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EBF response to the ECB consultation on Draft guidance on leveraged transactions

Key points:

- ◆ EBF acknowledges that market conditions warrant a specific monitoring of credit quality in general and leveraged finance exposures in particular by the ECB. We welcome initiatives to bring discipline and best practices to this specific market segment.
- ◆ However, the very wide definition of leveraged transactions as well as the preeminent role implicitly assigned to the level of leverage as a risk indicator are of concern. The level of leverage is indeed a key figure to assess risk, but we deem important to stress that other factors (e.g. the purpose of the financing) as well as other key figures (e.g. internal and external ratings) significantly contribute to a comprehensive risk evaluation.
- ◆ Because of the very low commitment threshold (€5m) the guidance includes a significant number of SMEs, which are not financed by leveraged finance markets but are clients of retail and commercial banking networks. We therefore propose that the commitment threshold should be materially increased for example to €25m. In order to exclude SMEs being captured by the ECB guidance we also recommend to introduce an additional net sales threshold of €50m. Moreover, we propose that banks should conduct a purpose test to assess whether a transaction meets the relevant criteria to be considered leveraged lending. In its currently drafted form the guidance captures a large number of SMEs and many of these companies may be unable to provide the requested information and data and will therefore find it more difficult to raise bank financing. We are concerned that this may prove an obstacle to growth and jobs in the EU as SMEs are a crucial pillar in the European economy.
- ◆ The guidance captures companies with different risk profiles and does not take into account that some industries structurally carry higher leverage than others.
- ◆ It also raises level playing field concerns because it only applies to significant European institutions within the SSM. This does not only put significant European institutions of the SSM at a competitive disadvantage; it will also help unregulated players, including shadow banking entities such as private debt funds, to grow in this market segment, potentially leading to higher leveraged companies. We are concerned that this will contribute to systemic risk.
- ◆ The ECB guidance is, in a number of areas, more restrictive than the US Fed guidance, which does not seek to exclude adjustments/reasonable enhancements to EBITDA and does not require such transactions to be approved at the highest level of credit committee. As a matter of principle, we call for a harmonisation of the definitions between supervisors to ease the reporting burden for banks, improve the comparability / monitoring for supervisors and ensure a level playing field.

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- ◆ The guidance introduces complexity for significant institutions that are active in the US. The co-existence of two diverging guidelines and guidance will make leveraged lending business difficult, if not impracticable, to conduct for European banks in the US.
- ◆ The ECB guidance establishes a leverage finance definition with specific thresholds (i.e.: € 5m, Total Debt to EBITDA ratio of 4.0x, etc) that are closer to a regulatory framework rather than to a guide. This issue should be considered as other jurisdictions outside the SSM could have local regulations that do not share the same definition of these guidelines.
- ◆ We also seek clarification on the fact that the ECB expressly states the guidance is non-binding though it includes additional constraints to banks and non-compliance may trigger supervisory measures.
- ◆ The requirement to approach “the highest credit committee” for Leveraged Transactions whose leverage level is 6x Total Debt to EBITDA or higher places unduly restrictive procedures on the credit process of the SSM banks with potential negative implications on their lending activity.
- ◆ We would appreciate more clarity on the intended timing of the implementation. We also propose that the ECB organises a 2nd industry meeting/workshop after the consultation period has ended and comments have been reviewed. This would provide an opportunity to discuss the findings and ensure a smooth implementation.

EBF position

Introduction

The European Banking Federation (EBF) welcomes the ECB consultation on leveraged transactions. European banks have engaged in the discussion and do appreciate the opportunity to provide their views and data.

1. Definition of leveraged transactions

As explained in the introduction of the ECB draft guidance the prolonged period of low interest rates and the subsequent search for yield have fuelled growth of the leveraged finance market and led to growing risk appetite and the weakening of deal structures, warranting a specific monitoring of credit quality by the ECB. We acknowledge this situation and welcome initiatives to bring discipline and best practices to this specific market segment. However, we are concerned that the ECB draft guidance is based on a very wide definition of leveraged transactions. This definition goes well beyond LBO transactions; because of its low commitment threshold (€5m) and the absence of a purpose test it includes a significant number of small and medium sized enterprises (SMEs), which are not financed by leveraged finance markets but are clients of retail banking and commercial networks. Companies, particularly smaller ones, which are unable to provide the requested information/data will find it difficult to raise bank financing. The draft guidance seems to contradict the recognition by the EU that small and medium-sized businesses are one of the pillars of the Union economy given their fundamental role in creating economic growth and providing employment, hence the importance of the availability of capital and funding to these businesses in the Union. As a consequence, we propose that the commitment threshold should be materially increased, for example to €25m. In addition, we suggest excluding companies with a turnover of less than €50m. Moreover, we propose that, similar to the US guidelines, banks should conduct a purpose test to assess whether a transaction meets certain criteria (as explained in 1a and 1b) to be considered leveraged lending. Any definition of leveraged lending should be individual to the specific institution but based on the below minimum criteria. This allows banks to broaden the definition if required in view of the individual bank’s strategic direction and exposure to leveraged lending. This further allows for adequate proportionality.

A transaction could be considered as leveraged lending when all the following conditions are fulfilled at deal inception:

1. The specific purpose of the financing is one of the following:
 - a) Company purchase, by buy-out or acquisition of shares and/or
 - b) Capital distribution, such as dividends distributions, share buy-backs, repayment of subordinated debt, etc.
2. The borrower is not an SME (i.e its net sales figure is greater than €50m)
3. The borrower of the transaction has an internal rating below BBB-(equivalent)
4. For companies that are not majority-owned by private equity firms the borrower's "Total Financial Debt /EBITDA" leverage ratio is greater than 5 times and/or the borrower's "Net Total Financial Debt / EBITDA" leverage ratio is greater than 4 times. The assessment of leverage should be made at consolidated level.
5. All transactions will be subject to a commitment materiality threshold of €25m.

In addition to the exclusions currently proposed by the draft guidance different multiples based on sectors would be advisable. Some activities and industries are more capital-intensive or tend to generate stable cash-flows, so the affected companies carry higher leverage ratios (e.g. utilities, regulated sectors, real estate companies, leasing and factoring companies as well as finance companies) while enjoying an investment grade rating. For this reason it does not appear sufficient to use the leverage ratio as the dispositive criteria to determine if the financing qualifies as leverage lending.

1.1 EBITDA Adjustments/Enhancements

We note that the definition of EBITDA to be used allows for no (positive or negative) adjustments to be made. This will clearly result in many transactions being unduly caught in the definition if one does not take into account significant non-recurring costs, the pro-forma impact of acquisitions already made, or the full year impact of cost savings already implemented, that is supported by external due diligence and then included on a reasonable and appropriately conservative basis. We also note that the US Fed guidance allows for EBITDA adjustments, which raises further concerns as outlined below (see 2. Level playing field and scope of applicability).

1.2 Definition of debt

The definition of debt raises a number of questions: i) why is gross debt used, which gives no value to cash held by companies financed? We would recommend using net debt. ii) shareholder loans subordinated to senior debt, which are provided in substitution to equity as well as other local law variations, should be excluded from total debt.

In addition, during the workshop held on 16 December 2016, the ECB indicated that there was an "open question on the treatment of incremental debt". This is an issue and potential incremental and undrawn debt should not be included in the total debt calculation. This would i) inflate the leverage of companies as it would ignore the additional EBITDA that the drawdown of incremental debt is expected to generate, ii) it would penalise companies that secure committed liquidity lines, and would have the unfortunate and unintended consequence of discouraging companies from securing liquidity, and ultimately of weakening their liquidity profile.

1.3 Classification of a transaction at inception

Given that the guidance seeks to address the weakening of structures, leverage should be measured exclusively at the inception of a transaction (unlike suggested in footnote 8). When a deterioration of the borrower is due to an EBITDA decrease (maintaining a constant level of debt), the existing financing should not be included as a leverage transaction. "Fallen angels" or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged should not be included within the scope. This should also apply to borrowers classified as "foreborne", "defaulted" or "impaired". If they were included the leveraged transactions portfolio may over time include a significant share of underperforming corporate loans. This would skew reporting and tracking of the portfolio and unduly duplicate monitoring requirements.

1.4 Exclusions to the leveraged transactions definition

- **project finance loans**

We propose to amend the definition of "project finance loans", which is currently too narrow as (i) it is limited to long-term facilities, (ii) it does not capture all sectors where limited-recourse finance is used (e.g. energy including renewables, natural resources), (iii) it seems limited to "projects", without covering for example concession companies or regulated utilities (which are corporates) and (iv) it is unclear whether it covers only greenfield financing or whether it extends to the refinancing of brownfield assets, the financing of acquisitions and the financing of working capital requirements.

Over the past few years European institutions have deployed a number of initiatives in order to support investment and financing in the infrastructure and renewables sectors (e.g. Juncker plan, recent amendment of Solvency II rules in order to spearhead infrastructure financing by institutional investors). They have also recognized the robust credit strength of such investments. These financings usually do not use leverage as a credit metric. Therefore, it seems logical to exclude them from the definition of leveraged transactions and from the application of the related guidance.

- **loans secured by an asset that pertains to asset based loans**

In the draft guidelines it is now stated that "loans secured by an asset that pertains to asset based loans" are not expected to be covered by the leveraged transaction definition. Footnote 12 provides further clarification as to what is understood to be asset-based. When implemented in this form, it would result in large quantities of clients/transaction having to be classified as leveraged, while these represent in most cases normal corporate style financings to companies with ample assets. Furthermore it should be possible to assess this on a consolidated client level rather than on a transaction level, as the concern should primarily be with the risk of over-crediting the client and not whether or not the bank has sufficient collateral.

It is therefore proposed to change this into: If a borrower has provided sufficient tangible assets to cover its debt obligations to the bank under a credit facility, such credit facility will not be considered leveraged. Such to be tested by way of an LTV test (max 100%) to be assessed upon appraisal values or, if not available, audited values. In case of an acquisition finance arrangement, the client's opening balance sheet may be used. LTV tests are to be performed when offering a new credit facility or upon any material change made to such facility. Furthermore, if no tangible collateral is provided and lenders are pari-passu, and the tangible unencumbered assets are sufficient to cover the debt obligations to the pari-passu banks, such credit facility will not be considered leveraged either.

- **charitable and not-for-profit organisations**

In addition to the list of exclusions we would also seek to exclude loans with charitable and not-for-profit organisations.

- **Further exclusions**

As explained in the ECB workshop on 16 December 2016 we understand that high yield bonds and CLOs are excluded from the definition. Borrower exclusions should be expanded to exclude government-like borrowers (central, federal and regional governments including their agencies and departments and facilities supported by these entities) as well as entities such as Export Credit Agencies (i.e. Export-Import Banks), multilateral agencies (i.e. International Finance Corporation (IFC)) and other bilateral agencies, as well as facilities guaranteed by any such entities;

1.5 Cessation

We would recommend that some guidance should be provided to assess when a transaction ceases to be classified as leveraged lending (rating, leverage ratio).

2. Level playing field and scope of applicability of guidance

One of the ECB's stated goals for developing the guidance is to "strengthen the level playing field for financial institutions active [in the leveraged lending market] on a global basis". Our collective view is that the guidance, if implemented as currently drafted, would tilt the playing field considerably. This arises due to the scope of applicability of the guidance which applies only to significant credit institutions directly supervised by the ECB. This has a number of principal impacts:

- In the core leveraged finance market, we estimate that less than half of the bank exposure to the total European leveraged loan market would be subject to the guidelines with all lending by, for example, Swiss, Asian, UK, US and certain Nordic banks not being caught. The ability of these banks to operate without being subject to the guidance will present them with an immediate competitive advantage relative to the ECB supervised banks directly affected, especially if those affected banks act 'in the spirit' of the new guidance by truly limiting exceptional approvals.
- The guidance will not apply to non-regulated entities such as private debt funds; private debt funds play an increasingly important role in directly financing corporates, including small and medium-sized. The proposed guidance, as drafted and with its proposed definition, will provide a competitive advantage to these funds driven by additional supervision imposed on banks. As drafted, the guidance will thus favour the growth of shadow banking, generally seen as contributing to systemic risk. In this regard, we would note that the US guidance applies to both US banks and foreign banks with respect to leveraged loans originated and distributed by them in the US. We believe that the ECB should ensure wider applicability of its guidance to banks in the UK, US etc. for their activities in the European leveraged finance market. This is critical to ensure both, a level playing field amongst those banks operating inside the European Union, and for the purposes of the ECB being able to deliver an effective framework for the European leveraged finance market.
- Further, the guidance applies to the affected ECB supervised banks on a global basis. Such banks' ability to compete effectively in the United States, the world's

largest leveraged finance market, will be severely weakened where specific terms of the guidance are more restrictive than those implemented generally in the market under the US guidance framework. An example of this is the provision in the guidance for the use of unadjusted EBITDA, which does not reflect international market usage and convention in both major markets and deviates from the Interagency guidance (see 2.1 below). There should be a uniform position and global alignment when it comes to the key terms of the guidance. Notwithstanding the foregoing, given there will still inevitably be some smaller differences between the US guidance and ECB guidance, we also think it would be desirable to provide that where an affected ECB supervised bank is originating a leveraged loan transaction which is caught by the US guidance, the US guidance alone should apply.

2.1 Lack of consistency with US Interagency guidelines

The ECB states that one objective is to ensure a level-playing field with US banks subject to the US Interagency guidelines on leveraged finance (November 2013). However, a number of inconsistencies exist between the two documents which would create level playing field issues for ECB-supervised banks:

- In general the approach taken by the US agencies is to provide a framework allowing banks to formulate their own definitions following a number of criteria, which is quite different from the ECB's approach, which is much more prescriptive
- The US agencies allow sector-based exclusions or exclusions based on types of borrowers, if documented, whereas the ECB document limits exclusions to types of facilities
- As a result, the approach taken by the US agencies is largely based on the characterisation of obligors, not facilities
- The US agencies allow an exclusion for small business loans, which banks can further define, while the ECB document attempts to exclude small businesses based on a minimum commitment amount of €5m
- The US agencies allow EBITDA adjustments, if documented and justified, when the ECB draft guidance does not allow any adjustments (beyond pro-forma financials)

2.2 Overall market impact of guidance

- The guidance as drafted would apply to less than 50% of the core leveraged loan market in terms of the market share of the banks affected and therefore will limit its effectiveness and general impact.
- With respect to traditional SME and corporate lending, and as outlined above, only significant banks will be subject to the guidance where normal customer borrowing levels exceed 4x EBITDA. Less significant institutions ("LSIs") will continue to operate under current procedures again which we expect to lead to a concentration of lending to leveraged SME and corporate borrowers on the balance sheets of the LSIs and therefore a decrease of the guidance's impact on market and systemic risk;
- As seen in the US, it is likely that more leveraged lending will be undertaken outside the regulated banks. As an example, the market share of non-regulated firms grew substantially in the first three years following the introduction of the interagency guidance. Considering a circa 90% (market share) coverage of market participants

by the US guidance compared to the initial less than 50% of the ECB guidance, we would argue that collectively this will over time reduce further the influence of the guidance as it will apply to an increasingly less material group of market participants, which must surely be of concern from a macro-prudential perspective and is therefore relevant to the ECB's role in relation to financial stability.

In summary, we believe that for the guidance to be effective and market changing, and to avoid market distortion, it will be key to capture the activities of all market participants active in the European leveraged finance market.

3. Credit committee requirements

The requirement to approach "the highest credit committee" for Leveraged Transactions whose leverage level is 6x Total Debt to EBITDA or higher risks to considerably stretch lending activity of the bank. Instead, such transactions should be escalated to the next higher decision authority with regular tracking and reporting, in order to raise internally the awareness of the risk profile. This is finally up to an involvement of a high credit committee of each Legal Entity which is empowered and qualified also to decide on large-sized Leveraged Transaction exposures.

4. Data requirements

The data requirements for regulatory reporting as set out in the annex of the guidelines will require substantial IT investments. Adjusting the systems to be able to reclassify the entire lending portfolio will impose significant costs on banks, which will ultimately end up in the cost price of lending money to our SME and wholesale clients. Furthermore, information needed to be provided by SME clients under the proposed guidelines would be inappropriate for smaller transactions (i.e. detailed projections) and would put an increased burden on SME's to comply with these information requirements.

5. Consistency with other regulations

The guidance proposes a number of processes or guidelines regarding impairment tests, collective provisioning or liquidity treatment of undrawn facilities. Our view is that these guidelines are not connected with the overall purpose of the guideline, which is to provide lending and underwriting standards for leveraged lending.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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