



# Public consultation

Draft guidance of the European Central Bank on leveraged transactions.

Template for comments

Name of Institution/Company      European Savings and Retail Banking Group (ESBG)

Country      ---

## Comments

Guide	Issue	Guidance (Include number)	Comment	Concise statement of why your comment should be taken on board
<input type="checkbox"/>	Threshold of Total Debt to EBITDA ratio of 4.0 times	Point 3	Amendment	<p>The threshold of total debt to EBITDA of at least 4.0 times could be modified to reflect the threshold used in the “Asset Quality Review” (European Central Bank, AQR phase 2 Manual, March 2014) where the “High Risk” definition was established at Total Debt to EBITDA of at least 6.0 times.</p> <p>In addition to this, the ECB’s currently proposed threshold may not be as effective in sectors where the borrowers’ businesses</p>

				<p>are highly regulated (for instance, in Spain: Red Eléctrica, Enagas, highway concession companies...).</p> <p>Furthermore, ESBG also proposes to use the exceptions established by the ECB in the AQR methodology: Total Debt to EBITDA at least 10.0 times for utilities and Total Debt to EBITDA at least 12.0 times for infrastructures.</p> <p>Finally, since the US guidelines (from the Fed) allow for the use of the adjusted EBITDA, we suggest considering the latter instead of the unadjusted one. The net debt in this ratio could also be considered.</p>
<input type="checkbox"/>	Total financing size below EUR 5 million	Point 3	Amendment	<p>ESBG suggests increasing the threshold from EUR 5 million to EUR 30 million in order to adequately reflect the nature of the leveraged lending activity.</p> <p>In addition, we are of the opinion that it should be focused on the total credit exposure of the borrower to each financial institution acting as a lender (instead of all lenders across all deal tranches).</p>
<input type="checkbox"/>	Credit approval: "Due diligence - valuation of the enterprise value of the borrower by an independent unit	Point 6	Deletion	<p>We propose to remove this statement from the final guidelines since the due diligence of the transaction is based on the borrower's generation of future cash flows to repay the debt at the due time (carried out in "bank case" and several "stress case" scenarios). A full valuation of the enterprise value of the borrower would, in our opinion, add unwanted uncertainty and</p>

	other than the origination unit”			burden without adding new material information for the repayment of the debt, especially for the smaller borrowers.
<input type="checkbox"/>	Definitions	Entire draft Guidance	Clarification	The draft Guidance also refers to a large number of new concepts and definitions. These definitions – as they have not been used or harmonised so far – would potentially be subject to a large variety of interpretations and be understood in a heterogeneous way and, perhaps even more importantly, their implementation would significantly increase the complexity of relevant banks’ Business Data Models and, as a consequence, the running and one-off costs for banks. Additionally, it should be kept in mind that, by nature, more complexity (like frameworks that generate reporting requirements) is accompanied by increased failure risks and diminished capability to effectively monitor the portfolio. ESBG suggests fine-tuning several definitions based on these considerations.
<input type="checkbox"/>	Scope of the guidance on leveraged transactions	Point 2	Clarification	If we understand it correctly, the draft also aims to regulate the underwriting and syndication of non-leveraged transactions. If this is indeed the intention of this Guidance (as stated under point 2: Scope of the Guidance on leveraged transactions), it should be made clear at the outset in the title of the regulation.
<input type="checkbox"/>	Proportionality	Entire draft Guidance	Amendment	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. However, further details in the conditions outlined in the following sections do not allow for a proportionality based

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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, ESGB recommends reflecting the proportionality principle for the specific requirements listed in the following sections.

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<input type="checkbox"/>	Scope of the guidance on leveraged transactions	Point 2	Clarification	How is the last paragraph of point 2 to be interpreted? According to which criteria should banks define “other types of transactions”?
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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 for this policy.

<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Amendment	<p>The following examples show how this approach could lead to unintended side effects - in some cases leading to a double flagging e.g. with the early warning systems of the bank:</p> <ul style="list-style-type: none"><li>• 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);</li></ul>
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- 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-outs, acquisitions or recapitalisations of companies as well as applying the criteria to groups of connected customers instead of single borrowers.

An approach which ESBG deems 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). 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 4.0 times leveraged threshold would mainly be (i) work out clients, (ii) clients already flagged by early warning systems and (iii) members of client groups which have lower leverage on a consolidated basis.

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<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Amendment	<p><u>Precise definition of Total Debt and EBITDA:</u></p> <p>Regarding the details, neither Total Debt nor EBITDA are defined prescriptively by IFRS norms. Therefore, we assume that banks will be allowed to use their already existing</p>
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definitions. If this is not the case, will new regulatory standards be adopted?

Apart from the fact that the latter would generate new material investment costs, as existing definitions have proved to work perfectly well, we do not see the rationale behind giving up a functioning system so easily. In consequence, it would mean to maintaining two different definitions, regulatory and risk-driven internal ones.

An alternative would be to use the definitions used by clients in their disclosures, thereby creating an incentive to optimise such figures, which is not, however, something that 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 is that EBITDA that is not a standard measure defined by IFRS and many companies, in particular smaller ones, do not report EBITDA figures at all. Even in cases where 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 draft 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. ESG thinks 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 at loan origination. At the

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very least adjustments to EBITDA which are confirmed by third party due diligence should be allowed.

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

Definition of leveraged transactions      Point 3      Amendment

It 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 in additional implementation burden, cost and effort for the relevant leveraged transactions.

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Definition of EBITDA when calculating the Debt/EBITDA ratio (complement to the previous point):

Definition of leveraged transactions      Point 3      Amendment

The draft Guidance does not permit the adding 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

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circumstances) if they are rated as investment grade by the agencies.

Moreover, while we 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 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 adding back. Therefore, we believe that supportable adding 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, ESG would suggest using (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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Net Senior Debt vs. Total Debt:

In general a leverage of 4.0 seems to be very low when using Total Debt. Instead using Net Senior Secured Debt (which is usually already as part of the deal structure a bank is investing in) appears to be more appropriate. Indeed, a distinction should be made between the different types of debt, i.e. Senior Debt, Mezzanine, Junior Loan, Subordinated loan, etc.



Definition of leveraged transactions

Point 3

Amendment

				<p>Moreover, we believe that 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.</p>
<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Amendment	<p><u>Proposed calibration of gross leverage (Total Debt/EBITDA):</u></p> <p>The considered high leverage, as described in the draft Guidance, which per se can be fully justified in the lifetime of non-current assets 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). These kind of industries would be unfairly discriminated against, and it would have a considerable and detrimental impact on economies throughout the EU if not appropriately incorporated or excluded from this guidance.</p>
<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Clarification	<p><u>Financial sponsors:</u></p> <p>The proposed definition would cover all credit exposures to a borrower “owned by a financial sponsor”. We do not see the rationale as to 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-</p>

				<p>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.</p> <p>Therefore, we suggest defining more clearly the term “financial sponsor”, 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.</p>
<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Amendment	<p><u>Trade finance:</u></p> <p>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 needs. They should, in ESBG’s opinion, therefore also be excluded from the definition for financings which do not constitute trade finance.</p>
<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Clarification	<p><u>Secondary purchases of non-investment grade bonds &amp; loans:</u></p> <p>ESBG does not fully 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).</p>
<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Clarification	<p><u>CLOs are defined as Leveraged Transactions:</u></p> <p>While ESBG recognises that collateralised loan obligation (CLOs) are highly leveraged financial assets, their structured</p>

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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 analysis cannot conform with the GLT's corporate credit analysis requirements (e.g. ability to repay more than 50% of total debt within 5-7 years; leverage tests; industry analysis; etc. are not applicable to the analysis of a CLO). ESG would appreciate if the rationale for defining CLOs as leveraged transactions could be elaborated on.

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 do not see either why the fact that a loan is purchased in the secondary market should be risk relevant.

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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 over time.

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<input type="checkbox"/>	Definition of leveraged transactions	Point 3	Clarification
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Proposed approach for alternative definitions

Taking into account all above mentioned obstacles or critical aspects, ESBG suggests considering the following alternative definitions for a (potential) guidance to ensure not only a regulatory perspective but also a pragmatic approach that recognises implementations that are already successfully in place:

Scope: to be focused on high risk lending transactions only; that is:

- Buy-outs, 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 times 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 times EBITDA;
  - Non-investment grade counterparty (or the equivalent according to the internal rating measures of the bank);
  - For U.S. transactions, these fulfil the criteria of the U.S. Interagency Guidance on Leveraged Lending.
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Definition of leveraged transactions      Point 3      Amendment

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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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<input type="checkbox"/>	Risk appetite and governance	Point 4	Clarification	<u>Settlement risk:</u> Where does the ECB see settlement risk in relation to leveraged transactions?
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<input type="checkbox"/>	Policies and procedures for new deal approval, and monitoring and managing of longer-term leveraged transaction holdings	Point 6	Amendment	<u>Stress testing framework:</u>  We understand the requirement of 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.  Contrarily, we see the requirement in Point 4, (ii) On-going monitoring, 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, and collateral discounts for the specific leveraged transaction portfolio. If such a portfolio is deemed immaterial to the bank's risk profile, such stress testing requirement would be unproportional for ensuring adequate risk steering.
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<input type="checkbox"/>	Underwriting and syndication	Point 5	Clarification	<u>Settlement risk:</u>
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				What is meant by “settlement risks” in relation to “best-effort deals” and “club deals”
<input type="checkbox"/>	Underwriting and syndication	Point 5	Amendment	<p><u>Failed syndication:</u></p> <p>90 days seems to be too short as the time horizon for the (re-) selling is agreed as being up to 6 months. ESG’s counter-proposal would be that banks should define and document for each transaction a target period 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”.</p>
<input type="checkbox"/>	Underwriting and syndication	Point 5	Amendment	<p><u>“Best effort”/ ”club deal”:</u></p> <p>We do not see the rational as to 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.</p>
<input type="checkbox"/>	Policies and procedures for new deal approval, and monitoring and managing of longer-term leveraged transaction holdings	Point 6	Amendment	<p><u>Valuation of enterprise value of the borrower in credit approval process:</u></p> <p>The draft Guidance is asking for a valuation to be performed 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 the secondary market, rather than in a unit independent from these ones. Nevertheless “valuation” is always challenged and checked in “underwriting”, thus the four-eye principle is respected and</p>

				therefore should also be considered to be sufficient with an upcoming Guidance.
<input type="checkbox"/>	Policies and procedures for new deal approval, and monitoring and managing of longer-term leveraged transaction holdings	Point 6	Clarification	<p><u>Definition of weak covenants:</u></p> <p>What is the exact definition of “significant headroom”?</p> <p>Additionally the inclusion of weak covenants in the rating is, in ESBG’s view, 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"/>	Policies and procedures for new deal approval, and monitoring and managing of longer-term leveraged transaction holdings	Point 6	Clarification	<p><u>Risk verification of leveraged loan pricing:</u></p> <p>We would appreciate a more precise wording, which emphasises that under “verified by risk function prior to the credit granting” 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>
<input type="checkbox"/>	Reporting requirements and IT systems	Point 8	Amendment	<p>The minimum requirements for reporting make sense only if this portfolio is material for an institution’s risk profile. Therefore, in ESBG’s opinion, a better recognition of the proportionality principle could be reflected in this section.</p>