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IOSCO Consults on Good Practices for Leveraged Loans and CLOs

By **Alix Prentice**
Partner | Financial Regulation

The International Organisation of Securities Commissions, or IOSCO, has published a Consultation Report on good practices for consideration in relation to leveraged loans and CLOs.

Background

Against a backdrop of low default rates, Leveraged Loan ("LL") and Collateralised Loan Obligation ("CLO") markets have evolved significantly since the Great Financial Crisis, both in terms of growth and in terms of borrower and investor base. This growth and a shift in market participants from banks to non-banks has led IOSCO to focus on what it sees as a rise in covenant-lite LLs using 'overly optimistic' EBITDA adjustments in increasingly complex documentation that potentially works to the detriment of LL investors. After extensive engagement with market participants, credit rating agencies and other professionals on the impact of fewer and looser covenants on investor protection, the adequacy of current transparency standards in the LL and CLO markets and other conduct issues, IOSCO is setting out 12 proposed good practices grouped into five themes spanning the intermediation chain from LL origination to sale of CLOs.

IOSCO Good Practices

Theme A – origination and refinancing based on a sound business premise:

- Measure 1 – debt repayment capacity test: this should be underpinned by sound business and financial risk assumptions and borrowers should be able to demonstrate sufficient debt repayment capacity (the ability to repay 100% of senior debt or 50% of total debt over the medium term).

- Measure 2 – dividend recaps: dividend recapitalisations should be considered by reference to remaining equity support, degree of leverage and debt repayment capacity and the use of incremental debt should be limited.

- Measure 3 – enterprise values (“EV”): EV’s should be based on ‘well-constructed’ financial models with disclosure of key assumptions and independent review and validation.

Theme B – EBITDA and Loan documentation transparency:

- Measure 4 – EBITDA complexity and transparency: EBITDA definitions should not be unnecessarily complex and adjustments should be made on a reasonable and justified basis.

- Measure 5 – transparency on covenants’ limitations: clear, concise and effective documentation on covenants’ with full disclosure of key terms that could materially impact a borrower’s credit risk.

Theme C – strengthening alignment of interest from loan origination to end investors:

- Measure 6 – transparency and fairness during underwriting and syndication: sufficient, clear information to allow well-informed investment decisions.

- Measure 7 – alignment of interest between underwriting entities and investors: whether through risk retention or other means. Underwriting entities and LL investors are “encouraged to obtain independent and impartial legal advice which represents their interests”.

Theme D – addressing interests of different market participants throughout the intermediation chain:

- Measure 8 – reducing restrictions on transferability of loans: broad transferability and transparency of any restrictions are encouraged.

- Measure 9 – managing conflicts of interest where PE sponsors also act as lenders: conflicts management and disclosure are key here.

- Measure 10 – managing conflicts of interest in management of CLOs: the use of indentures and the provision of sufficient opportunity to do due diligence on valuation methodologies and results are emphasised alongside the identification and management of conflicts.

Theme E – disclosure of information on an ongoing basis:

- Measure 11 – disclosure in CLOs: regular provision of all materially relevant information on valuation, credit quality and performance of the CLO portfolio should be made according to local regulatory requirements.

- Measure 12 – disclosure on underlying loans: this should be timely, up to date and include any events that may invalidate affect any assumptions or impacts.

Final Thoughts

The draft of IOSCO good practices is intended for the “consideration of market participants” and are not standards or recommendations. Responses to the consultation and the questions it raises are due by 15 December 2023.