



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Feedback statement

Responses to the public consultation
on the draft ECB guidance on
leveraged transactions

BANKENTOEZICHT

May 2017

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This document seeks to provide both an overview and an assessment of the comments received during the public consultation on the draft ECB guidance on leveraged transactions. It also explains the amendments made to that guidance as a result of the public consultation.

A Overview and analysis of responses

A.1 Context

On 23 November 2016, the European Central Bank (ECB) launched a public consultation on its draft guidance on leveraged transactions. This consultation was conducted in accordance with Article 4(3) of Council Regulation (EU) No 1024/2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (hereinafter “the SSM Regulation”). The public consultation ended on 27 January 2017. In addition to soliciting written comments, the ECB also gave industry participants and interested parties the opportunity to provide additional input at a public hearing with senior representatives of the ECB. This event took place in Frankfurt am Main on 20 January 2017. While the comments provided at the public hearing are not reflected in the tables and charts below, they have nonetheless been taken into account in this document. Moreover, most (if not all) of the comments made at the public hearing were also reiterated in written submissions. Accordingly, the ECB has given due consideration to all of the comments received during the consultation period.

A.2 Structure of feedback statement

This feedback statement presents an overall assessment of the comments received during the public consultation and aims to address the most relevant issues raised by those comments. The guidance has been amended as a result of the comments received.

Sections B and C of this document summarise the key comments received and the resulting amendments to the guidance by chapter. However, they only list the most relevant comments and amendments.

A.3 Statistics on responses

A total of 445 comments from 24 respondents were received. Contributions were submitted by credit and financial institutions, as well as market and banking associations, representing a broad cross-section of relevant stakeholders. Table 1 and Figure 1 show the numbers of responses received from each type of respondent, while Table 2 and Figure 2 provide a breakdown of the comments received by type of comment.

Table 1

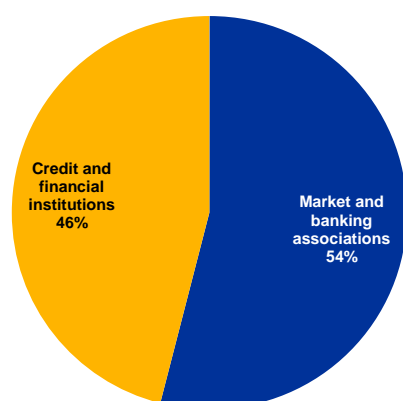
Responses to the public consultation

Breakdown of responses by type of respondent

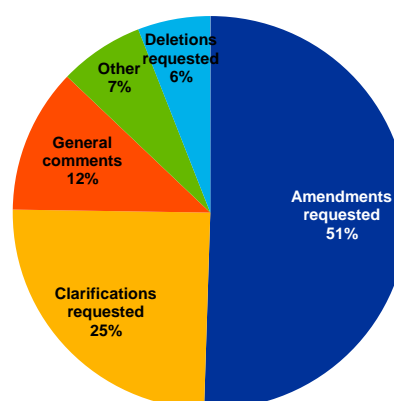
Type of respondent	Number of responses	Percentage of total
Private persons	0	0%
Credit and financial institutions	11	46%
Market and banking associations	13	54%
Total	24	100%

Figure 1

Breakdown of respondents

**Figure 2**

Breakdown of comments received

**Table 2**

Individual comments received

Type of comment	Number of comments	Percentage of total
General comments	53	12%
Amendments requested	227	51%
Clarifications requested	110	25%
Deletions requested	25	6%
Other	30	7%
Total	445	100%

A.4 Adoption of the guidance

A proposal for the adoption of the draft ECB guidance on leveraged transactions was sent by the Supervisory Board of the ECB to the Governing Council of the ECB on 28 April 2017. The final ECB guidance, as adopted by the Governing Council on 05 May 2017, was published on the ECB's website on 16 May 2017, together with this feedback statement.

B Explanation of the supervisory approach and the ECB guidance on leveraged transactions

B.1 Background and rationale

The prolonged period of very low interest rates and the ensuing search for yield strategies have resulted in a need for specific monitoring targeting credit quality in general and leveraged finance exposures in particular. In this context, a number of credit institutions in different jurisdictions across the euro area were surveyed in 2015 as part of a thematic review looking at leveraged finance.

The survey showed that global leveraged finance markets have experienced a strong recovery following the crisis and are characterised by fierce competition. Both the appetite to underwrite transactions and the propensity to retain parts of the exposure have increased among significant credit institutions supervised by the ECB. In addition, borrower-friendly conditions have translated into a weakening of deal structures (increased leverage levels, importing of “covenant-lite” structures into European markets, etc.) and have, in many cases, led to greater leniency in credit institutions’ credit policies. Most importantly, several areas for improvement have been identified in credit institutions’ monitoring practices, as have significant discrepancies in individual institutions’ approaches to defining, measuring and monitoring leveraged transactions.

In view of the above-mentioned developments, and in light of Articles 76 and 79 of Directive 2013/36/EU¹ and both recital 30 and Article 4(1)(e) of Council Regulation (EU) No 1024/2013² (the “SSM Regulation”), the ECB considers that closer supervisory scrutiny of leveraged transactions is justified. This closer scrutiny has led to the establishment of guidance summarising key supervisory expectations in the area of leveraged transactions and the monitoring of both syndication risk and the fundamental credit quality of leveraged exposures.

¹ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

² Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

B.2 Applicability of the guidance

The guidance applies to all significant credit institutions that are supervised by the ECB under Article 6(4) of the SSM Regulation.

While all significant credit institutions should incorporate the guidance in their internal policies, the implementation of all aspects of the guidance should be subject to the principle of proportionality. Accordingly, the internal implementation of the supervisory expectations expressed in the guidance should be consistent with the size and risk profile of institutions' leveraged transaction activities relative to their assets, earnings and capital.

While the guidance focuses primarily on leveraged transactions, credit institutions are also encouraged to apply the supervisory expectations outlined in the guidance to other types of transaction where relevant.

B.3 Key objectives of the guidance

The objectives of the guidance are twofold.

It seeks to facilitate the identification of leveraged transactions by means of a unique overarching definition encompassing all business units and geographical areas, so as to give the credit institution's senior management a comprehensive overview of the institution's leveraged lending activities.

It also seeks to establish expectations regarding the risk management and reporting requirements applied to leveraged transactions, with the aim of fostering stringent risk management for these types of exposure, strengthen credit institutions' ability to operate during any economic downturn and ultimately facilitating lending to leveraged borrowers throughout the business cycle.

The objectives of this guidance are a direct result of the 2015 thematic review on leveraged finance, which identified considerable heterogeneity in credit institutions' definitions of leveraged transactions, as well as significant variation across credit institutions in terms of risk management and reporting frameworks.

B.4 Expectations with regard to the implementation of supervisory expectations

While the guidance is not binding, it will be enforced through the ongoing supervision of credit institutions by Joint Supervisory Teams (JSTs), as well as dedicated on-site inspections. It will also be taken into account in the Supervisory Review and Evaluation Process (SREP).

Following the implementation phase, in which JSTs will monitor the implementation of the supervisory expectations outlined in the guidance, the ECB will apply a combination of off-site investigations and more comprehensive on-site investigations,

which will be accompanied by specific recommendations looking at how to assess credit files.

In addition, the ECB will engage in ongoing monitoring of leveraged lending activities, asking selected credit institutions to report, on a regular basis, on their exposure to leveraged transactions, the evolution of those exposures and the riskiness of those activities.

B.5 Economic impact of the guidance

The aim of the guidance is not to prevent leveraged borrowers from accessing financing solutions. The supervisory expectations expressed in this guidance are aimed at bringing consistency to risk management practices and facilitating the harmonisation of the definition of leveraged transactions. The ECB is of the view that sound origination and credit risk management practices – both key objectives of this guidance – have an important role to play in ensuring the smooth financing of the economy throughout the business cycle.

B.6 Issue of a level playing field

The application of this guidance to all significant credit institutions supervised by the ECB raised questions as to whether credit institutions that were subject to it were on a level playing field relative to institutions to which it did not apply.

The guidance seeks to ensure the alignment of supervisory expectations across jurisdictions, while accounting for regional specificities. Ensuring a level playing field was one of the objectives in the drafting and issuance of the guidance. This was facilitated by close interaction and cooperation with other regulators and supervisory agencies throughout the project phase.

As regards the issue of US credit institutions in Europe, we would like to reiterate that the scope/purpose of the ECB guidance is aligned with that of the 2013 Interagency Guidance on Leveraged Lending (hereinafter “the US guidance”). The introduction of the ECB guidance should thus be seen as a further step towards ensuring a level playing field across jurisdictions. Furthermore, US credit institutions are subject to the US guidance’ on an enterprise-wider basis.

Participants in the public consultation raised concerns regarding the impact that the guidance could have on the competitive landscape and the role/position of non-bank lenders.

The ECB would like to reiterate that the aim of the guidance is not to prevent credit institutions from providing financing solutions to leveraged borrowers. The guidance does not establish non-pass thresholds in terms of the origination of transactions. As outlined in Section B.3 above, the guidance seeks primarily to ensure sound risk management for leveraged transaction activities. The guidance describes supervisory expectations in respect of such activities, highlighting the importance of

(i) defining and monitoring leveraged transactions consistently across all business lines, (ii) structuring leveraged transactions in a way which reflects sound and viable business premise, (iii) maintaining well-defined standards when it comes to underwriting and credit approval and (iv) adopting stringent risk management practices in terms of the ongoing monitoring of “hold book” and pipeline exposures.

B.7 Supervisory letters sent to SSM institutions

As a result of the 2015 thematic review on leveraged finance, two follow-up work streams were launched.

The first work stream targeted the immediate remediation of the shortcomings identified during the thematic review. Institution-specific shortcomings were addressed via recommendation letters from the various JSTs. All institution-specific recommendation letters underwent a thorough consistency check at a horizontal level to ensure a level playing field.

The second horizontal work stream comprised the drafting of the ECB’s guidance on leveraged transactions, reflecting the supervisory objectives outlined above.

The two work streams are to be seen as complementary. Following the publication of the guidance, institutions are required to critically review their risk management frameworks on the basis of the expectations outlined in that guidance – independently of the recommendation letters received – and remedy any shortcomings that have not already been addressed by the JSTs in their individual follow-up letters.

C Comments and amendments to the draft ECB guidance on leveraged transactions

2. Scope of the guidance on leveraged transactions

The principle of proportionality

A number of participants stressed the need to further clarify the manner in which the principle of proportionality should be applied when translating the supervisory expectations expressed in the guidance into internal risk management practices.

The ECB has taken note of the comments received. We would like to reiterate and emphasise the importance of the principle of proportionality in the context of the implementation of the guidance. The wording of the guidance has been amended accordingly. We would also like to reiterate that the internal implementation of the supervisory expectations expressed in the guidance should be consistent with the size and risk profile of credit institutions' leveraged transaction activities relative to their assets, earnings and capital. Please also refer to Section B.4) above.

Scope of transactions included in the guidance

For the purposes of the guidance, leveraged transactions cover the entire debt structure of the leveraged obligor, encompassing debt held by both bank and non-bank investors. References to leveraged transactions refer to all debt, with the exception of bonds and non-investment-grade bonds ("high-yield bonds") held by bank and non-bank investors. The wording of the guidance has been amended accordingly, and we have removed the reference to non-investment grade corporate bonds in Section 5 of the guidance.

We have also further clarified expectations with regard to the broader applicability of the guidance to credit institutions' other lending activities. In particular, the ECB is of the view that the supervisory expectations expressed in this guidance may – where relevant – be applied to other types of transaction. The wording of the guidance has been amended accordingly. Please also refer to Section B.4) above.

3. Definition of leveraged transactions

Designation of financing as a “leveraged transaction” and treatment of “fallen angels”

A number of participants indicated that there was a need for a more nuanced definition of the term “modification”. Furthermore, some participants requested that “fallen angels” (commonly defined as borrowers that have exhibited deterioration in their financial performance) be explicitly excluded. Similarly, a number of respondents argued for the exclusion of forbore, impaired and defaulted loans, as well as loans managed by a recovery unit.

In line with other regulatory initiatives, the term “origination” refers, for the purposes of this guidance, to a new extension of credit, the refinancing or modification of an existing loan agreement, or a renewal of a matured or maturing transaction. In this context, the term “modification” is intended to cover any restructuring of or change to an existing non-matured loan. We have removed the reference to “extension”, as it is captured in the above definition.

Consequently, “fallen angels” (i.e. borrowers which have exhibited a deterioration in their financial performance after loan inception or have become leveraged thereafter) should not be included in the scope of leveraged transactions unless that credit is modified, extended or refinanced as outlined above. The same logic applies to all other leveraged transactions, irrespective of their accounting or regulatory classification or the business line or unit under which they are managed.

In order to allow the identification of leveraged transactions, the credit institution’s senior management is expected to have a comprehensive overview of all of the institution’s leveraged transaction activities.

Calculation of leverage threshold

The ECB would like to clarify the supervisory expectations expressed in the guidance as regards the level at which the leverage threshold should be calculated. In particular, the ECB expects the leverage threshold to be calculated at the consolidated borrower level, unless group support cannot be assumed in the event of the borrowing entity encountering financial difficulties (i.e. no explicit group support in the form of a guarantee, letter of comfort, etc.). We have amended the wording of the guidance accordingly.

Total debt and treatment of drawn and undrawn debt

A number of participants pointed out a discrepancy in the definition of total debt that was used for the purpose of calculating the ratio of total debt to EBITDA. In particular, the draft guidance stated that total debt was defined for these purposes as the aggregate of the “IFRS current and non-current financial liabilities (or similar

nGAAP requirements applicable to the institution)” of the borrower after giving effect to the transactions in question – i.e. that committed but undrawn facilities and any uncommitted “incremental” facilities were not factored in when determining the leverage level for these purposes. At the same time, it stated that, for the purposes of the guidance, “exposure refers to all gross direct commitments to a leveraged borrower, including drawn and undrawn facilities, term loans, bridge loans or revolving credit facilities, committed exposures not yet syndicated or distributed, and exposures being warehoused for a later sale”. Thus, including these gross direct (unfunded) commitments to a borrower was inconsistent with the IFRS and GAAP definitions of current and non-current financial liabilities.

The ECB has taken note of the comments received. The reference to “IFRS current and non-current financial liabilities (or similar nGAAP requirements applicable to the institution)” has been removed, and the wording of the guidance has been amended accordingly. The ECB would like to reiterate that, for the purposes of identifying leveraged transactions, the entire debt structure of the leveraged obligor should be taken into account, encompassing debt held by both bank and non-bank investors. Leverage multiples should thus be calculated at origination on the basis of total committed debt, including drawn and undrawn debt, and any additional debt that the loan agreement may permit.

The focus on total debt and additional debt that loan agreements may permit has been prompted by the growth in incremental facilities (also known as accordion or additional facilities). These facilities have become a permanent feature of leveraged loan markets and increasingly common in the corporate lending space. Credit institutions are expected to account for pre-approved additional term or revolving facilities when computing total debt; in particular facilities where lender consent is not required and which can be utilised provided that the borrower group, and the incremental facility, are in compliance with certain pre-agreed parameters.

The ECB expects credit institutions to have in place stringent risk management practices to assess and monitor incremental facility provisions for the cases outlined above.

Participants also requested further clarification as to whether undrawn committed lines which are made available to borrowers primarily to enhance their liquidity situation are expected to be included in the total debt metric.

The ECB has taken note of these comments, and the guidance has been amended accordingly. Committed undrawn revolving credit facilities which are designated as liquidity facilities according to BCBS 238 are excluded from the calculation of total debt.

Participants also highlighted the operational difficulties involved in determining a borrower’s undrawn facilities, pointing out that information may not be readily available.

The ECB expects credit institutions to undertake detailed due diligence before entering into a (leveraged) loan agreement, including thorough analysis of all

undrawn revolving credit facilities or committed and unfunded lines. Furthermore, the risk management function should be able to monitor the leverage ratio of borrows including all undrawn facilities.

Following the approval of credit, credit institutions should also ensure constant monitoring of leveraged transactions. This ongoing review should focus on the borrower's repayment capacity and whether the transaction and/or the borrower is showing signs of financial difficulty or unlikelihood to pay.

A few participants stated that undrawn available commitments, in particular capex facilities, should be excluded from the definition of total debt, as they lead to additional EBITDA going forward and thus have a moderating effect on leverage.

The ECB is of the view that capex, incremental and undrawn facilities do not necessarily have a binding limitation on the purpose of the use of the possible drawdown of debt. The ECB shares the concern that an institution cannot easily assess potential enhancements to EBITDA and the inclusion of additional EBITDA should not be seen as a reliable metric. Furthermore, a capex project does not directly generate EBITDA, as timing, execution risk and maintenance costs also play a significant role.

A number of participants argued that subordinated shareholder debt and other forms of subordinated debt, such as payment-in-kind (PIK) instruments, should be excluded from the calculation of total debt. Participants calling for the exclusion of these instruments pointed to their equity-like features.

PIK instruments and other shareholder loans are types of credit facilities which pay interest in the form of additional debt or equity, rather than cash. Thus, PIK and shareholder loans are essentially liabilities and should be included in the calculation of the total debt metric.

Gross debt vs net debt

A number of participants called for further clarification of the term "total debt" and asked whether the netting of cash against debt was permitted for the purposes of calculating total debt.

The ECB has taken note of the comments received. We would like to reiterate that the guidance explicitly refers to total debt. As outlined in the section above on the treatment of drawn and undrawn debt, the wording of the guidance has been amended and further aligned with existing regulatory initiatives.

The ECB would like to reiterate that cash should not be netted against debt for the purposes of calculating total debt. The adoption of a net debt metric would entail supervisory concerns relating to a lack of conservativeness. Moreover, cash is usually required for working capital and day-to-day operations, as well as the distribution of dividends, so it is not necessarily available for the repayment of debt.

Exclusions

A significant number of participants raised the issue of the exclusions contained in the definition of leveraged transactions. Comments focused on the level of corporate exposure, specifically pointing to borrowers in particular industries which may be able to cope with higher levels of leverage.

Participants argued that there was a need to:

- (i) (i) clarify current exclusions;*
- (ii) (ii) consider extending the list of exclusions to include borrowers in specific industries;*
- (iii) (iii) consider excluding small and medium-sized enterprises (SMEs) or raising the current materiality threshold;*
- (iv) (iv) introduce a use of proceeds or purpose test and/or a rating threshold.*

Credit institutions and investment firms

A few participants argued that there was a need to broaden the definition of credit institutions and investment firms – which are defined with reference to the Capital Requirements Regulation (CRR) – to include other financial sector institutions (i.e. insurance companies).

The ECB has taken note of the comments received. The guidance foresees the exclusion of credit institutions and investment firms as defined in Article 4(1)(1) and (2) of the CRR. Financial sector entities as defined in Article 4(1)(27) of the CRR are also excluded. We have amended the wording of the guidance accordingly.

Sovereign and sovereign-related exposures

A number of participants called for further clarification regarding the treatment of sovereign and sovereign-related exposures.

The ECB has taken note of the comments received. Sovereign and sovereign-related exposures are excluded from the definition. We have amended the guidance accordingly and added a further item to the list of exclusions, namely “public sector entities” as defined in Article 4(1)(8) of the CRR.

Materiality threshold and SMEs

A significant number of respondents focused on the proposed €5 million materiality threshold. Participants argued that the materiality threshold should be raised or SME exposures should be explicitly excluded.

The ECB takes note of the comments received. The ECB is of the view that comments are best addressed through the exclusion of loans to small or medium-sized enterprises (SMEs) as defined by Commission Recommendation 2003/361/EC with the exception of those where the borrower is owned by one of more financial sponsors as defined in definitional trigger (ii). The guidance has been amended accordingly.

Specialised lending exposures

Participants argued that there was a need to (i) further clarify the structured credit activities to be excluded from the definition and (ii) broaden the exclusion criteria for structured credit activities. Particular emphasis was placed on the definitions of asset-based loans, commercial real estate and project finance loans.

The ECB has taken note of the comments received and the comprehensive list of proposed exclusions. The guidance has been amended accordingly, with “specialised lending” exposures (as defined in Article 147(8) of the CRR, as well as BCBS 2001 and EBA/RTS/2016/02) being specifically excluded. Consequently, the reference to asset-based loans has been removed from the list of exclusions.

Article 147(8) of the CRR defines specialised lending exposures as exposures with the following characteristics: “(a) the exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure; (b) the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; (c) the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.”

BCBS 2001 identifies four product lines that exhibit these characteristics, namely (i) project finance, (ii) income-producing real estate, (iii) object finance and (iv) commodities finance. Article 2 of EBA/RTS/2016/02 defines the assessment criteria for the four different classes of specialised lending exposures.

Trade finance exposure

A few participants argued that there was a need to further clarify the definition of trade finance, which is defined with reference to the CRR. In particular, they raised the issue of whether only facilities that are trade-oriented, self-liquidating and short-term in nature should be excluded. A number of participants pointed to maturity considerations, in particular the short-term nature of facilities as prescribed by Article 4(80) of the CRR, and sought clarification as to whether all trade-financing facilities (irrespective of maturity) should be excluded from the definition of leveraged transactions.

The ECB has taken note of the comments received. The term “trade finance” is generally reserved for products which are specifically linked to underlying international trade transactions (including imports and exports). As such, a working

capital loan that is not specifically tied to trade is generally not included in this definition. The guidance focuses on short-term trade finance, since these facilities are trade-oriented and self-liquidating in nature. Please also refer to the section above on specialised lending.

Rating threshold

A number of participants called for a rating threshold and the explicit exclusion of investment-grade rated borrowers from the definition of leveraged transactions.

The ECB has taken note of the comments received. The ECB is of the view that participants' concerns regarding the scope and nature of the exposures captured by the ECB's definition of leveraged transactions are best addressed by excluding investment-grade rated borrowers. We would like to reiterate that leverage represents a key risk which requires stringent risk management frameworks. The credit institution's senior management are expected to have a comprehensive overview and understanding of their institution's leveraged financing activities and the inherent risks that they entail.

At the same time, the ECB confirms that other indicators of credit risk should also be assessed, including financial metrics (debt service cover, cash conversion, liquidity headroom, equity cushion, etc.) and other factors affecting the stability of the borrower's cash flow (regulated businesses, long-term contracts, etc.). These factors are, to a large extent, reflected in the internal and external ratings of borrowers, which supports the exclusion of investment-grade rated borrowers. The wording of the guidance has been amended accordingly, with a new item being added to the list of exclusions.

Other industry exclusions

A number of participants called for the guidance to differentiate between borrowers operating in different industry sectors. Moreover, a number of respondents argued for the explicit exclusion of specific industries where a higher degree of leverage is market standard.

The ECB has taken note of the comments received. It is of the view that the exclusion of investment-grade rated borrowers will provide for a more differentiated approach to the inclusion of exposures. As regards infrastructure financing, the ECB is of the view that the exclusion of specialised lending addresses the comments received.

EBITDA

A large number of comments during the public consultation focused on adjustments to EBITDA.

One set of participants pointed out that the draft guidance referred to the post-financing level of leverage, which would, by definition, require a pro-forma calculation of EBITDA and debt after the completion of the transaction and thus conflict with the requirement to use unadjusted EBITDA.

A second set of respondents argued that there was a need to use adjusted EBITDA, referring to market standards.

Meanwhile, a third set of respondents focused on the consistency of the ECB's approach to EBITDA vis-à-vis existing regulatory initiatives, particularly the US guidance.

The ECB has taken note of the comments received and the industry's concerns regarding the use of unadjusted EBITDA, especially in the area of acquisition financing. The guidance has been revised accordingly, as we recognise the potential burden resulting from the calculation, monitoring and assessment of unadjusted EBITDA, particularly for SME corporates and SSM institutions operating in the United States.

The ECB reiterates that, for the purposes of this guidance, any adjustments made to EBITDA should be duly justified and reviewed by a function independent of the front office.

As demand remains strong for issuers with weak balance sheets and companies are able to negotiate aggressive adjustments to EBITDA in loan documentation and financial covenants in credit agreements, understanding the limitations of EBITDA is important. Overly optimistic adjustments with respect to pro forma "future synergies", "future earnings" or "run-rate EBITDA", will leave investors vulnerable to the next downturn in the credit default cycle.

Consequently, in the context of the ongoing implementation of the supervisory expectations outlined in the guidance, the ECB may decide to look again at the definition of EBITDA and the issue of the adjustment of EBITDA.

Use of proceeds or purpose test

A number of participants called for the introduction of a "use of proceeds or purpose test" as a way of identifying leveraged transactions.

The ECB has taken note of the comments received. We would like to reiterate that the supervisory expectations in this guidance require that credit institutions establish sound origination and risk management frameworks and processes for a broad range of credit provided to leveraged borrowers. Excluding loans from the scope of leveraged transactions solely because they do not meet a use of proceeds or purpose test is inconsistent with a comprehensive risk management framework for leveraged transactions. This approach is in line with other regulatory initiatives, such as the US guidance issued in 2013 and the associated FAQs published in 2014.

Private equity sponsors

A number of participants focused on the second dimension of the definition of leveraged transactions and the financial sponsor criterion stipulated therein. In particular, several participants sought clarification regarding the ECB's intentions in respect of the inclusion of a financial sponsor dimension in the definition of leveraged transactions. Respondents also sought clarity regarding (i) the definition of financial sponsors in the guidance, (ii) the counterparties the ECB intends to capture, (iii) the interaction with other exclusions set out in the guidance and (iv) the alignment with other regulatory initiatives.

The ECB has taken note of the comments received. We would like to reiterate that the intention is to capture loans and credit exposures that are used by financial investors for the purposes of raising capital to finance private equity deals, notably leveraged acquisition finance transactions used in order to generate capital appreciation. The exclusions set out in the guidance are equally applicable to the financial sponsor dimension of the definition. The ECB would also like to reiterate that the sponsor test is only met if the financial sponsor controls or owns more than 50% of the borrower's equity and thus actively influences its financial policies. Passive trading investments, for instance, do not fall under this definition. In principle, the transaction will continue to be regarded as a leveraged transaction even if leverage falls below particular threshold levels.

The ECB's objective is to capture leveraged buyouts (LBOs), as well as related financing measures such as capital distribution (dividend recapitalisation, share buy-backs, repayment of subordinated debt, etc.). The ECB considers that these transactions constitute core leveraged transactions and present specific risks warranting closer scrutiny of risk management. This is confirmed by credit institutions' current organisational arrangements in terms of their front office (business line) and risk management set-ups, which reflect the relevant commercial relationships and the specificities of these counterparties in transactions.

The 2015 thematic review on leveraged finance revealed that a large number of credit institutions currently apply a definition of leveraged loans which is limited to LBO financing with presence of a private equity sponsor. The ECB considers this approach to be too narrow and inconsistent with a comprehensive risk management framework for leveraged transactions.

4. Risk appetite and governance

Risk appetite

A number of respondents commented on the supervisory expectations regarding risk appetite and governance arrangements for leveraged transactions. Participants flagged the need for a reference to the principle of proportionality in order to further frame expectations regarding risk appetite and governance.

The ECB has taken note of the comments received. We would like to reiterate that the principle of proportionality as outlined in Section 2 of the guidance applies to all sections and subsections of the guidance. The risk appetite and governance framework should be consistent with the size and risk profile of the credit institution's exposure to leveraged transactions relative to its assets, earnings and capital. Please also refer to Section B.4).

Budget

A number of participants pointed out that establishing a budget for leveraged transactions would be difficult from an operational perspective, as budgets are determined by business lines.

The ECB has taken note of the comments received and removed the reference to the budgeting process.

5. Syndication activities

Scope of leveraged transactions

A number of participants called for further clarification regarding the use of terminology and defined terms in order to ensure consistency and the correct interpretation throughout the guidance. Particular reference was made to Sections 4 and 5 and the terms "credit risk", "syndication risk", "underwriting risk" and "settlement risk".

In addition, a number of respondents asserted that leveraged transactions completed on a "best efforts" basis and "club deals" should not be subject to monitoring and reporting requirements, as these deals do not entail underwriting or syndication risk. Other participants maintained that supervisory expectations regarding underwriting and syndication should only apply to credit institutions which are heavily engaged in these practices.

The ECB has taken note of the comments received. We have amended the wording of Sections 4 and 5 of the guidance to provide greater clarity regarding the scope of the supervisory expectations.

We would like to reiterate that the risk appetite and governance-related expectations in Section 4 mean that all leveraged transactions that entail credit, syndication and underwriting risk should be reviewed and approved in advance by an independent risk function. Such transactions include all syndicated loans, including underwritten and "best efforts" transactions, as well as "club deals" and bilateral loans.

Furthermore, we have amended the wording of the guidance and removed the reference to settlement risk in Sections 4 and 5.

The ECB would like to reiterate that supervisory expectations regarding underwriting and syndication are applicable to the origination and distribution of all leveraged transactions. This includes all syndicated loans, including loans originated on a “best efforts” basis, as well as fully committed distributions. We have renamed Section 5 “Syndication activities” and amended the wording of the guidance accordingly.

In order to further streamline supervisory expectations regarding syndicated and underwritten loans, the reference to “club deals” has been removed. Nevertheless, the ECB’s expectations regarding governance and risk management for leveraged transactions with high levels of leverage (defined as transactions where total debt is more than six times EBITDA at origination) also apply to “club deals” and bilateral loan structures. The wording of the relevant paragraph has been amended accordingly.

A few participants argued that there was a need to harmonise the references to leveraged transactions in Section 5 of the guidance in order to clarify the intended scope of the supervisory expectations.

The ECB has taken note of the comments received and amended the wording of the guidance in order to refer to leveraged transactions in a consistent manner.

Highly leveraged transactions (i.e. total debt in excess of six times EBITDA)

A number of participants argued that there was a need to align expectations regarding excessive leverage with the risk appetite framework of each institution. Particular reference was made to the section of the guidance which required all transactions with total debt in excess of six times EBITDA to be escalated to the “highest level of credit committee or similar decision-making level”. Furthermore, a few respondents asked for further clarification of the term “supervisory concerns” in the context of such leverage levels. Lastly, a few participants called for further clarification regarding the intended scope of these expectations, asking whether they apply only to underwritten transactions or also to “club deals” and bilateral loan structures.

The ECB has taken note of the comments received. The objectives of the expectations set out in the guidance as regards highly leveraged transactions are twofold, focusing on (i) risk appetite and (ii) governance and risk management.

The ECB does not regard total debt of six times EBITDA as a bright line when evaluating the risk in a leveraged transaction. All risk indicators and financial metrics should be assessed in conjunction with one another, and they should include (but not be limited to) an assessment of the sustainability of the capital structure and the borrower’s repayment capacity. The ECB regards excessive leverage as a key risk which raises supervisory concerns. Overall, we expect credit institutions to ensure that more stringent risk management practices are put in place for transactions where total debt is in excess of six times EBITDA.

As regards risk appetite, risk management should stratify the leveraged transaction portfolio into meaningful segments based on risk. Credit institutions are expected to define acceptable leverage levels, both globally and at the more granular industry level, which are in line with their senior management-approved risk appetite framework. The defined risk acceptance criteria and risk management framework should take into account a range of drivers of risk, as well as both sector and borrower-level specificities.

Where transactions exceed approved risk thresholds or total debt is in excess of six times EBITDA, additional evidence of the involvement of senior management and the risk function is required. These transactions should form an integral part of the credit institution's credit delegation and risk management framework. We have amended the wording of the guidance accordingly and removed the reference to the "highest level of credit committee".

The ECB would like to reiterate that the supervisory expectations regarding risk management for transactions with high levels of leverage are also applicable to other forms of leveraged transaction financing, including "club deals" and bilateral loan structures. We have amended the wording of the guidance accordingly.

Furthermore, credit institutions are required to put policies and procedures in place to ensure comprehensive reporting to senior management on leveraged transaction exposures. These policies should clearly articulate the requirements governing such reporting, including as regards the frequency, scope and recipients of such reports.

Failed syndications and "hung transactions"

A few participants argued that the 90-day limit, after which a transaction is to be classified as a failed syndication, should be increased to 180 days. Participants also asked questions regarding the extent to which the 90-day limit is to be seen as an automatic trigger for the reclassification of transactions as failed syndications. A second set of comments focused on definitional aspects with regard to the deal closure date, seeking clarity regarding the specific date on which the 90-day period should begin.

The ECB has taken note of the comments received. Generally speaking, the ECB's supervisory expectations focus on the risks an arranger faces when syndicating leveraged transactions – in particular, the risk of having to retain a larger share in the event that adverse market developments result in a lack of investor appetite.

The supervisory expectations in respect of failed syndications are twofold, focusing on (i) harmonising definitions and (ii) detailing expectations with regard to risk management for failed syndications and excess exposures. Accordingly, credit institutions are expected to put in place stringent risk management and controls for transactions in the pipeline. These should include details of the amounts the credit institution is willing to hold and the amounts that are to be distributed.

As regards the harmonisation of definitions of failed syndications and “hung transactions”, the ECB believes that credit institutions should put in place clear policies and procedures defining and managing the syndication process, as well as policies and procedures governing scenarios where syndications fail and the bank is not able to sell or dispose of long positions. We note that credit institutions determine final hold targets for transactions as part of the risk approval process, and those targets are expected to be in line with the senior management-approved risk appetite framework. The difference between the commitment amount and the approved final take is regarded as market risk exposure to be reduced during syndication. Exposures in excess of these approved hold levels require stringent risk management.

Classifying a transaction as a failed syndication 90 days after the deal closure date was identified as a best practice in the 2015 thematic review on leveraged finance, with the majority of the institutions examined applying a 90-day limit in their internal policies. Furthermore, that limit is in line with other regulatory initiatives. We have, however, changed the term “deal closure date” to “commitment date”. This date should be defined as the date on which the credit institution enters into a legally binding commitment to lend to a counterparty by virtue of an executed loan agreement. All credit institutions are expected to incorporate the above supervisory expectations in their internal policies and procedures. All exceptions should be justified and approved by an independent risk function.

The ECB reiterates that the supervisory expectations expressed in the guidance are focused on wider risk management for failed syndications. This includes the need for a clearly defined and senior management-approved de-risking strategy, as well as dedicated policies and procedures defining and managing distribution failures. The credit institution’s senior management should establish clear expectations governing the disposal of transactions that have not been sold in accordance with their approved distribution plan. In addition, the guidance also sets out supervisory expectations regarding the regulatory classification of failed syndications. In particular, excess positions which the credit institution has not been able to syndicate, sell or dispose of within 90 days of the commitment date should be transferred to the “hold book”. Information concerning the reclassification of exposures as “held to maturity” should be reported to senior management on a regular basis.

The role of the risk function in syndication

A few participants argued that there was a need to further clarify supervisory expectations with regard to the role and position of the risk function in the monitoring of syndication risks borne by credit institutions.

The ECB’s supervisory concerns are focused on the pipeline risks faced by credit institutions engaged in the syndication of leveraged transactions. The ECB reiterates that the involvement of the risk function in the monitoring of syndication activities is considered crucial in order to prevent over-reliance on opinions and information

received from the syndication unit. This should include (but should not be limited to) the assessment of credit and distribution risk at the deal approval stage, the ongoing monitoring of syndicated deals' compliance with senior management-defined limit frameworks, the monitoring of excess positions and approved final hold levels, and regular reporting to the credit institution's senior management on the size and quality of the syndication pipeline.

6. Policies and procedure for new deal approval, and monitoring and managing of longer-term leveraged transaction holdings

Debt repayment capacity

A large number of participants commented on the ECB's supervisory expectations in respect of borrowers' repayment capacity. One set of comments sought clarity on the question of whether the quantitative requirements regarding the total debt repayment capacity should be considered a binding minimum requirement. A second set of comments focused on the need for greater flexibility in the assessment of other factors allowing borrowers to deleverage over the medium term. Another set of participants asked for further clarification regarding the connection between total debt repayment and the issue of total debt exceeding six times EBITDA.

Overall, the ECB has observed a marked trend towards more liberal amortisation profiles in recent loan agreements. In such instances, the ability to service total debt (i.e. cover both interest and required principal payments) may be acceptable, but the ability to repay total debt may be weak. This may signal a high degree of potential refinancing risk. The ECB is of the view that an assessment of a borrower's repayment capacity should include analysis of the likelihood of the borrower actually repaying its debt.

The ECB reiterates its supervisory expectation that a credit institution's credit risk standards should evaluate a borrower's capacity to repay and deleverage to a sustainable level over a reasonable period of time. The wording of the guidance has been amended in order to bring it more into line with existing regulatory initiatives and now includes a reference to the borrower's ability to deleverage. The ECB expects credit institutions to consider all aspects of credit risk when evaluating credit. Additional considerations should also be taken into account in this regard. These should include (but not be limited to) assessments of (i) support from guarantors or sponsors, (ii) the stability of projected cash flow sources, and (iii) the borrower's ability to restrict dividend payments or reduce expenses without affecting ongoing business operations.

In light of the above, the ECB expects credit institutions to use realistic repayment assumptions to determine a borrower's repayment capacity. Credit institutions are expected to consider whether baseline cash flow projections adequately demonstrate the ability to repay debt over the medium term. Critical reviews of business plans and projections should include downside or stress scenarios which

reflect events directly impacting the borrower's ability to generate cash flows. The guidance also expresses supervisory expectations with regard to critical reviews of business plans and projections.

A few participants called for further clarification as to whether the quantitative assessment of borrowers' repayment capacity obliges lenders to impose a contractual repayment profile of facilities on borrowers.

The ECB would like to clarify that an assessment of a borrower's repayment and deleveraging capacity should be carried out irrespective of whether the repayment profile is contractually required under the loan agreement.

A number of participants indicated that the reference to total debt "granted by the financial institution" is misleading, as the borrower's capital structure may include other creditors.

The ECB has taken note of the comments received. We have clarified this situation by removing the reference to debt "granted by the financial institution". The ECB is, however, of the view that senior secured debt, which is often held by credit institutions, should be fully amortised within a five to seven-year period. We have therefore revised the supervisory expectation relating to the debt repayment capacity and added a second supervisory expectation relating to the repayment of senior secured debt. The latter also further aligns the guidance with existing regulatory initiatives.

A number of participants focused on the expectations set out in the guidance with regard to collective provisioning. Further clarification was sought regarding the ECB's intentions in this regard, particularly against the backdrop of the implementation of IFRS 9.

The ECB has taken note of the supervisory expectations set out in the guidance and removed the expectation in question. We would like to emphasise the ECB's supervisory expectations with regard to the assessment of the borrower's repayment and deleveraging capacity as part of the risk management framework underlying leveraged transactions.

Enterprise valuation

A number of participants argued that there was a need for further clarification regarding supervisory expectations in respect of enterprise valuation. Furthermore, some participants asked for further information regarding the requirements governing enterprise valuations.

The ECB has taken note of the comments received. We would like to stress the central role that enterprise valuation plays in the assessment of a borrower's repayment capacity, and ultimately the assessment of credit risk. In many instances, credit institutions rely on enterprise values as a supplementary or secondary source of repayment. Furthermore, enterprise values may be used, during the life of the leveraged transaction, to assess a financial sponsor's economic incentive to provide

financial support to the borrower. The determination of credible enterprise values is thus of vital importance not only in the syndication and underwriting of leveraged transactions, but also in the ongoing risk management and assessment process.

Credit institutions are expected to establish sound methodologies determining enterprise values. The assumptions underlying estimates of enterprise values should be documented, well supported, and duly reviewed, challenged and validated by an independent function other than the originating or front office function. Consequently, they should form an integral part of the credit approval process.

The ECB sees three possible approaches to the valuation of enterprises: an income-based approach, an asset-based approach and a market-based approach. A combination of these approaches may be used, while the income-based approach is regarded as the most common and reliable method. In order to ensure credible final values, assumptions should be clear, well documented and appropriate for the company's industrial and financial situation. It would generally be inappropriate to regard enterprise values as a secondary source of repayment unless that value was well supported.

Another set of comments focused on the relevance and applicability of enterprise values in non-LBO transactions, pointing out that the specific characteristics of such transactions warrant the calculation of enterprise values. Such a credit process is not generally applied when financing is provided to companies that are not the subject of LBO transactions.

The ECB has taken note of the comments received. We would like to reiterate and emphasise the importance of the principle of proportionality in the context of the implementation of this guidance. Please also refer to Section B.4).

Pricing of leveraged transactions

A number of participants indicated that the guidance should further clarify supervisory expectations with regard to the independent verification of pricing by the risk function during the credit approval process.

The ECB has taken note of the comments received. The ECB reiterates that a function independent of the front office is expected to verify the pricing of the loan during the credit approval process. This assessment should be based on detailed analysis prepared by the front office. We have amended the wording of the guidance in this regard and removed the reference to the risk function. The supervisory expectation has been moved to Section 5.

Furthermore, the evaluation of risk/return metrics for proposed leveraged transactions should form an integral part of the information provided to senior management during the credit approval process.

Ratings

A number of participants focused on the ECB's supervisory expectations with regard to the rating of leveraged borrowers. In particular, participants pointed out that the wording of the draft guidance, which required a single rating combining all features (such as leverage and structure), would not be consistent with PD and LGD instructions.

The ECB has taken note of the comments received and removed the relevant expectation from its guidance. We would, however, like to reiterate that all of the aspects outlined in Section 6(i) should form part of the credit approval process and the ongoing monitoring of leveraged transactions.

Impairment test triggers

A number of participants focused on the supervisory expectations relating to impairment testing and their alignment with existing regulatory initiatives and guidelines.

The ECB has taken note of the comments received. We have amended the guidance to ensure alignment with the recently published EBA and ECB guidelines, which indicate that each credit institution is expected to ensure that the internal policies and procedures governing its impairment methodology are fully aligned with all the requirements in the respective guidelines.

However, the ECB deems it necessary for credit institutions to have clearly defined internal criteria identifying indicators of unlikelihood to pay (UTP), which should refer to clearly defined triggers (UTP events). In particular, credit institutions should ensure that their internal criteria in respect of non-performing exposures, default and impairment classification are fully aligned with the specificities of leveraged transactions (covenant breaches, increases in leverage, etc.).

The above-mentioned internal criteria must be fully aligned with (i) the EBA's implementing technical standards on supervisory reporting on forbearance and non-performing exposures under Article 99(4) of the CRR, (ii) the EBA's guidelines on the application of the definition of default under Article 178 of the CRR, and (iii) the ECB's guidance to banks on non-performing loans.

Stress-testing framework

A number of participants indicated that the guidance should further clarify supervisory expectations with regard to stress testing. Participants called for further clarification with regard to the content and format of the stress-testing framework for pipeline exposures, including details of the business functions involved and the expected frequency of stress tests for these exposures.

The ECB has taken note of the comments received. It would like to reiterate that credit institutions' stress-testing frameworks should be defined internally, taking account of institution-specific characteristics such as their business models and organisational arrangements while emphasising the issue of proportionality.

The wording of Section 6 of the guidance has been amended to provide further clarity regarding "tail-end events". Tail-end market events are defined as unlikely events in the tail of the probability distribution which have a significant impact on credit institutions' portfolios. The reference to "directly impacting a borrower's credit portfolio" has been removed to avoid contradictory interpretations.

7. Secondary market activities on leveraged transactions

A number of participants called for the guidance to clarify supervisory expectations with regard to secondary market activities relating to leveraged transactions.

The ECB has taken note of the comments received. We would like to reiterate that the ECB expects credit institutions to be able to identify and aggregate their exposures to leveraged borrowers irrespective of the accounting classification.

Exposures should be reported to senior management as part of general reporting on leveraged transactions.

8. Reporting requirements and Management Information Systems (MIS)

Various participants asserted that credit institutions should be given sufficient time to adapt their management information systems in order to identify, aggregate and monitor leveraged transactions and take account of all other relevant aspects of the guidance.

The ECB has taken note of the comments received. We would like to reiterate the ad hoc requirements set out in Section 9 of the guidance. In particular, 18 months after the publication of the guidance, an internal audit report should be drawn up and submitted to the JST responsible for the credit institution. This report should detail the extent to which the supervisory expectations expressed in the guidance have been implemented by the credit institution. The JST will then assess the implementation of the guidance.

9. Requirements following release of the guidance

Some respondents argued that the proposed 18-month period for the implementation of the guidance and the submission of an implementation report to the JST was not long enough.

The ECB has taken note of the comments received. The guidance has been amended and a new requirement has been added. In particular, requirements set out in the guidance will enter into force six months after its publication.

Furthermore, the ECB would like to reiterate that 18 months after the publication of this guidance, an internal audit report should be drawn up and submitted to the JST detailing how the supervisory expectations expressed in the guidance have been implemented by the credit institution. The JST will then assess the implementation of the guidance. Thus, the ECB deems 18 months to be sufficient to implement the key aspects of the guidance.

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