EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Public consultation

on the draft guidance on leveraged transactions

Questions and answers

1. What is the purpose of the guidance?

The European Central Bank (ECB) aims to develop a clear and consistent definition of what constitutes leveraged transactions and to establish guidelines on how to measure and monitor such exposures. The guidance also summarises how the supervisor expects banks to both ensure the credit quality in their leveraged transactions and monitor related risks to their balance sheets.

2. What is a leveraged transaction?

There is a wide range of definitions used in the market to capture what constitutes a leveraged transaction. Those have in common that such a transaction substantially increases a borrower's debt level. The guidance outlines the conditions for a transaction to qualify as a leveraged transaction. The definition of leveraged transactions should encompass all business units and geographical areas.

One condition that would qualify a transaction as leveraged is that it exceeds a specific debt-to-profit ratio, meaning that a borrower's total debt after financing the transaction is larger than four times the amount of his earnings before interest, tax, depreciation and amortisation (EBITDA).

The guidance also recommends that banks' independent audit functions regularly review whether banks correctly implement the definition to avoid excluding or overlooking transactions that fall in the "leveraged" category.

As a key part of this consultation, banks are invited to quantify exposures that are newly captured by the conditions outlined in the guidance. In addition, they are invited to comment on whether they consider the proposed definition feasible and whether they can implement it in their internal risk management. Banks are also encouraged to propose additional triggers as part of the definition that they deem relevant to be considered.

3. What triggered supervisors to monitor these transactions closely?

Leveraged finance markets have experienced a strong recovery since the crisis, and are characterised by an increased competition between banks and with other market participants in a context of search for yield strategies. The quality of credit standards is – in this context and in the long run – a key supervisory point of attention.

4. Do banks have to follow the guidance once finalised?

The guidance itself is non-binding. However, the supervisor expects all significant credit institutions to translate this guidance into their internal policies proportionally to the size and risk profile of the banks' leveraged transactions, in relation to its assets, earnings and capital.

5. What about the level playing field?

The draft guidance on Leveraged transactions is intended to ensure that banks conduct leveraged activities in a safe and sound manner. The goals of the guidance are aligned with those expressed by the US Guidance on Leveraged Lending (Interagency Guidance issued in March 2013). The ECB aims at strengthening the level-playing field for financial institutions on a global basis by aligning supervisory expectations and practices more closely.

6. What happens next? What are the next steps?

Credit institutions and other interested participants are invited to contribute to the draft guidance by submitting their comments. All comments will be thoroughly assessed by the ECB and considered when finalising the guidance.

Following its implementation, the guidance will serve as the basis for supervisory dialogue between individual banks and the ECB or Joint Supervisory Teams. The ECB will review, benchmark and, as part of its supervisory process, ascertain whether banks have addressed supervisory expectations appropriately.

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