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FRENCH BANKING FEDERATION RESPONSE TO ECB CONSULTATION

ON GUIDANCE ON LEVERAGED TRANSACTIONS

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

General Comments

The FBF welcomes the opportunity to share its comments on the ECB's consultation on a guidance on leveraged transactions. The FBF understands the need for closer supervisory scrutiny in the leveraged finance market. The leveraged finance market, as explained in the draft guidance preamble, is fueled by the current low interest rate environment, which creates a search for yield and investor pressure towards more aggressive structures. We acknowledge this situation and welcome initiatives to bring discipline to that specific segment of the loan market.

However, the approach taken in the ECB draft guidance starts from a **very wide definition of leveraged transactions**, which goes well beyond LBO transactions. Because the definition is focused on leverage and contains very few exclusions, in particular giving no consideration to industry sectors, company size or profile, it is likely to regroup companies with different risk profiles and thus its effectiveness in addressing leveraged market dynamics can be questioned. Because of the low commitment threshold selected (5mln€), it will potentially include a significant number of small and medium size corporate clients, which are not financed by leveraged finance markets but are clients of retail banking networks. The credit process, monitoring and reporting requirements proposed for leveraged transactions in the draft guidance are very onerous and, in some aspects (in particular credit-process related), disconnected from the way retail networks finance these clients. As a result the guidance, if adopted with the current proposed definition, will **create a level playing field issue**, penalizing significant institutions vis-a-vis competitors such as non-significant institutions, banks outside the Eurozone, or unregulated debt providers such as private debt funds. It would constitute an unmanageable constraint to banks in their crucial role of financing the real economy. Of note, the weakening of deal structures coincides with an increasing proportion of non-bank lending, including to small and medium size businesses.

This growing role of shadow banking through debt funds is likely to be encouraged by the draft guidance. The benefit of the guidance in terms of risk management can thus be questioned, as a significant number of debt providers to the leveraged finance market will not be subject to it; at the same time, it will impose an additional cost of doing business and create additional processes on SSM-regulated banks in their activities with clients that are not linked with leveraged finance markets.

We observe that not only the initiative is far too extensive in terms of instruments (the definition covers not only LBO, acquisition finance, cash out...but also loans to farming cooperatives) but in addition it exclusively addresses banks supervised by the SSM. Considering that this market is not handled by banks only, we object to the ECB analysis that this is banking issue and urge the ECB to require a much broader policy, at European or even international level, which would apply to all market participants.

Moreover companies that would not be able to provide the type of information requested would also find it **more difficult to raise bank financing**. On this last point, the proposed guidance seems to contradict the recognition by the EU that small and medium-sized businesses are one of the pillars of the Union economy given their fundamental role in creating economic growth and providing employment, hence the importance of the availability of capital and funding to these businesses in the Union.

In addition, the draft guidance proposes standards of default and impairment that are likely to contradict recent supervisory or accounting initiatives. Among other issues, this guidance poses difficulties of implementation because of its contradiction with some of the existing regulations.

Finally, French banks seek clarification on the fact that the ECB expressly states the guidance is non-binding, though it includes additional constraints to banks and non-compliance may trigger supervisory measures.

1. Fundamental issues

1.1 The wide definition appears disconnected from the original objective of the guidance

1.1.1 Rationale

It is difficult to reconcile the definition with the objectives of the guidance. In its preamble, the guidance appears to be driven by the evolution of leveraged finance markets and trends such as covenant lite structures (as highlighted in the 2015 survey and thus based on banks' own definitions of leveraged finance, which often is limited to private equity ownership). To address concerns raised by this evolution, the guidance proposes a framework based on a definition of leveraged transactions that is very wide and addresses a universe of borrowers which is very different from that of "leveraged finance markets", as referred in the preamble.

In particular:

- Companies to which commitments of more than 5mln€ are provided are captured. Due to the low commitment threshold, the universe of clients captured includes a very large number of small and medium size corporate clients, including in retail networks, which are not borrowers in leveraged finance markets and to which commitments granularity and diversification offer mitigation to the leverage level.
- The definition captures companies with potentially different risk profiles, among others because the definition is not sector-sensitive or size-sensitive. The use of gross leverage instead of net reinforces this concern.
- No difference is made between a corporate borrower belonging to a business group and benefitting from an ongoing financial support, which provides a credit risk mitigation, and a stand-alone corporate with the same intrinsic characteristics.

The definition thus appears disconnected from the original objective of the guidance of bringing discipline to the leveraged finance markets; it seems to capture corporate borrowers with different risk profiles so that ultimately the rationale of the definition and guidance can be questioned.

We would like the ECB to reconsider the definition along the following axes (in addition to detailed comments provided further in this document):

- Allow banks to have their own individual definition of leveraged lending based on criteria proposed by the ECB, which would be in line with the US Interagency Guidance's approach. This will allow banks to broaden the definition if required in view of the individual bank's strategic direction and exposure to leveraged lending. This will further allow for adequate proportionality.
- Include a reference to a purpose test in the definition in order to be closer to the objectives the ECB is pursuing with the proposed guidance. A definition for example could be any Borrower with which the bank has a transaction that meets, at inception, at least one of the conditions below :
 1. All LBO transactions where the borrower is owned by one or more financial sponsors;

2. Corporate acquisition transactions or financing of exceptional transactions, such as capital distributions, where net leverage post-financing exceeds 4x, excluding from this scope corporates identified as SMEs (given the granularity of the exposures and their distribution over several sectors and countries).

In addition to the proposed exclusions in the draft guidance:

- Exclude from the scope of corporate acquisition transactions borrowers with an investment grade rating from one or more recognized international credit rating agencies.
- Exclude sectors (such as utilities, real estate, project finance, state-owned entities, concession companies or entities such as French agricultural cooperatives that have distinct risk features) for which leverage is not a relevant metric and take into account relevant sector specificities in the calculation of leverage. *A list of companies is provided in Appendix showing how, in some sectors, companies like utilities with solid investment grade profiles have leveraged multiples in excess of 4x.*

Finally should the definition not be reconsidered and still capture retail customers notably SMEs, the FBF asks the ECB to revisit the threshold of 5m€ exposure which is extremely low.

1.1.2 Complexity of facility approach

The definition also introduces the notion that, for a given borrower, certain facilities could be leveraged transactions and others not. For example, asset-based loans would be excluded when unsecured facilities to the same borrower could be classified as leveraged if the borrower meets the classification criteria. Given the reporting requirement proposed by the draft guidance, this facility approach and associated complexity constitutes a real operational concern. An obligor-based approach would be preferable.

1.1.3 Lack of consistency with US Interagency Guidance

The ECB states that one objective is to harmonize practices regarding the definition, measuring and monitoring of leveraged transactions by significant credit institutions within the SSM and to ensure a level-playing field with US banks subject to the US Interagency Guidance on Leveraged Lending of November 2013 (the “US Interagency Guidance”).

However, a number of discrepancies exist between the two guidance approaches. These discrepancies would not lead to such a harmonization and would create level playing field issues for ECB-supervised banks:

- In general the approach taken by the US Interagency Guidance is to provide a framework allowing banks to formulate their own definitions following a number of criteria, which is quite different from the ECB’s approach, which is much more prescriptive (see 1.1.1 above).
- The US Interagency Guidance allows sector-based exclusions or exclusions based on types of borrowers, if documented, whereas the ECB document limits exclusions to types of facilities.
- As a result, the approach taken by the US Interagency Guidance is largely based on the characterization of obligors, not facilities.

- The US Interagency Guidance allows an exclusion for small business loans, which banks can further define, while the ECB document attempts to exclude small businesses based on a minimum commitment amount of 5mln€.
- The US Interagency Guidance allows EBITDA adjustments, if documented and justified, when the ECB draft guidance does not allow any adjustments (beyond pro-forma financials).

As a matter of principle, we call for a harmonization of the definitions between supervisors (which would ease the reporting burden for banks, and improve the comparability / monitoring for supervisors).

1.2 Level-playing field issues

Due to the very wide nature of the definition and the requirements set by the draft guidance, it raises a number of significant level-playing field issues, in terms of competition and complexity of doing business.

1.2.1 Competition

The draft guidance will dictate transaction structures, as well as credit process and monitoring requirements –see below- that will apply to the businesses of significant institutions supervised by the ECB and not apply to:

- Banks in Europe not subject to ECB supervision either because of their size (non-significant institutions) or because they are located in countries outside the Euro-zone (UK, Switzerland).
- US banks, to the extent the guidance documents diverge (see above).
- Non-regulated entities such as private debt funds.

The case of non-regulated entities is of particular concern. Private debt funds play an increasingly important role in directly financing corporates, including small and medium-sized. The proposed guidance, as drafted and with its proposed definition, will provide a competitive advantage to these funds driven by additional supervision imposed on banks. As drafted, the guidance will thus favour the growth of shadow banking, generally seen as contributing to systemic risk.

1.2.2 Complexity

The guidance also introduces complexity for large institutions supervised by the ECB and active in the US. The co-existence of two diverging guidance approaches (see above) will make leveraged lending business very difficult to conduct for European banks in the US. For example the use of an unadjusted EBITDA, when US arranging banks can use adjusted EBITDA, will essentially prevent European banks from arranging transactions in the US.

1.3 Appetite and governance

The appetite and governance of the draft guidance requires banks to define their appetite for leveraged transactions, among others, to define a limit and budget framework.

Given the wide nature of the definition and the fact that it will capture companies with very different risk profiles and in various business units, it is not possible to define a uniform risk appetite for companies falling under the definition.

As a result:

- Any limit framework should be defined based on sub-sets of transactions that share common risk characteristics and not a single limit allocated to all leveraged transactions.
- It will not be possible to identify a budget for leveraged transactions as defined in the draft guidance: indeed, budgets being usually determined by business unit (each potentially originating both leveraged and other types of transactions), that requirement would be operationally complex to implement. Of note, the US Interagency Guidance does not require setting a budget for leveraged lending.

1.4 Underwriting and syndication

We consider that a number of industries and business models would have capacity for leverage above 6x, and whilst this would be a minority of cases, we do not consider such cases to be “exceptional” based on the overall historic track record and default rates of transactions that fall into this category. Indeed, we would consider that the approval of such transactions at the highest level should also be based on a size and rating threshold in terms of either underwriting and/or final take (this case is already frequent through Risk committees involving senior management and/or delegations of authority rules).

1.5 Liquidity treatment of undrawn facilities

The treatment of liquidity and credit facilities is clearly addressed in article 31.1 of the Delegated Act on the Liquidity Coverage Ratio, thus there is no reason for it to be addressed in this guidance.

1.6 Credit process

The draft guidance suggests applying an extensive credit process to leveraged transactions. Of note, this credit process is inspired from the credit process usually associated with LBO transactions: critical review of business plan and projections, assessment of enterprise value, assessment of term sheet including covenant structure, assessment of industry sector and review of cash-flow projections under a bank case and a stressed case.

Such a credit process is generally not applied when financing is provided to companies that are not subject to LBO transactions. The requirement to apply this credit process to companies that fall under the proposed definition and are not LBO transactions would have important consequences, notably:

- Further encouraging the growth of shadow banking through private debt funds that would not be subject to these credit process requirements.
- Making access to credit more difficult for companies that would not be able to provide this type of due diligence information, which is usually not required outside LBO transactions, thus discouraging the financing of the economy.

Specifically, this process is not applicable to or operationally feasible for small & medium size businesses: in addition, the risk presented by this class of clients is mitigated by a granularity and a distribution on a variety of sectors / countries which encourages us to think that they should be excluded from the scope of leveraged transactions.

- Creating a level-playing field issue in retail networks with banks not subject to ECB supervision (non-significant institutions).

1.7 Reporting

The guidance creates a reporting obligation on a very large number of counterparties. This includes qualitative information, such as quality of covenants, which is also not something required by the US Interagency Guidance. The inconsistency with the US Interagency Guidance will also create reporting difficulties, effectively dual reporting obligations.

2. Detailed Comments

2.1 Definition (section 3)

- Level of assessment of leverage: we seek clarity on the level at which leverage should be assessed, especially for leveraged corporates: do we indeed consider consolidated funded debt vs consolidated EBITDA or are the metrics slightly different? We think we should be reporting and managing total exposures at group level (even in the absence of explicit intra-group support) and not on solo legal entities. Indeed we can have a borrower considered as leveraged (based on ECB's criteria), whereas the group is not:
 - holding companies will often be in this case, as well as non-industrial subsidiaries (trading subsidiaries, cash pooling entities...);
 - this can also happen for industrial subsidiaries with higher leverage but parent company support.

For LBO transactions, the level of assessment should be the “Restricted or Target Group perimeter” as commonly seen in legal documentation.

- Debt definition: the definition of debt raises a number of questions: i) why is gross debt used, which gives no value to cash held by companies financed? We would recommend using net debt, ii) shareholder loans and third party held PIK debt subordinated to senior debt, which are provided in substitution to equity, should be excluded from total debt.

As regards undrawn debt, during the workshop held on 16th December, the ECB indicated that there was an “open question on the treatment of incremental debt”. This is an issue and potential incremental and undrawn debt should not be included in the total debt calculation. This would i) inflate the leverage of companies as it would ignore the additional EBITDA that the drawdown of incremental debt can generate, ii) it would penalize companies that secure committed liquidity lines, and would have the unfortunate and unintended consequence of discouraging companies from securing liquidity, and ultimately of weakening their liquidity profile, and (iii) it will often in practice be difficult to know the level of undrawn facilities that a borrower may have available and how that might change over time.

It will therefore be highly impractical for banks to be expected to monitor their borrowers' leverage measured by this metric. The level of drawn debt on balance sheet is an objective figure which will be reliably available from the borrower's published accounts.

- We note that the definition of EBITDA to be used allows for no (positive or negative) adjustments to be made which clearly results in many transactions being caught in the definition if one does not take into account significant non-recurring costs, the pro-forma impact of acquisitions already made, or the full-year impact of cost savings already implemented, that is supported by external due diligence and then included on a reasonable and appropriately conservative basis. See Appendix 2 for typical EBITDA adjustments and their rationale.
- Classification as a leveraged transaction should be done at inception:
 - Because the guidance seeks to address the weakening of structures, leverage should be measured exclusively at inception of a transaction, unlike footnote 8 suggests.
 - When a deterioration of the borrower is due to an EBITDA decrease (maintaining a constant level of debt), the existing financing should not be included as a leverage transaction. Similar to the US Interagency Guidance, "Fallen angels", or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged, should not be included within the scope.
- In footnote 5, it should be clarified that "gross direct commitments" are debtor risk direct commitments only.
- Project finance exclusion: we propose to amend the definition of "project finance loans" –see below, which is currently too narrow as (i) it is limited to long-term facilities, (ii) it does not capture all sectors where limited-recourse finance is used (e.g. energy including renewables, natural resources and industrial sectors), and (iii) it is unclear whether it covers only greenfield financing or whether it extends to the refinancing of brownfield assets, the financing of acquisitions and the financing of working capital requirements and capital expenditure. Besides we have hybrid transactions (acquisition + project finance) based on an opco / holdco scheme, where the opco is a project finance structure (repayment based on the cash-flows of a project) and the holdco's debt is repaid by dividends coming from the opco. We should make sure that the project finance exclusion also applies to the holdco because its revenue is directly linked to the underlying project's cash flow, even if this cash flow is generated at opco level.

In general, European institutions have deployed over the past few years a number of initiatives in order to support investment and financing in the infrastructure and renewables sectors (e.g. Juncker plan, recent amendment of Solvency II rules in order to spearhead infrastructure financing by institutional investors). They have also recognized the robust credit strength of such investments.

Finally, these financings usually do not use leverage as a credit metric. Therefore, it seems logical to exclude them from the definition of leveraged transactions and from the application of the related guidance.

- Reserve-based finance (“RBF”) transactions should clearly fall within the exclusion list because they include some components of asset-based finance (repayment based on the value of hydrocarbon reserves) and of project finance (repayment from project cash flows). We think that the definitions proposed by ECB permit to justify this exclusion but an express mention of RBF transactions could be clearer.
- Loans with credit institutions and investment firms: this exclusion should be clarified to encompass debt funds so that indirect exposures are not included and a look through approach is not intended. Other financial counterparties, like insurance companies should be excluded.
- Commercial real estate financing: it should be clarified that all commercial real estate financing, secured or not, falls within this proposed exclusion (see comment on facility approach).

2.2 Underwriting and syndication (section 5)

- The concept of “*deal closure date*”, from which the 90 days for determining long positions are counted, should be clarified. It should be the earlier of the end of the agreed syndication period and the date on which commitments are allocated to lenders.
- The provision is unclear « *to set an underwriting limit and granular set of sub-limits ...* ».

2.3 Policies and processes – Credit Approval (Section 6(i))

- We do not think a specific process should be exhibited for the leverage finance portfolio. We consider that procedures already in place for the vast majority of portfolios (setting credit risk limits, delegations etc. based on internal ratings) meet the requirements of the guidelines, and that the corresponding paragraphs should be deleted. In the monitoring section there is no need either to specify a specific monitoring framework, as banks have watchlist processes in place that ensure a closer monitoring of deteriorated files.
- The concept of “material modification” (requiring the extensive due diligence process of section 6(i)) should be clarified.
- Rating methodologies: the guidance suggests giving weight to weak covenant structures in rating methodologies. Although we recognize the value of covenants and see them as an efficient tool to monitor the financial performance of borrowers, there is no compelling evidence from latest model calibration work that weak covenant structures are a driver of default probability or recovery that would support in a documented way their inclusion in rating methodologies.

- Collective provisioning: the guidance suggests a specific collective provisioning framework based on the assessment of borrowers' ability to repay. The implementation of IFRS9 provides a comprehensive and duly audited framework for collective provisioning based on the risk parameters of each facility and it is difficult to understand why leveraged transactions should have a dedicated framework.
- The guidance requires banks to assess the ability of leveraged borrowers to repay at least half of their debt over a 5-7 year period.
- It is unclear under which assumptions this assessment should be made. It should also be clarified that this does not mean that transaction structures should effectively impose a 50% repayment of facilities over 5-7 years; rather the analysis should be done by measuring cash-flow generation against that period, whether repayment is contractually required or not. The mention "granted by a financial institution" is not consistent with the concept of assessing a borrower's ability to repay its debt (which could include other creditors).
- The guidance suggests an enterprise valuation of the borrower reviewed and validated by an independent unit. The credit process applied by banks is typically that credit files are reviewed by independent risk teams; this consists in a comprehensive review of the file, including of the enterprise value. As such, there is no need for an additional independent review of the enterprise value by another unit and it should be clarified that the review of credit files by risk teams does not involve a recalculation of enterprise values; enterprise values are reviewed and challenged like other information in the credit file.

For many banks without an M&A advisory function or one of substantial size and resources, and taking into account the volume of transactions that would be captured under the definition set out in section 3, the ability for an enterprise valuation to be reviewed and validated by an independent unit raises significant concerns. In addition, we stress that leveraged lending is a cash-flow-based discipline and credit decisions are based on the anticipated ability of the borrower to generate sufficient funds from operations to service its own debt in accordance with contractual terms. Enterprise value analysis can only serve as an additional reference point to assess reasonableness and should not constitute a material decision factor.

- The guidance requires banks to identify transactions "where there is significant headroom in financial covenants". Covenants are sized according a borrower's specific situation. As already said in the 1.7 of this document, we are not in favor of providing covenant-related reporting, as it is not operationally practicable to provide such type of qualitative reporting.
- The guidance suggests independent verification of pricing by the risk function. The guidance has a specific section on underwriting risk, in which market risk, including pricing, is addressed. It is difficult to understand the reference to pricing in this section. Outside an underwriting context, a pricing verification (against what benchmark?) is not done and difficult to understand.

2.4 Policies and processes – Monitoring (section 6 (ii))

- The guidance suggests running impairment tests in a number of situations, in some cases in contradiction with recent guidelines on default definition issued by the EBA on 28 September 2016. For example the refinancing of a bullet facility or at an increased leverage, per se, is not a sign of unlikelihood to pay and thus impairment. Conversely, a conversion of loans into equity is a form of distressed restructuring and is not a presumption of default but often occurs well after a classification into default.

It is difficult to see why leveraged transactions should carry specific impairment tests; the use of various definitions or supervisory references can be a source of inconsistency and will not lead to the expected harmonization objective; the guidance should refer to the EBA guidelines. The question of whether a refinancing (presenting the above features or not) is a “forced restructuring” is routinely addressed at each file case. The concept of forbearance is also well addressed in existing and recent regulations and does not need to be addressed here.

APPENDIX 1: Examples

A number of specific examples¹ show that the guidance as drafted will capture companies of very different profiles, including companies well rated by external rating agencies (S&P, Moody's, Fitch), and therefore will have a questionable rationale from a risk management perspective. This can be because of sector specificities or because of risk drivers like state support which the guidance does not take into account. Because companies in these sectors tend to have solid credit profiles, banks tend to have large commitments to these companies, which would distort the objective of identifying "risky" leveraged transactions.

Altogether, we deem that the current draft definition without purpose test will be procyclical.

1. Utilities

Utilities tend to have regulated and stable cash-flows and therefore can support debt levels higher than in other sectors while keeping a solid risk profile. Companies like EnBW in Germany, Veolia in France, National Grid in the UK or EdP in Portugal have investment grade profiles with leverage levels in excess of 4x.

These four names are selected as examples, but many European utilities share the same characteristic and would fall in the leveraged lending definition. Utilities in this analysis include all companies that are involved in the production or distribution of essential regulated public services, including electricity, water, gas, transportation (including for example airports) etc. and companies operating under concession agreements granted by public authorities.

2. Car manufacturers

Because of the large manufacturing base of car manufacturers and the fact that most of them have integrated finance companies, many car manufacturers have leverage in excess of 4x, while maintaining investment grade profiles. That includes some of the largest car manufacturers in Europe, such as Volkswagen (BBB+/A3), BMW (A+/A2), Daimler (A/A3) in Germany and Renault (BBB-/Baa3) in France. In the same industry, main French car dealers report leverage ratios above 4x.

3. State-owned entities

A number of state-owned corporates have leverages in excess of 4x because they own large strategic assets for the country. This is the case for example of national railway companies. Deutsche Bahn is a good example, with a leverage in excess of 4x and a solid investment grade profile (AA-/Aa1), as well as SNCF Mobilités (AA-/Aa3) and RATP (AA/Aa2). As drafted, the guidance would capture bank exposures to these companies as leveraged transactions.

A large number of national railway companies share characteristics similar to Deutsche Bahn, SNCF Mobilités or RATP.

¹ Examples mentioned in this annex have been identified based on publicly available information.

4. Retirement houses (EHPAD)

Due to resilient cash flows and to a high level of capital expenditures and of real estate assets needed for their operations, retirement houses in France typically carry significant debt levels; most companies have leverages in excess of 4x, without bearing excessive risks. For instance, one of the major players, with a headline gross leverage >6x, publishes a 2.9x ratio excluding real estate-related debt and is rated at investment grade equivalent by Banque de France.

5. Agricultural cooperatives

The agricultural cooperatives business model in France focuses on value delivery to its members, which is reflected in cash-flow generation, and has leverages typically in excess of 4x with Banque de France ratings ranging from 3 (eq. A) to 5+ (eq. BB-).

APPENDIX 2: EBITDA Adjustments

- Market practice is that EBITDA adjustments (which can in fact be positive or negative) are almost invariably subject to due diligence and typically include matters such as:
 - Cost savings made but for which a full year's impact has not been seen,
 - Costs previously incurred because of the nature of ownership and capital structure that existed pre buy-out (eg costs associated with being a listed company or fees paid to the selling parent company for certain functions),
 - Run rate of new business units (eg retail shops), that have only been open for part of the last twelve months,
 - The combination of the nature of the adjustments and the diligence done on them ensures that reasonableness in structuring is maintained.
- For some transactions the use of Unadjusted EBITDA would effectively make the transaction impossible:
 - In the case of business carve-outs from a group, for example through the sale of a number of divisions or assets, it may be the case that there were no consolidated accounts previously produced for the entities comprising the buy-out Target. In these circumstances it is necessary for pro forma, adjusted, EBITDA to be drafted and diligence to be done. The guidance as currently drafted would not enable that sort of analysis to be admitted and the transaction would therefore not be possible. Such transactions are not intrinsically different from other leveraged finance transactions from a risk perspective.