Summary: Leveraged Loans and CLOs: Good Practices for Consideration

Overview

This summary provides an overview of the 'Leveraged Loans and CLOs: Good Practices for Consideration' report by The International Organization of Securities Commissions. The report delves into the intricacies of the leveraged loan and collateralized loan obligation markets, examining their growth, the shift in market practices, and the potential risks and vulnerabilities that have emerged. It presents a series of good practices for market participants, which, while not constituting formal standards or recommendations, aim to enhance market functioning and align with the objectives of investor protection, fair and efficient markets, and systemic risk reduction.

Section 1: Introduction

Section 1.1: Mandate from IOSCO Board

Section 1.1.1: Original mandate

The IOSCO Board, recognizing the significant growth and evolution of the leveraged loan (LL) and collateralized loan obligation (CLO) markets since the Global Financial Crisis, mandated a review in March 2020 to address potential conduct-related issues in these markets. This review, aimed at safeguarding IOSCO's objectives of investor protection, market fairness, efficiency, transparency, and systemic risk reduction, was delegated to a working group formed by experts from IOSCO's Committee 3 on Regulation of Market Intermediaries and Committee 5 on Investment Management. The working group's task was to examine the intermediation chains and origination practices within the LL and CLO markets, focusing on the transmission of risk from LL origination to the sale of CLOs. Key areas for analysis included the effects of diminishing and more lenient covenants on investor protections, the adequacy of market transparency, and the emergence of potential conduct-related issues due to recent market developments.

Section 1.1.2: Phase 1 - Exploratory Analysis

In 2021, the Working Group (WG) conducted an exploratory analysis of the leveraged loan (LL) and collateralized loan obligation (CLO) markets, culminating in a report to the IOSCO board in March 2022. The analysis, which included surveys, industry roundtables, and academic research, identified several potential vulnerabilities. Key concerns included the growing proportion of lower-rated borrowers in the LL market, which could lead to an increased risk of default, particularly in light of recent monetary policy changes. The report also pointed to a rise in the risk of loss given default due to a shift towards more borrower-friendly loan contract terms, such as covenant-lite loans.

Additionally, the report noted that certain market practices and participant behaviors could exacerbate these vulnerabilities. For example, aggressive EBITDA adjustments and lenient contract clauses could provide undue flexibility to private equity sponsors and corporate borrowers at the expense of LL investors. Concerns were also raised about the potential misalignment of interests between bank lenders and LL investors, which could skew negotiating power in favor of borrowers. Lastly, the report highlighted that some CLO managers might prioritize maximizing return on equity over protecting debt investors during stressful periods.

Section 1.1.3: Development of a Consultation Report on Good Practices

Following the exploratory analysis in Phase 1, the IOSCO Board sanctioned a second phase in June 2022, directing the Working Group (WG) to create a public consultation report. This report would outline "good practices" for stakeholders in the leveraged loan (LL) and collateralized loan obligation (CLO) markets to mitigate identified vulnerabilities. The initial focus areas included the proper use of EBITDA add-backs, conflict of interest management, enhanced disclosure of key financial terms in LL contracts, and improved ongoing financial information disclosure to investors.

To supplement the initial findings, the WG initiated a second outreach program. This involved reviewing existing regulatory guidance, engaging with regulators and trade bodies on LL term sheet completeness, and conducting industry roundtables with various market participants. These roundtables were instrumental in gathering feedback on potential good practices.

The current report encapsulates the findings and outcomes of this second phase, providing a comprehensive overview of the LL and CLO markets. It describes LLs as loans offered to highly indebted, non-investment grade corporate borrowers outside the financial sector.

Section 1.2: Markets overview of LL and CLO markets

Section 1.2.1: LL Markets

Leveraged loans (LLs) are typically extended to highly indebted, non-investment grade corporate borrowers, often to finance mergers and acquisitions, leveraged buyouts, capital distributions, refinancing of existing loans, or for general corporate purposes. These loans are usually secured by the borrower's assets and carry a floating interest rate. The debt structure of LLs often includes a revolving credit facility with traditional financial covenants and a Term Loan B with bullet repayment terms. Less commonly, a Term Loan A may be included. Banks usually retain the revolving credit and Term Loan A on their balance sheets, while distributing Term Loan B to institutional investors such as CLOs, insurance companies, and other banks. The market for LLs has seen a shift from broadly syndicated loans, which are underwritten by banks and distributed among various investors, to private credit, where loans are made directly by private or public funds without bank intermediation. The lack of a standardized definition for LLs results in varying market estimates and characteristics, even within the same jurisdiction.

Section 1.2.2: CLO markets

The global leveraged loan (LL) market was valued at approximately $4.7 trillion at the end of 2023, with collateralized loan obligations (CLOs) being a significant securitization vehicle within this market. CLOs involve the purchase of LL assets by a special purpose vehicle (SPV), which finances the portfolio through tranched bonds that cater to various investor risk appetites. Payments from the underlying loans are distributed according to a predetermined "waterfall" structure, with senior investors receiving priority. Managed by CLO managers, these structures are governed by contractual rules ensuring minimum credit quality and include performance tests to protect senior noteholders.

Leveraged loans, often secured with a first lien and featuring floating interest rates, contrast with high-yield bonds, which are typically unsecured and subordinate within a borrower's capital structure. CLOs have gained popularity among institutional investors due to their higher returns and market resilience, with the global CLO market reaching around $1.2 trillion by the end of 2023. In the U.S., CLOs accounted for nearly 70% of all institutional LL purchases that year.

The LL and CLO markets involve a range of participants, including private equity sponsors, bank lenders/arrangers, CLO managers, investors, and credit rating agencies (CRAs). The markets have experienced growth, with the LL market nearing record highs.

Section 1.3: Market Developments

Section 1.3.1: Growth in the LL and CLO markets

The global leveraged loan (LL) market has reached approximately $4.7 trillion, nearing record highs, with the U.S. market expanding by almost 130% since the Global Financial Crisis (GFC), outpacing GDP growth. Similarly, the European market has seen significant growth, with other regions also experiencing expansion in their LL markets. The collateralized loan obligation (CLO) market has more than doubled since 2010, growing alongside the LL market. This growth has been fueled by a combination of economic expansion post-GFC and a prolonged period of low interest rates up until 2022.

Low interest rates have prompted institutional investors to seek higher yields, leading to increased demand for riskier investments and enabling higher corporate leverage. Additionally, easy monetary policies have provided liquidity that private equity firms have used to bolster mergers and acquisitions, further driving demand for LLs. LLs and CLOs, as floating rate instruments, have been particularly appealing in a rising interest rate environment. The year 2021 marked a peak in new LL and CLO issuances. However, the onset of higher borrowing costs and growing recession concerns since early 2022 have led to a notable decline in issuance volumes.

Despite the growth of these markets, there have been 59 defaults across over 17,800 CLO tranches rated by S&P since 2010, indicating some level of risk within the market.

Section 1.3.2: Evolution of the type of LL borrowers

The leveraged loan (LL) market has seen a shift in borrower profiles, with an increase in the number of borrowers that are generally smaller in size. The credit quality of these corporate borrowers has declined, as evidenced by a greater proportion falling into the B/B- rating categories compared to the BB-rated category. Specifically, the percentage of the US LL index rated BB has dropped from 49% to 22%, while the B-rated segment has expanded from approximately 30% to over 61%. Additionally, there has been a sectoral shift among these borrowers, moving away from traditional industrial sectors towards technology, software, and healthcare sectors. These newer sectors tend to offer higher returns but provide less tangible collateral.

Section 1.3.3: Evolution of the LL investor base

Since the Global Financial Crisis (GFC), banks have shifted their business models due to prudential constraints and tighter capital allocation, focusing on underwriting leveraged loans (LLs) and distributing them to institutional investors while retaining less risky and less capital-intensive revolving credit facilities (RCF) and short-term amortising loans (TLA) on their balance sheets. This shift has raised concerns about the alignment of interests between banks and non-bank investors during contract negotiations. Collateralized loan obligations (CLOs) have become the predominant investors in the broadly-syndicated LL market, and the presence of credit funds in direct lending has expanded, catering to borrowers who prioritize swift transaction execution. The investor base's growth has increased the demand for non-amortising bullet loans (TLB), which offer higher yields over extended periods. The diversification of the investor base appears to have enhanced the liquidity of the LL secondary market but has also diluted the individual negotiating power of investors regarding the terms of LLs.

Section 1.3.4: LLs emulating High Yield Bonds

Leveraged loan (LL) borrowers, particularly those with private equity sponsorship, have been structuring their loans to resemble high yield bonds, capitalizing on strong market demand and a favorable credit environment. These loans are increasingly featuring weaker covenants, bullet maturities, and less collateral, moving away from traditional structures where LLs were supported by a layer of subordinated high yield debt. This shift towards 'loan-only' issuances has been noted by S&P Global Ratings and LCD, part of Pitchbook, as a dilution of first-lien credit quality. Moody's research from August 2018, which was still relevant according to IOSCO roundtables, suggests that this convergence of loan and bond characteristics could lead to poorer recovery rates in future downturns.

Section 1.3.5: Erosion of lender protections and the rise in covenant-lite LLs

The prevalence of covenant-lite loans in the leveraged loan (LL) market has significantly increased, constituting 90% of the market share, a stark rise from 1% in 2000. These loans typically offer fewer protections for lenders, such as relaxed financial ratio constraints and limited restrictions on borrowers' actions, including the transfer of collateral and the prioritization of debt repayment. While these loans provide borrowers with greater flexibility to manage financial stress, as observed during the COVID-19 pandemic, they also pose risks to lenders by potentially reducing the assets available for recovery in the event of default and complicating covenant negotiations due to a diversified investor base. The shift from bank-dominated LL investor bases to institutional investors, such as CLOs and hedge funds, mirrors the investor base for high-yield bonds and is a key factor in the rise of covenant-lite loans. This shift has been driven by the search for yield in a low-interest-rate environment and has resulted in a market dynamic that favors borrowers over lenders.

Section 1.3.6: Complexity of LL Documentation

The leveraged loan market is characterized by highly customized documentation, with each transaction featuring unique investor protection measures. These include covenant packages and leverage/EBITDA calculations, which are disclosed within the loan documents. However, the complexity and length of these documents have been increasing, leading to concerns about the clarity of their drafting. Market participants have noted that while stronger credits can negotiate more flexible terms, these terms may set precedents for other borrowers. Additionally, the lack of standardization in loan documentation poses challenges for investors when comparing deals and for lenders in identifying clauses that could potentially weaken their protections.

Section 1.3.7: Higher Leverage Raised to Fund Buyout Valuations

Purchase price to EBITDA multiples for buyouts have increased, reaching 11-12x in 2022, driven by low interest rates and strong market demand. Consequently, debt levels have risen, often exceeding 6x total debt to EBITDA, indicating highly leveraged transactions. These elevated leverage levels carry additional financial risk, exacerbated by aggressive EBITDA assumptions and the ability to incur more debt through covenant-lite deals. A shift towards higher interest rates could lead to a reevaluation of these buyout valuations, as evidenced by recent significant valuation corrections in the private equity sector, particularly within venture capital.

Section 1.3.8: Increased use of EBITDA adjustments

The section discusses the increasing trend of EBITDA adjustments in the context of leveraged loans and private equity buyouts. It notes that these adjustments, which account for expected synergies or operational

improvements, are often factored into EBITDA calculations to comply with incurrence covenants. However, the reliability of these add-backs is questionable due to their uncertain magnitude and timing, potentially leading to an understatement of the actual debt-to-EBITDA ratios. The section also highlights that incurrence covenants have become more permissive, allowing for a wider range of EBITDA adjustments, estimated to be between 15-30%. Furthermore, it points out that many borrowers have failed to meet their EBITDA and deleveraging projections, suggesting that the real leverage levels may be higher than what is implied by the covenants. This trend is contrasted with historical data, noting that purchase price multiples for US leveraged buyouts (LBOs) peaked in 2022 at 11.9 times before dropping to 10.8 times in 2023, with a pre-GFC peak of 9.7 times in 2007.

Section 1.3.9: Sharp increase in borrowing costs since 2022

Analysis of Standard & Poor's data revealed that borrowers in leveraged loan deals from 2015 to 2019 underestimated their leverage by an average of 2.2 times EBITDA in the first year and 2.9 times in the second. Interest rates have surged across various jurisdictions in 2022 and into the first half of 2023, with central banks raising rates to combat high inflation. This has led to the average yield on US leveraged loans more than doubling from 4.2% at the end of 2021 to over 10% by the end of 2023. The increase in borrowing costs has made refinancing more difficult, particularly for lower-rated borrowers (B- and below), who are most at risk of refinancing challenges. Despite these difficulties, some borrowers have managed to refinance in late 2023 and early 2024, extending maturity dates to 2027 and 2028 due to favorable market conditions and strong secondary market demand. For those unable to refinance, 'amend-and-extend' transactions have been an alternative, allowing them to defer loan maturities through amendments. However, the weakest borrowers may not have this option and could face financial distress and debt restructuring.

The report also discusses the increased credit risk in the leveraged loan market over the past decade, characterized by a trend towards more highly leveraged and lower-rated borrowers. This section sets the stage for the subsequent discussion on good practices for market participants, focusing on origination and refinancing based on sound business premises.

Section 2: Good practices for the consideration of market participants

Section 2.1: Origination and refinancing based on a sound business premise

The leveraged loan (LL) market has seen an increase in credit risk, characterized by a trend towards engaging lower-rated and more highly leveraged borrowers. This risk is exacerbated by a lenient financing environment, diminished emphasis on cash flow and debt repayment abilities, and a growing dependence on refinancing predicated on enterprise value (EV) and EBITDA growth. In certain instances, heightened leverage has been utilized for dividend payments or to reimburse private equity sponsors, which amplifies systemic risk, especially if financing conditions become more challenging. Data indicates that there is approximately $740 billion in LLs set to mature in the US during 2027-2028, which could lead to increased restructuring activity. Sources such as S&P, Bloomberg, and Moody's Investors Service have provided insights into these trends and potential refinancing pressures on lower-rated companies.

Section 2.1.1: Debt repayment capacity

The leveraged loan (LL) market, integral to the leveraged finance (LF) sector, has shown resilience historically, even during the Global Financial Crisis (GFC). However, recent trends towards riskier borrowers, increased leverage, and weaker lender protections have raised regulatory concerns. The investor base has shifted from banks to non-bank institutions, and debt structures now heavily rely on

interest-only or bullet loans, often with the expectation of future refinancing based on business growth and EBITDA increases.

Debt repayment capacity has become less emphasized, with refinancings sometimes serving to facilitate acquisitions, pay dividends, or return capital to private equity (PE) sponsors, rather than reducing debt. Some refinancings, termed "amend-and-extends," resemble debt restructurings, with changes indicating potential cash flow insufficiency for debt servicing.

Market participants have noted that the focus on EBITDA for debt service cover may obscure true financial risk, advocating for cash flow available for debt service (CFADS) as a more accurate measure. Concerns have also been raised about the growth of preferred equity and PIK notes usage, credit rating downgrades, and the entry of less predictable cash flow companies into the LL market.

Good practices proposed include ensuring that leveraged loans in new originations, refinancings, and restructurings are based on sound business and financial risk assumptions, with borrowers demonstrating sufficient debt repayment capacity. Regulatory guidance from entities like the FRB, OCC, FDIC, and ECB suggests a debt repayment test of 5-7 years for assessing adequate repayment capacity. Investors often conduct their own cash flow modeling over a 7-year period, incorporating various scenarios to evaluate debt repayment capacity.

It is recommended that borrowers disclose their ability to repay drawn debt based on projected free cash flows and that documentation includes explicit disclosures about total drawn debt repayment capacity. Transparency in debt repayment capacity is emphasized, focusing on cash generative capacity rather than potentially optimistic EBITDA adjustments.

Section 2.1.2: Measure 2 - Dividend recapitalisations

Lenders are advised to exercise increased diligence when evaluating dividend recapitalizations, particularly in scenarios where borrowers exhibit high leverage. This enhanced scrutiny should be applied when equity constitutes less than 40-50% of the total capital structure, when total committed leverage exceeds 6x, or when there is insufficient evidence of debt repayment capability. An independent function should review such transactions, separate from the origination team. Data from 2021 indicates that in the US broadly syndicated loan market, $82 billion in loans were issued to fund dividend recaps, with over 45% involving borrowers leveraged over 6x. Historical trends show that equity contributions in US leveraged buyouts (LBOs) have varied, with recent years (2015-2020) averaging between 42-47%, and specifically 47% in both 2019 and 2020.

Section 2.1.3: Enterprise Values

Enterprise values (EVs) have risen, with buyout multiples reaching 11-12x EBITDA in 2022, driven by high debt levels, low interest rates, and easy financing conditions. Concerns have been raised about the ability of highly leveraged borrowers to service debt, especially with increased borrowing costs since 2022. The report suggests that EVs should be based on credible financial models and encourages transparency in disclosing the assumptions behind these models. It recommends that EV calculations be reviewed by an independent function and that DCF models should be scrutinized for optimistic assumptions, particularly regarding terminal values. Good practices include disclosing the rationale for EV methodology, applying appropriate discount and growth rates, and considering a right-sizing of debt based on realistic future debt servicing costs. Independent validation of EVs is also encouraged, in line with US Interagency and ECB guidance. The section also touches on the issue of EBITDA adjustments and loan documentation complexity, which can obscure credit risk assessment.

Section 2.2: EBITDA and Loan Documentation Transparency

The increasing use of EBITDA adjustments and the complexity of loan documentation are raising concerns about investors' ability to accurately evaluate credit risk in leveraged loans. Industry discussions have revealed that EBITDA figures presented by borrowers often do not reflect true leverage levels at the outset of a deal due to inappropriate adjustments. The complexity of loan documentation further complicates investors' assessment of lender protections. These trends may challenge the integrity of fair, efficient, and transparent markets and could heighten systemic risk.

Section 2.2.1: EBITDA complexity and opacity

EBITDA, a common metric for assessing a borrower's ability to service debt, lacks strict definitions and is prone to optimistic adjustments, which can obscure the true credit risk of borrowers in the leveraged loan (LL) market. Studies by S&P have shown that a significant majority of borrowers fail to meet their EBITDA and debt reduction projections, with missed EBITDA projections by at least 25% in the first and second years post-inception. These misses are often due to inaccuracies in synergy and cost-saving projections, which are difficult to predict and can constitute a large portion of EBITDA adjustments.

To address these issues, it is recommended that EBITDA definitions avoid unnecessary complexity and that pro-forma adjustments be made on a reasonable basis with clear justifications. Independent reviews of EBITDA adjustments by a second line control function are encouraged, along with periodic back-testing. Regulatory guidance already emphasizes scrutiny of EBITDA calculations, and good practices include setting prudent caps on adjustments, ensuring asset sales are legally contracted, and excluding cost savings or synergies forecast beyond 24 months from pro-forma EBITDA at deal inception.

For disclosures, borrowers should provide detailed reconciliations from net income to marketed EBITDA and regular reports on EBITDA and adjustments. Industry best practice guides, such as the ELFA/LMA best practice guide for loan term sheet completeness, should be utilized to ensure investors have sufficient information for informed decision-making. These practices aim to enhance transparency and market efficiency, supporting more informed and accurate forecasts.

Section 2.2.2: Transparency on Covenant Limitations

The section discusses the trend towards covenant-lite loan structures in the leveraged loan market, which offer borrowers more flexibility but reduce lender protections. Leveraged loans have increasingly adopted features from the high yield bond market, moving away from traditional, more restrictive covenants. In the US, covenant-lite facilities grew from 32% to 90% of the market from 2013 to 2023, and in Europe from 6% to 97%. This shift has been driven by macroeconomic factors, such as prolonged low interest rates and the search for yield, as well as changes in the investor base and origination models.

The section highlights concerns over the ability of borrowers to raise incremental debt, often based on adjusted EBITDA figures that may not accurately reflect leverage and credit risk. It also points out the risks associated with asset stripping techniques like "trap doors" and "up-tiering," which can undermine the position of senior lenders.

The lack of transparency in loan documentation and marketing materials, such as term sheets, is identified as a problem that hinders investors' ability to assess risk and price credit accurately. This opacity, coupled with the dilution of lender protections, could impact future recovery rates and increase systemic risk.

The section recommends good practices for transparency on covenant limitations, urging clear and concise disclosures of material covenants and terms in loan documentation and term sheets. It suggests that

borrowers and sponsors provide detailed information on incremental debt capacity, asset transfer restrictions, and the calculation of financial ratios. Industry best practice guides, such as the ELFA/LMA guide, are recommended for clearer disclosures. Enhanced transparency is seen as critical for investors to effectively analyze transaction risks and challenge terms that weaken lender protections.

Section 2.3: Strengthening alignment of interest from loan origination to end investors

The shift in the leveraged loan (LL) investor base from banks to non-banks has led to a greater emphasis on the 'originate-to-distribute' model, which has resulted in a reduced alignment of interests between intermediary banks and the LL lender syndicate. To address this issue, it is considered good practice for banks to demonstrate alignment with end investors' interests. This can be achieved through robust risk management practices and seeking independent and impartial legal advice. These measures are intended to strengthen the relationship between the originating banks and the final investors, ensuring that the banks' interests are closely tied to the performance and risk management of the loans they distribute.

Section 2.3.1: Transparency and fairness during underwriting and syndication

The section discusses the transparency and fairness issues in the underwriting and syndication process of leveraged buyouts (LBOs). It outlines the steps involved in syndication, from the borrower soliciting bids to the arranging banks preparing an information memorandum (IM) and engaging with credit rating agencies (CRAs) and potential investors. The process includes a book-building phase to determine loan pricing and allocation based on investor demand. The document highlights the variability in when investors receive term sheets and the challenges they face due to late or insufficiently detailed term sheets, which can hinder informed investment decisions. It also addresses the limited negotiation power of individual investors and the lack of transparency in how banks consider investor opposition to certain terms.

The document suggests good practices for underwriting entities, such as providing clear information early in the syndication process, thoroughly reviewing loan documentation before signing the commitment letter, and transparently addressing investors' documentation points. It recommends timely sharing of term sheets and full loan documentation with investors, allowing adequate review time, and avoiding prohibitions on using third-party legal services. The section also touches on the shift from 'Originate-to-retain' to 'Originate-to-distribute' in banking post-Global Financial Crisis (GFC), the implications for the alignment of interests between banks and investors, and the use of designated counsel in Europe, which has raised concerns about independence and potential conflicts of interest.

Section 2.3.2: Alignment of interest between underwriting entities and investors

Underwriting entities are advised to align their interests with leveraged loan (LL) investors by implementing robust risk management practices and negotiating loan terms effectively. This includes obtaining independent legal advice to strengthen their negotiation position and influence market trends. Both US interagency and ECB guidance highlight essential risk management elements for banks' leveraged lending activities, such as a clear definition of leveraged lending, a sound governance structure, accurate management information systems, a well-defined risk appetite and strategy, uniform underwriting standards, independent risk function review, stress-testing, and managing potential conflicts of interest and confidentiality.

Additionally, market participants are encouraged to disclose their credit risk retention practices to demonstrate alignment of interests with investors, including the methodology used, such as retaining the first loss tranche. The complexity of the intermediation chain and the design and distribution of securitized assets in LL and CLO markets can lead to conflicts of interest, which market participants should address to maintain the integrity of these markets.

Section 2.4: Addressing interests of different market participants throughout the intermediation chain

The section discusses the complexities and potential conflicts of interest within the leveraged loan (LL) and collateralized loan obligation (CLO) markets due to the long intermediation chain and intricate design and distribution of securitized assets. Industry roundtables have highlighted concerns about transfer provisions in LLs that may negatively affect secondary market liquidity. To address these issues, it is crucial for market participants to recognize, disclose, and manage conflicts of interest, such as private equity groups investing in multiple debt classes of the same borrower or CLO managers holding specific tranches of a CLO. Additionally, efforts should be made to enhance LL secondary market liquidity by easing transferability restrictions.

Section 2.4.1: Reducing restrictions on transferability of loans

The section discusses the evolution of transferability provisions in leveraged loans (LLs) post-Global Financial Crisis (GFC), highlighting the shift from 'lend to hold' to a more distributed model involving non-bank investors. European LLs often require borrower consent for transfers, with exceptions for affiliates, existing lenders, and during events of default. The US and Asian markets use disqualified lender lists to restrict transfers. These provisions impact liquidity, with industry participants expressing concerns about the use of agreed lists, potential market collusion, and coercion into borrower-friendly terms.

The document notes that restrictions on transferability can limit the pool of potential lenders, affecting secondary market liquidity. It outlines good practices to enhance liquidity, such as providing transparency on transfer restrictions and the rationale behind agreed and disqualified lender lists. It recommends that transfer restrictions be minimized, particularly during events of default, and that any limitations on transferability be clearly defined and documented. The document encourages transparency and the provision of agreed lists early in the syndication process, with an annual update if changes are possible. It suggests avoiding overly expansive definitions that unnecessarily limit the investor pool and recommends a short period for deemed borrower consent to facilitate transactions.

Section 2.4.2: Managing conflicts of interest where PE sponsors also act as lenders

Private equity (PE) groups acting as lenders in leveraged loans (LLs) can lead to conflicts of interest, particularly when they hold different positions within a borrower's capital structure. This can result in issues such as the misuse of voting rights or the mishandling of confidential information. The "sponsor disenfranchisement" clause in the LMA leveraged facilities agreement was designed to mitigate such conflicts by restricting sponsor affiliates from voting on amendments and waivers, attending lender meetings, or receiving lender information. However, the effectiveness of this clause has diminished over time due to a shift towards more borrower-friendly terms, although it is still commonly used with certain exceptions for independently managed debt funds.

Market feedback suggests that sponsors purchasing debt can sometimes benefit the borrower by reducing leverage, especially when loans are available at discounted prices in secondary markets. To manage conflicts of interest effectively, it is recommended that PE groups clearly identify and disclose any conflicts to all participants in the syndication and LL investors. This includes instances where a group acquires debt while also being the borrower's sponsor or holding other debt classes. Disclosures should clarify whether the sponsor affiliated lender is subject to disenfranchisement provisions. The use of the sponsor disenfranchisement clause is advised to manage potential conflicts when PE groups hold both debt and equity of a borrower. In cases where this clause is not used, third-party lenders should be aware of the risks, which vary depending on the sponsor group's share of the total debt commitments.

Section 2.4.3: Managing conflicts of interest in management of CLOs

CLO managers are responsible for purchasing leveraged loans (LLs) from banks and selling CLO tranches to investors, with their regulatory status varying by jurisdiction. They are expected to manage CLOs with care and in good faith, balancing the interests of different investors. Risk retention requirements in some regions mandate CLO managers or original lenders to maintain an economic interest in the CLOs, often through equity tranche exposure, to align their interests with investors. Management fees for CLO managers are structured to incentivize performance that benefits all investors.

Conflicts of interest between equity and debt holders in CLOs are managed through performance tests and metrics, such as overcollateralization (O/C) and interest coverage (I/C) tests, which prioritize senior debt holders when breached. The management of distressed assets and the valuation of loans, particularly CCC/Caa-rated assets, are crucial for maintaining O/C tests and overall CLO performance. The COVID-19 pandemic highlighted differences in CLO managers' approaches, with some appearing to favor equity holders.

Good practices proposed include clear documentation of policies for purchasing distressed assets and managing CCC/Caa-rated loans, regular disclosure of trading activity and asset valuation, and transparency in CLO managers' valuation methodologies. CLO managers should manage potential conflicts of interest, considering their own investment in CLO tranches and the design of management and performance fees. Transparency in trading distressed or CCC/Caa-rated assets and valuation policies is encouraged, with investors given opportunities for due diligence on valuation methods and trading strategies, especially when performance tests are at risk. Regular trustee reports should disclose trading activity, valuation of assets, and rationale for cross-sales between CLOs managed by the same entity.

Section 2.5: Disclosure of Information on an Ongoing Basis

Industry roundtables facilitated by IOSCO highlighted concerns among market participants regarding the lack of ongoing transparency in leveraged loan (LL) deals. Investors pointed out that essential financial and management information, including the evolution of EBITDA and leverage ratios, was not being disclosed in a timely fashion. This ongoing disclosure is crucial for both the lender syndicate and CLO investors, as it enables them to make informed investment decisions. Regular trustee reports are also vital for CLO investors for the same reasons. Addressing these transparency issues is important for maintaining informed investment practices in the LL and CLO markets.

Section 2.5.1: Disclosure in CLOs

CLO investors typically have access to portfolio composition and underlying leveraged loans (LLs) information but lack detailed data on the credit and structure of each LL, relying instead on ratings, structural protections, and CLO manager due diligence. The COVID-19 crisis highlighted the importance of CLO manager skills, as investors engaged more with managers for in-depth portfolio understanding. To enhance informed decision-making, it is recommended that CLO investors receive regular, detailed disclosures on the valuation, credit quality, and performance of the CLO portfolio, including prices, leverage ratios, and debt service coverage. The EU and UK securitisation regulation mandates such disclosures. CLO managers should present information clearly to facilitate assessment and assist Trustees in compiling accurate monthly reports. Timely updates on key performance tests and asset concentration limits are also considered good practice, including overcollateralization and interest coverage ratios, and compliance with CLO document limits. This information should be presented in a manner that aids investors in evaluating CLO manager performance.

Section 2.5.2: Disclosure on Underlying Loans

Investors in leveraged lending have expressed concerns about the declining quality and availability of financial information from borrowers, which affects their ability to assess ongoing performance and financial strategies. This has led to increased reliance on third-party documentation review providers and credit rating agencies (CRAs). To address these issues, borrowers are encouraged to provide timely and regular financial updates, including audited statements, management information, and forecasts. They should also promptly disclose any events that could affect EBITDA projections or debt capacity, and regularly report on incremental debt and associated calculations.

Investors have found it challenging to obtain information on the ongoing performance of leveraged loans due to the private nature of the market. To improve transparency, it is suggested that borrowers inform lenders of any significant events impacting EBITDA addbacks and provide regular updates on debt repayment capacity and EBITDA adjustments, using consistent methodologies. Borrowers should establish communication practices to update lenders on financial positions and deviations from projected EBITDA, share budgeting information, and provide forward-looking estimates and non-financial information upon request.

These practices aim to guide market participants in the leveraged loan and CLO markets, supporting decision-making and market development in line with IOSCO's objectives of investor protection, market fairness, and systemic risk reduction.

Section 3: Conclusion

The concluding section of the report emphasizes that the outlined good practices are meant to guide market participants in the leveraged loan (LL) and collateralized loan obligation (CLO) markets. These practices aim to foster market development and shape participant behavior in a manner that supports the objectives of the International Organization of Securities Commissions (IOSCO). However, it is clarified that the report does not establish formal standards or recommendations according to IOSCO's classification.

Appendix: Feedback Statement on Good Practices for the Leveraged Loan Market

The Appendix, titled "Feedback Statement," summarizes the industry responses to a consultation by IOSCO on a set of 12 good practices related to leveraged loans and CLOs. The feedback, which includes input from trade associations, a regulatory authority, and an individual, was considered in the finalization of the report. The Appendix details the industry's perspectives on proposed measures such as debt repayment capacity assessments, dividend recapitalizations, enterprise value calculations, EBITDA complexity, transparency on covenants, and disclosures in CLOs. It also outlines IOSCO's responses to the feedback, including minor amendments to the measures and broader changes to supporting text, aiming to clarify and enhance the proposed good practices without imposing standardized definitions or overly prescriptive requirements.