB expects to see in banks' [leveraged transactions'] RAFs, while Annex 2 sets out the ECB's expectations as regards the recognition and management of market risk arising from underwriting and syndication activities."

[3] Available here.

[4] The Dear CEO Letter notes that from the quarterly "Leveraged Finance Dashboard" the aggregate leveraged loan exposures in the books rose by 80% between the first quarter of 2018 and third quarter of 2021 i.e., from less than EUR 300 billion to around EUR 500 billion. What the ECB did not report on but what stands reason is that such increase also was most likely reflected in related hedged amounts and thus overall risk in leveraged loan exposure and hedged amounts vis-à-vis borrowers but also funding channels of BUSIs. Over the last few years, and particularly in 2021, the Letter notes that "…highly leveraged transactions (HLTs) - have accounted for a very significant percentage of these increases. On aggregate, HLTs accounted for around half of all new leveraged transaction volumes originated in 2019 and 2020, with that figure rising to more than 60% in the first and second quarters of 2021." The Letter goes on to state "While that is not necessarily reflective of developments at each of the SIs for which the ECB collects supervisory data, the aggregate increase is in line with the 70% rise in the notional of the main European leveraged loan indices over the same period and is material in both absolute and relative terms. In less than four years, reporting SIs have, on aggregate, increased leveraged loan exposures in their hold books from around 40% of CET1 capital to close to 60%."

> "The ECB intends to actively follow up on all aspects of this letter using a wide range of supervisory tools. Failure to remedy these deficiencies will be addressed using all available supervisory tools - including, where relevant, increases in Pillar 2 requirements in the context of the annual SREP process.
>
> Your institution's management body should, in its supervisory function, discuss the contents of this letter."

Consequently, affected SCIs are expected to document discussion and remedial actions stemming from the Dear CEO Letter, including at Board Level, an aspect that the JSTs will be able to review and opine on as part of their on-going supervisory engagement.

Outlook

Aside from BUSIs needing to now act, it is conceivable that the ECB-SSM will, following its completion of targeted reviews and on-site inspections, publish an update to the 2017 Guidance on Leveraged Transactions and complement this by a further supervisory "Guidance" document as it relates to prime brokerage risks. It cannot be ruled out that the definition of HLT may change and/or that other quantitative measures are introduced – Annex 1 of the Dear CEO Letter, sets supervisory expectations on limit levels that should be set in group-wide as well as leveraged transaction specific RAFs including in terms of overall concentration risk management (as a minimum on geography, industry and single name metrics) basis as well as with respect to other transactions that, due to fallen angel risk (see our standalone Thought Leadership on this) can, according to the ECB-SSM "eventually qualify as [leveraged transactions] or as HLTs." The ECB-SSM has also expressed its supervisory expectations on how SCIs should deal with completion risk including with respect to limits and corresponding remedial actions to improve underwriting activities.

In a wider-reaching context the ECB-SSM is expected, as already announced as part of its multi-annual supervisory priorities through to 2024, to continue both thematic reviews and on-site inspections with respect to loan origination standards but also treatment and work outs of non-performing exposures in line with its own rules on the subject as well as those from the European Supervisory Authorities, the EU more generally and ultimately at the national level. An area that has consistently been raised, even prior to the Dear CEO Letter (and this is reiterated therein) is the consistent implementation of the ECB's definition requirements across business units, internal stress testing frameworks to address direct and indirect risks, and underlying management information reports which often rely too much on manual treatments.

In particular, compliance with quantitative supervisory expectations shows room for improvement and the Dear CEO Letter shows that the ECB-SSM's patience is earing worryingly thin in light of BUSIs having insufficiently developed RAFs for leveraged transactions and that these "…do not adequately capture and limit the multiple risks posed…" by them. This is particularly echoed by concerns that the origination of HLTs remains very high with the strength of the HLT risk management often not commensurate with the considerable risks incurred notably but not limited to concentration risks.

Lastly, as expected national competent authorities (**NCA**s), both in the Banking Union and the wider EU-27 may themselves conduct their own efforts with a similar degree of supervisory scrutiny with respect to SCIs but also to the wider set of BUSIs that they directly supervise, and which are only subject to oversight by the ECB-SSM. The same is true in the context of such efforts being applied to non-BUSI financial services firms more broadly by both EU-level authorities but also NCAs.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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