

Public consultation

Draft guidance of the European Central Bank on leveraged transactions

Template for comments

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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Draft guidance of the European Central Bank on leveraged transactions.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 UniCredit

Country Italy

Comments

| Guide | Issue | Guidance (Include number) | Comment | Concise statement of why your comment should be taken on board |
|-------------------------------------|-----------------|------------------------------|-----------|--|
| | | | | UniCredit agrees that a specific monitoring of leveraged finance exposures by the ECB should be based on a more coherent approach in terms of best practices within the industry. |
| <input checked="" type="checkbox"/> | General Remarks | 1 | Amendment | Nonetheless, the very wide definition of leveraged transaction is of high concern. While the ECB declares that there is no intention to constrain the resources available to finance the leveraged borrowers, this risks instead being the natural consequence of the proposed definition of leveraged transaction |

which does not take into account the nature of the transaction and of the counterparty. As a consequence, significant parts of traditional lending to corporates and SMEs would fall within the scope of application.

Also, the preeminent role attributed to the level of leverage as a risk indicator is of high concern. Leverage level is a key figure to assess risk, but cannot be assessed in isolation. The proposal for instance to escalate to the highest level of credit committee any position when the level of leverage exceeds 6 times the Total Debt to EBITDA ratio makes de facto this parameter the discriminant for risk assessment regardless of all the other risk indicators which contribute to a comprehensive risk analysis and are also taken into account in internal and external ratings (e.g. cash flow related credit metrics, underlying structures contributing to stable and predictable revenues).

To avoid disruptive effects on lending to the real economy and on markets liquidity, we warmly advice that the definition of "leveraged transactions" is limited to sponsor-driven leveraged buyout (LBO) transactions. Based on that approach, a global homogeneous asset class depicting similar risk drivers and following common market standards would be ensured and would allow to implement uniform risk governance framework, standards and procedures.

Also, we suggest some revision to the calculation of the level of leverage formula to further enhance the validity of the resulting leveraged transaction cluster by reflecting justifiable circumstances of a borrower that are not captured in its financial

reporting.

Moreover, even though the ECB draft Guidance is similar to the US Interagency rules issued in 2013 (hereby “the US Guidance”), there are significant discrepancies which make the European version much more restrictive, undermining rather than ensuring the level playing field. European banks supervised by the SSM, the ones to which this Guidance would apply, would be hence penalized vis-à-vis their US competitors at a time when European banks struggle to recover after the crisis. Moreover, European banks would be disadvantaged in favour of the non-regulated sector, often very active in leveraged transactions. The migration of activity to the “shadow banking” might exacerbate systemic risk rather than mitigating it.

UniCredit appreciates that the ECB has involved the industry in the consultation process which is a noteworthy opportunity to elaborate our concerns and to propose revisions to the framework. We warmly advise the ECB to keep into account the unintended consequences that the Guidance as currently proposed might have on the real economy in the form of less resources available for traditional lending and worse conditions for sponsors, with the risk of constraining rather than revamping activities which are crucial for the re-launch of the European economy.

Unicredit would welcome the chance to provide further details/examples in a bilateral meeting with the ECB to share views and elaborate on the above comments.



Scope of the
Guidance on
Leveraged
Transactions

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Amendment

The application of the guidance to significant credit institutions supervised by the SSM would lead to a serious risk of un-level playing field to the detriment of the European banking system and in favour of:

- banks that are not under the ECB's oversight (e.g. US, UK, Swiss, Asian banks);
- not significant European credit institutions (based on the definition of Art6(4) of the SSM regulation), that are likely to increase their market share of lending to corporates and SMEs;
- non-banks active in leverage transactions, underwriting and syndication, the so called 'shadow banking' sector, i.e. those entities performing banking-like activities without being subject to prudential regulation (e.g. such as private debt funds).

The shadow banking exemption might trigger arbitrage opportunities and pushing leveraged transactions 'into the shadow'. Following the introduction of the US Guidance, while regulated banks have retrenched from the most aggressive transactions, certain market participants – such as private debt funds, business development companies – were able to take up some of the banks' share in the leveraged credit market . We assume that the same could happen in Europe, exacerbating rather than mitigating systemic risk. In the search for yield strategies mentioned in the consultative ECB document, these non-banks are most likely to retrench from the leveraged finance market on an opportunistic basis, while commercial banks provide financing solutions to their often long term banking relationships throughout credit cycles. This could create detrimental effects on the economy including over-levered companies going bankrupt and loss of employment.

Based on estimates by the European Banking Federation, less than half of the bank exposure to the total European leveraged loan market would be subject to the guidelines.

Moreover, the guidance would apply on a global basis, hence also to activity run by European banks outside Europe. Since under several aspects, the ECB guidance are far more stringent than the corresponding US rules, then European banks would end up being in a difficult position to effectively compete with US banks in the US market, a very relevant one for the leveraged finance market.

Based on the above considerations, to ensure level playing field, we would suggest that the ECB aligns with the US guidance on those aspects where there is a significant discrepancy at the detriment of Europe, as better explained in our comments on the definition of "Leveraged Transactions"; also, we recommend that the ECB fosters a wider applicability to all banks operating in the European market via agreements with non-European relevant authorities (to note, US Guidance applies to both US and foreign banks operating in the US market); finally, we encourage European competent authorities to envisage similar guidance to be applied to non-bank players active in the leveraged market.

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| <input checked="" type="checkbox"/> | Definition of Leveraged Transactions | 3 | Amendment | In UniCredit's view, the two proposed criteria based on Total Debt over EBITDA ratio and the sponsor-ownership - are such that the range of exposures which fall under this guidance is excessively broad and might lead to the massive inclusions of |
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transactions which are traditional lending borrowers, based simply on the assumption of the “leveraged nature” of the borrower.

In that respect, the ECB guidance puts forward a wider definition of leveraged transactions compared to the corresponding US one. Firstly, the US Guidance makes only some suggestions of criteria, but then grants banks with a significant margin of manoeuvre in the identification of leveraged transactions based on the characteristics of their own portfolio. Secondly, it asserts that to be targeted as leveraged a transaction should meet a combination of the criteria. None of them automatically triggers the classification. Finally, it makes reference to LBOs type of transactions; based on a ‘purpose test’, those loans whose proceeds are used for buyouts, acquisition or capital distributions may fit within the definition if coupled with one of the other characteristics common to leveraged loans .

In UniCredit's view, the definition of “leveraged transactions” should be targeted at sponsor-driven leveraged buyout (LBO) transactions defined as non-recourse structured financing for the acquisition of a Corporate Target (including public-to-private transactions, refinancing of the Target's existing debt in connection with its acquisition or recapitalization of an existing acquisition financing or dividend pay-out) where financial sponsors participate with majority equity ownership and the lenders structure their facilities according to the cash flow profile of the Target.

LBO financings as described above are a global homogeneous

asset class with similar risk drivers, following common requirements on Due Diligence, Market participants and standards, Documentation and Credit Terms as well as objectives of Private Equity Investors.

Defining leveraged transactions as an asset class driven by common features is a prerequisite to implement the ECB's objective on a consistent and relevant risk management and to foster harmonisation of credit institutions' approaches in the definition, measurement and monitoring of those leveraged transactions where the ECB has noted in the last few years a weakening of deal structures.

Although driven by differing objectives, in the non-Investmentgrade space, acquisition financings (corporate-to-corporate) have some communalities with LBOs if a certain leverage level is exceeded, however it is excessively simplistic and not appropriate to apply the same level of leverage (4x) to different industries. Different industry dynamics/risks should be considered in the risk assessment, e.g. a 4x gross leverage may be conservative for an industry featuring strong and predictable cash flow generation (e.g. utilities, healthcare), while it can be aggressive for a cyclical and/or highly capex relevant industry (e.g. automotive, machinery, paper etc.). We suggest to define differentiated level of leverages for different industries. Also the US Guidance states that the thresholds of level of leverage, as reported in the text (i.e. 4.0 times Total Debt to EBITDA ratio or 3.0 times Senior Debt divided by EBITDA) can be adjusted, if not appropriate for some sectors. According to US rules, Industry norms and historical levels can be considered to

determine the proper level of leverage.

Moreover, in case an additional corporate leverage test were to be included, the list of exclusions would need to be integrated in respect to the ones already included in the ECB draft Guidance to avoid a very large mix of widely different credit exposures being clustered under the leveraged finance definition.

Specifically, we suggest that:

- while the level of leverage is an important criteria, there are other risk indicators which should be assessed in conjunction including financial metrics (e.g. debt service cover, cash conversion, liquidity headroom, equity cushion) and factors which determine the stability and predictability of the cash flow generation (e.g. regulated businesses, dominant market position, long-term contracts). Internal and external ratings take these factors into account to come to a comprehensive risk evaluation and therefore it would be adequate to exclude Investment Grade Borrowers.
- so called “Fallen angels” (i.e. those credits whose market or credit conditions post origination deteriorate to the point of bringing them within the leveraged lending definition) should be clearly excluded from the scope of application and leverage should be assessed only at inception. When an increase in the Total Debt over EBITDA is due to a decrease of the denominator with no changes in the level of debt, the existing financing should be exempted. As suggested by the European Banking Federation, this approach should also apply to borrowers classified as “forborne”, “defaulted” or “impaired”. If the leveraged transactions portfolio include a significant share of

underperforming corporate loans, reporting and tracking of the portfolio would be biased and monitoring requirements duplicated;

- Corporate collateralized transactions should be excluded to the extent they are fully covered by valuable collateral to account for the lower risk profile;
- In addition to trade finance transactions with a maturity of less than a year, also trade related finance transactions with a medium-term tenor should be exempted. This would contribute to preserve typical medium-term financings supporting international trade flows.
- Lending to SMEs (e.g. non-financial firms with a maximum yearly turnover of EUR 50 m) should be clearly excluded from the scope of application. As envisaged, the guidance would end up applying also to a significant number of SMEs, which are not financed by leveraged finance markets but are clients of retail and commercial banking networks. If not excluded, traditional lending to SMEs, that is characterized by jurisdictional and local market aspects and that is of crucial importance to support the European real economy, would be hampered.

In line with this, we also suggest to revise upward to EUR 50 million the threshold of EUR 5 million defining the consolidated exposures of the credit institutions below which loans are exempted.

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| <input checked="" type="checkbox"/> | Definition of Leveraged Transactions - Fallen angels | 3 | Clarification | In line with comments reported above, we would appreciate that the ECB clarifies that so called "Fallen Angels" are excluded |
| <input checked="" type="checkbox"/> | Underwriting and Syndication | 5 | Amendment | Based on the wide definition of leverage transaction suggested by the ECB, of high concern is also the requirement that any transaction with leverage above 6 would trigger "the highest level of credit committee or similar decision making body". It would be almost impossible to deal with the excessive workload of the highest level of credit committee. Hence, we suggest that transactions with leverage above 6x should be escalated to the next higher decision authority with regular tracking and reporting with a minimum volume threshold depending on the size of the credit institution. In the case of a banking group, this would be finally up to an involvement of a high credit committee of each legal entity which is empowered and qualified also to decide on large-sized leveraged transaction exposures. We also note that a risk weighted approach depending on the risk profile/rating of the borrowers is already in place towards the highest credit committees. Also US Guidance mentions this threshold saying that its breach would raise concerns for most industries, but it does not refer to the escalation to the highest level credit committee for approval. |
| <input checked="" type="checkbox"/> | Policies and procedures for new deal approval and | 6 | Amendment | In UniCredit's opinion, the proposed revision of the definition of leveraged transaction in combination with the revised list of exemptions would allow to avoid the undue recognition of |

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| | monitoring and managing of longer term leveraged transaction holdings | traditional lending in the scope of application and the related serious issues and unintended consequences on the financing of the real economy. The main serious issue would be as follows: banks usually have different risk management and approval procedures for traditional lending (SME and corporates) compared to leverage transactions, with the latter managed by dedicated offices and risk management areas. The proposed guidance would require a revision of the existing approach, with risk management and approvals procedures revised in order to deal differently with loans whose borrower is "levered" (leverage level above 4) or not. The unintended consequences are that the internal procedures will significantly differ if the related level of leverage is slightly below or above 4, even in case of similar borrowers transactions. In addition, it would create remarkable negative implications in terms of processing costs, lengthening of the internal procedures and time to market. This would potentially seriously undermine banks' lending to corporates, including SMEs, considering the requested due diligence requirements. The ability of banks to support European economic growth may be severely put at detriment. |
| ☒ | Definition of Leverage Transactions | Amendment 2 |

third party opinion aimed at evaluating the sustainable EBITDA of the borrower (e.g.: by excluding non-recurring exceptional items which in practice can be positive as well as negative). Also, the use of this figure, which normalizes income and expenses, would reduce the inconsistency which occurs as different companies treat each type of income and expense differently. Moreover, balance sheets of mid-cap companies sometimes do not have any EBITDA reporting, hence this will have to be calculated by the bank anyway which is per definition adjusted. Finally, some adjustments to the EBITDA are needed not to create inconsistencies in the way the numerator and the denominator of the level of leverage are calculated. For instance, based on current draft guidance, trade finance, leasing or lending to financial institutions would be excluded in the calculation of the numerator; however, such an exclusion is not similarly reflected if kept unadjusted.

Adjustment to EBITDA is usually common practise among banks and rating agencies. Moreover, such an approach would also contribute to level playing field, since based on US guidance adjusted EBITDA may be used where reasonable support can be provided.

Secondly, in UniCredit's opinion, cash on balance provides for available buffer against liquidity needs and hence should be taken into duly consideration in a risk assessment evaluation (especially against current financial liabilities). On the other hand, UniCredit agrees that trapped or restricted cash should not be netted.

For the avoidance of doubt, when referring to Total Debt, this

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| | | | shall include financial debt, but not other liabilities such as trade payables, shareholder loans, derivatives or finance leases. This is in line with market practice and reflects the underlying risk profile of the respective instruments. |
| ☒ | Definition of Leverage Transactions | 2 | Clarification |
| | | | With reference to undrawn lines, they provide for additional headroom in times of difficulty and sometimes are held to comply with rating agencies' requirements to achieve or maintain a certain rating. If they were included in the scope, companies with high reserve lines would be punished and treated as riskier whereas they are actually more flexible in the event of any crisis. Furthermore, banks might be pushed to revoke these available back up lines with negative consequences for small, mid- and even large corporates which all largely rely on these amounts to meet their temporary business needs. |
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