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Finance for Europe

Association for Financial Markets in Europe

AFME Position Paper

ECB Draft Guidance on Leveraged Transactions

27 January 2017

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to contribute to the ECB's consultation on its "Draft Guidance on Leveraged Transactions".

AFME represents a broad array of European and global participants in the wholesale financial markets. We are contributing to this consultation on behalf of our Special Committee on European Supervision (SCES) which, in its SSM configuration, provides a platform for the most systemically relevant banks who are lead-supervised by the SSM to engage with the ECB's supervisory function and, in its full configuration, is a vehicle for engagement on the future development of supervision within the EU more generally.

Objectives of the guidance

Level playing field between the EU and the rest of the world

Most European banks participate widely in the US loan syndication market and are already subject to the US Leveraged Lending Guidelines for their operations in the US. Having the ECB guidelines adhere as closely to the US requirement ensures consistency between the approach in the US and European markets and promotes a level playing field for internationally active banks. In our view, differences, even if in small nuances, could result in inconsistencies in implementation and interpretation of the guidelines, confusion amongst market participants and add unnecessary costs (like requirement for different monitoring and reporting) to the system.

We welcome the ECB's confirmation during the 21 January 2017 public hearing on the draft guidance that the intention is to ensure as much consistency as possible with the US Leveraged Lending Guidelines to avoid such issues occurring and many of the recommendations that follow in this paper have the objective of bringing the ECB guidance more in line with US guidelines.

A level playing field inside the EU

Application of the guidance will only be to those significant credit institutions supervised by the SSM, leading to the risk of competitive advantage for banks that are not under its oversight in the Eurozone, non-Eurozone banks and non-banks active in leverage transactions. It is of paramount importance to preserve level playing field within Europe to avoid an intended shift in the market for instance to the non-regulated sector.

Scope of the guidance

Similar to the scope set by the US regulator, the ECB guidance should cover only leveraged loan origination. In order to achieve this, the definition of exposure used in the context of the guidance requires clarification so that bonds and other form of credit exposure like derivatives are explicitly excluded from its scope. As currently written, the reference to non-investment grade bonds on page 5 can be understood to mean that the guidance applies to bonds as well. We do not think this is the intention, and indeed this was confirmed by the ECB during the public hearing, but the wording of the final guidance should be adjusted to provide this clarification.

We are also of the view that the guidance should only apply to such transactions when they meet a "purpose test", i.e. when they have the objective of financing buyouts, acquisitions or capital distributions.

Moreover, while leverage is a key consideration, it should not be the only indicator in determining whether a transaction should be within the scope of the guidance. Credit quality matters too and we consider that any guidance should only apply to non-investment grade borrowers (i.e. borrowers of rating BBB- equivalent or above should be excluded).

Further, borrowers, known as fallen angels under US guidance, that have exhibited a significant deterioration in financial performance after loan inception and have subsequently become highly leveraged (unless the credit is modified, extended, or refinanced), should be excluded from scope. In this context, it will also be important that the ECB clarifies that the guidance will not apply retrospectively.

Finally, it is important that the guidance explicitly allows for the refinancing of debt to borrowers which are either in financial distress or in a weak cash flow position, provided satisfactory risk mitigation for lenders is put in place.

Definition of leveraged transactions

While harmonisation through principles is welcome, we do not think that it is possible or desirable to create a single, specific definition of a leveraged transaction through this guidance (other than potentially for purposes of reporting/monitoring of such transactions). However, even in the case of reporting requirements, the current definitions provided in the draft guidance are not suitable.

For instance, we do not agree that a single level of the debt/EBITDA ratio (such as the 4x level used in the guidance consultation) can be used as a unique reference point. There are many kinds of borrowers operating in sectors with leverage parameters that are typically higher due to the capital-intensive nature of the business (e.g. utilities, real estate, health care, etc.). These will need to be reflected in the guidance.

Moreover, certain categories of borrowers and industries should always be excluded from the scope of any leveraged transactions guidance when they do not give rise to a "conventional EBITDA", have different purposes to normal commercial entities and are not otherwise intended to be in scope of requirements for leveraged finance.

For instance, government-like borrowers (central, federal, regional governments, as well as their agencies and departments and facilities supported by these entities) as well as entities such as Export Credit Agencies (i.e. Export-Import Banks), multilateral agencies (i.e. International Finance Corporation (IFC)) and other bilateral agencies, as well as facilities guaranteed by any such entities should not be covered by the guidance.

Industry exclusions should cover lending to as Personal Trusts, Personal Investment Companies and Personal Holding Companies, Not-for-profit organisations; Mutual Funds or Municipalities, etc. Moreover, residential real estate development loans should not be considered leveraged lending, as these transactions are based on a building development that will always be sold once it is completed and there is no EBITDA generation during the construction phase.

Moreover, given the intrinsic granularity of exposures to this segment of corporate clients, lending to SMEs (e.g. firms with a maximum EUR 50 million turnover) should be excluded in order to preserve lending to this sector of the economy.

Fully collateralised transactions, where the collateral is cash, a "standby" letter of credit of a financial entity, an investment grade government bond collateral or similar, or guaranteed by a 3rd party rated BBB- or higher, should also be excluded.

Finally, ownership of a borrower by a financial sponsor should not mean that a loan should automatically categorised as leveraged if the quantitative criteria are not met. It should also be made clear that uncommitted/guidance lines are exempt from the guidance.

Materiality threshold

To facilitate operationalisation of the guidance, only transactions where the exposure at deal inception when it is higher than EUR 25 million should be included in the definition.

Leverage measure

Debt

All reference to and calculations of total debt should be based on a net debt basis (i.e. gross debt minus cash). For internationally active banks, references to IFRS definitions may create issues and we recommend that the notion of debt be simply aligned with standard market understanding that debt involves loans, bonds, financial guarantees and other similar instruments. Referring to current and non-current financial liabilities under IFRS would include derivatives and other liabilities which may bring unnecessary volatility into the debt measure.

EBITDA

Risk-related adjustments are typically applied to accounting EBITDA to normalise income and expenses and reduce inconsistencies between borrowers who may treat types of income and expense differently. These adjustments are bi-directional (positive and negative). The guidance should therefore allow for non-recurring, reasonable EBITDA adjustments to be made if properly justified and documented. Moreover, the use of an adjusted EBITDA would be consistent with practice in other jurisdictions (e.g. adjusted EBITDA is taken as a reference in the US).

Transactions of higher leverage

While we understand that it is not the intention of the guidance to disincentivise transactions that would fall above a Debt/EBITDA ratio of 6x, we are concerned that this would be the net effect in practice. For instance, requiring that the "the highest credit committee" be approached for any such transactions will considerably stretch resources and is likely to result in a reduction of lending to leveraged borrowers. If the aim of the guidance is not to reduce bank lending to leveraged borrowers, this requirement must be revisited and nuanced, taking into account other risk drivers and sector/borrower specificities (see our comments above under "definition"). Ultimately, we consider that the need to define any "exceptional processes" should be determined by each institution given its risk appetite framework.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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