



## Public consultation

Draft guidance of the European Central Bank on leveraged transactions

Template for comments

Contact details (will not be published)

Institution/Company

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Please tick here if you do not wish your personal data to be published.

Please make sure that each comment only deals with a single issue.

In each comment, please indicate:

- the relevant article/chapter/paragraph, where appropriate
- whether your comment is a proposed amendment, clarification or deletion.

If you require more space for your comments, please copy page 2.

# Public consultation

Draft guidance of the European Central Bank on leveraged transactions.

Template for comments

Name of Institution/Company      **Division Bank and Insurance, Austrian Federal Economic Chamber**

Country      **Austria**

## Comments

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Concise statement of why your comment should be taken on board

### **General Remarks**

Guide	Issue	Guidance (Include number)	Comment
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One of our member institutions just received a letter from the ECB announcing what would be expected from the bank in respect of leveraged finance activities: the application of a group wide uniform definition of so classified transactions, a corresponding flagging in our systems and a monitoring making sure that in case strategy changes lead to increased exposure levels, regulators (e.g. the ECB) would get informed accordingly.

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The draft guidance is now substantially extending this requirement, as it switches from the individualized and proportionate approach to a “one size fits all” expectation of guidance implementation. In contrast the draft states as follows (scope definition): *“While all significant credit institutions should translate this guidance into their internal policies, the implementation of this guidance should be consistent with the size and risk profile of institutions leveraged transactions relative to its assets, earnings and capital”.*

Therefore, with the new draft paper it raises the following two general questions:

- What would be the effective requirement, implementing the above mentioned ECB letter or the new guidance? Will there be an interaction of both or will the guidance annul the ECB letter?
- Despite the above carve-out, due to the high level of detail we do not see any room of maneuver. In this context, how should the guidance practically be applied for banks while recognizing at least a certain level of proportionality when implementing the guidance?

One of the most critical aspects of the Guidance is the proposed definition of leveraged transactions. We see in the proposal a significant threat that transactions which belong to the classical activities of a commercial bank shall be taken into the scope of this Guidance and consequently flagged as “leveraged transactions” with the following effects:

- a) Diluting the pertinence of the proposed reporting tools;
  - b) Leading to a misallocation of bank resources.
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(Please see the respective section below for more detailed comments on the definition.)

Furthermore, by definition and based on regulatory requirements banks' risk measurement systems are designed to identify and flag (e.g. through corresponding risk parameters) transactions with higher risk profile so that the appropriate procedures are activated. The same goes for stress testing where the leveraged loan portfolio is anyway part of any general stress testing. That is why we are convinced that the **general risk procedures, policies and monitoring systems are already comprehensive and strong enough, according to the remarks of one member institution. A further special treatment** to single out specific loan categories appears disproportionate in this regard.

The draft guidance also refers to a large number of new concepts and definitions. Not only would these definitions – as they have not been used or harmonized so far - be potentially subject to a large variety of interpretations and be understood in a heterogeneous way but, more importantly, their implementation will **significantly increase the complexity of relevant banks' Business Data Models** and, following, the one-off and running costs for banks. Additionally, it should be kept in mind that by nature a more in complexity (like frameworks that generate reporting requirements) is accompanied by increasing failure risks and a diminishing in the capability to effectively monitor the portfolio.

To give a first non-exhaustive overview of these new regulatory

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definitions which banks would have to set and flag in their systems:

- Own and new Credit Exposure Definition (footnote 4)
- Total Debt
- EBITDA
- Loan or credit exposures (...) where the proceeds aim at capital or dividend distributions
- Corporate Bond (non-financial) exposures (...) either as part of a primary issuance or as part of a secondary purchase irrespective of the classification in the regulatory banking book or regulatory trading book
- Total financing size (footnote 13)
- Commercial Real Estate collateral
- Asset-Based Loans
- Project finance Loans
- „best-effort“ deals
- „club-deals“
- weak covenant
- breach of material financial covenant
- non-remediation of covenant breach
- bullet facility

In its consequence it needs to be highlighted why the implementation becomes a critical point, e.g. the usage of the EBITDA. It would be a **specific burden for fast growing companies** as historic EBITDA might no longer be a useful guidance for the company's appropriate financing needs.

As the proposal also aims to regulate the underwriting and syndication of Non-Leveraged Transactions – if this is indeed the intention of this Guidance, as stated under *ii. Scope of the Guidance on leveraged transactions* at page 3 -, it should be made clear at the outset in the title of the regulation.

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Taking all the aspects together (including the detailed remarks outlined below) we need to point at the fact that guidance (regulation) on leveraged transactions creates not only new burdens that have to be implemented. The guidance also **supports an imbalanced regulation**, lifting it on a new level especially when comparing it to those **applicable within SSM, EU and Non-EU regions**. It fosters institutions and/or its customers to shift transactions that (potentially) set thresholds to regions without such regulation. It is, hence, suitable to support **creating** a split market where regions not supervised by ECB (e.g. UK) are not just in a competitive advantage but also stimulate **an environment of regulatory arbitrage**.

Therefore, we urge the ECB to reconsider the need for such a regulation and to reflect possible alternatives. At least **we highly suggest to consider carefully the fine-tuning of definitions and thresholds to be implemented**.

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<input checked="" type="checkbox"/>	3 (i)	Amendment	P. 3/11 – 3 (i) the guideline should refer to Total <b>Net</b> Debt rather than Total Debt as companies should not be penalised for holding liquid funds to fund e.g. their day to day business or as liquidity back up
<input type="checkbox"/>	3 (i)	Amendment	3 (i) Should exclude any company with a post transaction external rating of [BB] or better
<input type="checkbox"/>	3 (i)	Clarification	3. (i) certain capital strengthening measures planned especially for corporate transaction post closing (planned capital increases or hybrid issuances to amongst other reflect bridge to equity

			structures, planned asset disposal) within a period of [6-12] month should be also taken into account
<input type="checkbox"/>	3 (i)	Clarification	3. (i) leverage ratios should refer to the consolidated numbers of the group and not the single borrower entity
<input type="checkbox"/>	3 (i)	Clarification	3 (i) The current draft wording would also include loans to SME companies, not being held by a Financial Sponsor. Reporting requirement seems excessive for these kind of companies.
<input type="checkbox"/>	3 (i)	Clarification	3 (i) depending on the industry and company specifics (e.g strong cash flow generation, high barriers to entry, strong cash flow visibility), an outgoing leverage level of 4x might not be appropriate.
<input type="checkbox"/>	2	Clarification	The guidance states that the implementation should be consistent with the size and risk profile of the institution's leveraged transactions relative to its assets, earnings and capital. Though further details in the conditions outlined in the following sections do not allow for a proportionality based consideration or a materiality assessment but rather set narrow and strict requirements. While we acknowledge that these might be meaningful for large investment banks with a significant leveraged transaction portfolio and strategy, it is definitely less relevant for retail banks with a small corporate portfolio and an immaterial leveraged transactions portfolio. Therefore, we recommend <b>reflecting the proportionality principle for the</b>

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**specific requirements** listed in the following sections.

*Question:* How is the last paragraph to be interpreted? According to which criteria should banks define “other types of transactions” to this Guidance?

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*Leveraged transactions vs. whole client exposure:* Although the text refers to “transactions”, when considering the wording under(i) “*All types of loan or credit exposures [...]*”, it effectively means that, as soon as a Corporate falls beyond the proposed threshold, **any single credit product contracted with the relevant client would be eligible to this policy.**

The following examples show how this approach could lead to unintended side-effects - in some cases leading to a double flagging with e.g. the Early Warning Systems of the bank:



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Amendment

- Conclusion of a new loan to a borrower being a Financial Holding (often highly leveraged and understanding that Total Debt/EBITDA shall be computed at borrower level);
- Conclusion of a new working capital facility with a weak borrower within a strong group of companies, irrespective of any explicit or implicit support.

To overcome these unintended obstacles we suggest **instead focusing on specific transactions like financing of buy-out, acquisitions or recapitalisations of companies as well as applying the criteria Groups of Connected Customers instead of Single Borrowers.**

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An approach we deem practicable would be to base the definition of leveraged transactions mainly on the purpose of facilities (i.e. where facilities are used to fund an acquisition or a dividend which exceeds a long term average). With a first analysis we came to the conclusion that in case all credit exposures where the borrower is owned by one or more financial sponsors are included in the definition one would cover all transactions which we would consider to be leveraged transactions. Other cases which would be captured by the 4x leveraged threshold as such would mainly be (i) work out clients, (ii) clients already flagged by early warning systems and (ii) members of client groups which have lower leverage on a consolidated basis.

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Amendment

*Precise definition of Total Debt and EBITDA:* When it comes to the details, neither Total Debt nor EBITDA are defined prescriptively by IFRS norms<sup>1</sup>. Therefore, **we would assume that banks will be allowed to use their already existing definitions.** Otherwise will there be adopted or new regulatory standards?

Apart from the fact that the latter would generate material new investment costs, as existing definitions have proved to work

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<sup>1</sup>Financial liabilities" are defined in IAS 32, IFRS 9 und IFRS 7. We are not aware that an exhaustive and normative classification exists, the standards are very broad and the only clear requirement is the existence of a financial contract or instrument.

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perfectly well, we do not see the rationale behind giving up a functioning system easily. In consequence it would mean to maintain 2 different definitions, regulatory and risk-driven internal ones.

Another alternative would be to use the definitions used by clients in their disclosures, yet thereby creating an incentive to optimize such figures, which is therefore nothing we would recommend; nevertheless, in this case banks would probably continue using an additional internal definition, at least for purposes of an appropriate risk analysis.

Another aspect with an EBITDA that is not a standard measure defined by IFRS, many companies, in particular smaller ones, do not report EBITDA figures at all. Even in case EBITDA is reported in the financial statements it will normally refer to calendar dates rather than the EBITDA over the last twelve months as used in the draft guidance.

Please also note that the guidance correctly refers to a post-financing level of leverage which will per definition require a pro-forma calculation of EBITDA and Debt after consummation of the transaction. We think that this is contradictory to the requirement to use unadjusted EBITDA given the fact that the designation of a financing as a “leveraged transaction” shall be made i.a. at loan origination. At least allowing adjustments to EBITDA which are confirmed by third party due diligence should be included.

If Total Debt is used as a parameter (rather than net senior debt which we would consider to be more appropriate) it should at

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least allow for the exclusion of subordinated shareholder debt (which is normally used as an equity surrogate for tax reasons) and other forms of deeply subordinated instruments (e.g. PIK notes, structurally subordinated debt).

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Amendment

Total Debt according to IFRS: It also has to be kept in mind that not all clients use IFRS in their reporting standards (in fact in some regions or industries it is the minority) which would result to additional implementation burden, cost and effort for the relevant leveraged transactions.

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Amendment

Definition of EBITDA when calculating the Debt/EBITDA ratio (complement to the previous point): The Draft does not permit the add-back of any **one-time items** (even if they are non-cash) and does not explicitly refer to any pro forma adjustments for acquisitions when calculating EBITDA (i.e. without pro forma adjustments debt would increase for a proposed acquisition but EBITDA would not). We believe the failure to add these items back to EBITDA will fundamentally understate cash flows thereby overstating the total leverage ratio, causing more transactions to be defined as leveraged loans even (under certain circumstances) if they are investment grade rated by the agencies.

Moreover, while we would agree that “one-time” items that seem to occur every year should not be added back to EBITDA, leveraged loan credit analysts should have sufficient expertise to appropriately determine if any such charges are truly one-time or recurring in nature and whether they should or should

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not be added-back to EBITDA. Similarly, credit analysts need to be permitted to make defensible judgments (and apply appropriate “haircuts”) to transaction synergies, a portion of which may also be added back to EBITDA, if analysis can justify the add-back. Therefore, we believe that supportable add-backs to EBITDA will result in the determination of “adjusted” EBITDA and this is the appropriate financial measure to use when calculating a borrower’s initial and on-going pro forma leverage. In other words, we would **suggest to use** (and the U.S. Regulator already agrees on this approach) **established market standards combined with appropriate “haircuts” to determine adjusted EBITDA which is more appropriate than unadjusted LTM EBITDA.**

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3 Amendment

Net Senior Debt vs. Total Debt: In general a leverage of 4 seems to be very low when using total debt. Instead using **net senior secured debt** (which is usually already part of the deal structure a bank is investing in) appears to be more appropriate. Indeed, distinction should be made between the different types of debt, i.e. Senior Debt, Mezzanine, Junior Loan, Subordinated loan, etc. Moreover, we suggest a **Net Leverage** is a more adequate measure of the true economic leverage of the counterparty especially while bearing in mind that leveraged finance transactions are generally structured with covenants and limitations ensuring that cash remains with the borrower.

3 Amendment

Proposed calibration of gross leverage (Total Debt/EBITDA): The considered High Leverage, as described in the Draft, which per se can be fully justified in the lifetime of non-current assets

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financed by debt, seems to be very long. This is in particular the case for the financing of investments into infrastructure (motorways, airports, train tracks, etc.), some transport equipment (e.g. locomotives, ships) or utilities (gas, electricity and heat transport or storage). This kind of **industries would be unfairly discriminated** as it would have a considerable and **detrimental impact on economies** throughout the EU **if not appropriately incorporated or excluded from this guidance**.

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Amendment

Financial sponsors: The proposed definition would cover all credit exposures to a borrower “owned by a financial sponsor”. We do not see the rationale why the nature of the owner of a company is sufficient to qualify all transactions contracted with it as leveraged, irrespective of any other criteria, in particular the level of debt. Besides, it should be highlighted that transactions involving financial sponsors are usually structured as non-recourse, booked in ring-fenced structures controlled through covenants and limitations (e.g. on dividends, use of cash and/or new debt) and thereby limiting any contagion risks.

Therefore, we suppose the term “financial sponsor” to become clearer defined, in particular with regard to infrastructure funds and financial conglomerates which operate similar to private equity funds but are not necessarily seeking to exit their portfolio companies on a medium-term basis.



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Amendment

Trade Finance: The exclusion of trade finance from the definition is too narrow. Traders generally run higher leverage ratios as the financing is in relation to their working capital

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needs. **They should therefore in general be excluded from the definition also for financings which do not constitute trade finance.**

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<input type="checkbox"/>	3	Amendment	<p><u>Secondary purchases of non-investment grade bonds &amp; loans:</u> We do not understand why secondary purchases of these assets would lead to a leveraged designation but primary allocations presumably would not (i.e. secondary purchases require a leveraged designation but primary allocations are not discussed in this section). Perhaps the regulators could explain what otherwise could be an inconsistent application of the leverage designation.</p>
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<input type="checkbox"/>	3	Deletion	<p><u>Item ii) of the Definition (page 4):</u> The fact that proceeds from a transaction are used for dividend distribution does not mean that there is elevated risk if the leverage remains low. In addition, you might argue that any loan for general corporate purposes might finance a dividend and should be included. We would appreciate to see the rationale behind; otherwise we suggest canceling this condition.</p>
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<input type="checkbox"/>	3	Clarification	<p><u>CLOs are defined as Leveraged Transactions:</u> While we recognize that CLOs are highly leveraged financial assets; their structured nature requires an analysis that is fundamentally different from the analysis of a corporate credit. As a result, while the initial and on-going credit analysis of a CLO must be comprehensive, a CLO's analyses cannot conform with the GLT's corporate credit analysis requirements (e.g. ability to</p>
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repay  $\geq$  50% of total debt within 5-7 years; leverage tests; industry analysis; etc. are not applicable to the analysis of a CLO). Perhaps the regulators could provide their rationale for defining CLOs as leveraged transactions.

More generally, the inclusion of all non-investment grade corporate bonds and non-investment grade syndicated loans purchased in the secondary market goes way beyond what the market considers to be a leveraged transaction. It is also unclear why one would differentiate between non-investment grade syndicated loans purchased in the secondary market and other non-investment grade syndicated loans. We also do not see why the fact a loan is purchased in the secondary market should be risk relevant.

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Clarification

Total financing size below EUR 15m: We welcome the introduction of a materiality threshold. However, the proposed definition refers to “the amount raised by the borrower from all lenders across all deal tranches”. How shall banks have access to this information? Is it planned to set up a register with corresponding data?

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Clarification

Flagging of transactions over time: It should be made clear that the **classification of a transaction is done once at the beginning and remains unchanged** over the lifespan of this particular loan. Any other approach would be counterproductive from a limit management and steering perspective. Therefore, it should be clarified that a plain vanilla loan does not become a leveraged transaction due to a deterioration of credit metrics

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over time. Footnote 7 should be more precisely formulated to avoid any doubt in this respect.

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#### **Proposed approach for alternative definitions**

Taking into account all above mentioned obstacles or critical aspects we suggest to consider the following alternative definitions for a (potential) guidance to ensure not only a regulatory perspective but also a pragmatic approach that recognizes implementation that are already successfully in place:

**Scope** -to be focused **on high risk lending transactions only**;  
i.e.:

- Buy-out, acquisitions and recapitalisations of companies by private equity funds and/or strategic investors with non-recourse structures, and
- Corporate acquisitions on a recourse basis if the debt funded portion of the purchase price is higher than X time the acquirer's EBITDA.

Within the same portfolio it should be considered as leveraged transactions those with the following features, after consummation of the transaction:

- **Net Senior Debt** / EBITDA is higher than Y time EBITDA,
- **Non-investment grade counterparty** (or the equivalent according to the internal rating measures of the bank),
- For US transactions, these fulfil the criteria of the US Interagency Guidance on Leveraged



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Amendment



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Lending.

The **Materiality Thresholds** of **EUR 25m** including own bank consolidated exposure instead of “total financing size” are to be considered more appropriate.

In addition, we suggest all metrics should be measured at the **level** of the **Group of Connected Customers** (which is the only comprehensive measure of the counterparty risk exposure).

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4

Clarification

Settlement risk: where does the ECB see settlement risk in relation to leveraged transactions?

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4

Clarification

Stress testing framework: We understand the requirement on a stress testing framework as being part of the general stress testing of the institution in the way of a simple scenario analysis and not a full separate stress test. As such the scenario may differ from one transaction to another.

Contradictory we see the requirement under section iv./ii) Ongoing monitoring (page 8), which implies the monitoring to be complemented by a full blown stress-testing framework capturing tail-end market events such as surge in default rates, rating migrations, collateral discounts for the specific leveraged transaction portfolio. If such portfolio is deemed immaterial to the bank’s risk profile, such stress testing requirement is viewed to be unproportional for ensuring adequate risk steering.

The meaning of the last paragraph in this section is unclear to us.

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<input type="checkbox"/>	5	Clarification	<u>Settlement risk</u> : What is meant by “settlement risks” in relation to “best-effort deals” and “club deals”?
<input type="checkbox"/>	5	Clarification	<u>Failed syndication</u> : 90 days seems to be too short as the time horizon for the (re-)selling is agreed of up to 6 months. Our counter-proposal would be that banks should define and document for each transaction a <b>target period</b> that could be combined with a cap, e.g. 9 months for all banks. In consequence not meeting this target would automatically flag the transaction as “hung”.
<input type="checkbox"/>	5	Clarification	<u>Clarification</u> : Chapters 5 and 6 of the draft guidance contains provisions which refer to (i) underwriting in general (ii) underwriting of leveraged transactions and (iii) final take holds. It is not clear which provisions apply to which of those activities. E.g. it seems that the 6.0 times criteria in Chapter 5 is applicable to underwritings only but not to take holds which are covered in Chapter 6. It should be clear from the guidance which provisions refer to which concrete activity.
<input type="checkbox"/>	5	Clarification	<u>“Best effort”/ “club deal”</u> : We do not see the rational why transactions on a “best effort” basis as well as “club deal” should be subject to specific reporting requirements as they do not constitute any underwriting or syndication risks.
<input type="checkbox"/>	6	Clarification	<u>Valuation of enterprise value of the borrower in credit approval process</u> : The guidance is asking for a valuation to be performed

			<p>by a unit independent from the origination unit. It appears to us as if valuation would be currently performed in “origination”, “coverage” or in the unit acquiring the asset on secondary market, rather than in a unit independent from these ones. Nevertheless “valuation” is always challenged and checked in “underwriting” and therefore the <b>four-eye principle is respected and therefore should also be considered to be sufficient with an upcoming guidance.</b></p>
<input type="checkbox"/>	6	Clarification	<p><u>Definition of weak covenants:</u> What is the exact definition of “significant headroom”? Additionally, the inclusion of weak covenants in the rating is not consistent with the general rating approach as a rating relates to a borrower while a weak covenant structure is a feature of a facility rather than the borrower as such.</p>
<input type="checkbox"/>	6	Clarification	<p><u>Risk verification of leveraged loan pricing:</u> The wording here should be more precise and underline that under “verified by risk function prior to the credit granting” is meant that the pricing and profitability as well as the evaluation of the risk/return relation of considered transactions should be an integral element of the information to be delivered to decision-makers.</p> <p><u>Stress-testing framework:</u> Please see our comments above at <i>iv. Risk Appetite and Governance</i>.</p>
<input type="checkbox"/>	7	Amendment	<p>As already underlined above, the inclusion of all non-investment grade corporates goes far beyond what we usually consider to</p>

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be leveraged finance.

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8

Amendment

The minimum requirements for reporting make sense only if this portfolio is material for an institution's risk profile, therefore a reasonable recognition of **proportionality principles** should be reflected in this section.

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Choose one option

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