EUROPEAN CENTRAL BANK

BANKING SUPERVISION

# Public consultation

Draft guidance of the European Central Bank on leveraged transactions

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Please make sure that each comment only deals with a single issue.

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- the relevant article/chapter/paragraph, where appropriate
- whether your comment is a proposed amendment, clarification or deletion.

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# Public consultation

Draft guidance of the European Central Bank on leveraged transactions.

Name of Institution/Company BELFIUS BANK

Country Belgium

## Comments

| Guide | Issue | Guidance (Include number) | Comment | |
|---|---|---|---|---|
| ☐ | Introduction | 1 | Clarification | Belfius Bank endorses the official response of the European Banking Federation (EBF) to the ECB consultation on the draft guidance on leveraged transactions, but wishes nevertheless to express some particular concerns |
| ☐ | Level playing field | 2 | Amendment | Less significant credit institutions and credit institutions based in EU member states which do not participate in the SSM (e.g. the UK) are outside the scope of the ECB guidance - see Appendix 1 for more details |

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| ☐ | Definition of leveraged transactions | 3 | Amendment | ECB guidance applies to all types of loan or credit exposure – regardless the leverage level - where the borrower is owned by one or more financial sponsors. See Appendix 2 for more details |
| ☐ | Exempted transactions | 3 | Amendment | Because of the € 5 million threshold, a significant number of SMEs will be impacted by the guidance, despite the fact that they are not financed through typical leveraged finance structures. See Appendix 3 for more details |
| ☐ | Exempted transactions | 3 | Clarification | The definition of "project loans" is too narrow as (1) it is limited to LT facilities, (2) it does not capture all sectors where limited-recourse finance is used (e.g. [renewable] energy, natural resources, brown- and greenfields) |
| ☐ | Exempted transactions | 3 | Amendment | Belfius Bank also insists on the exclusion of the following transactions from the leveraged transaction definition: loans with PSE or non-profit organisations as well as factoring. See Appendix 4 for more details. |
| ☐ | Reporting requirements and IT systems | 8 | Clarification | We wish to underline that banks should receive sufficient time to adapt their management information systems, in order to identify, aggregate and monitor leveraged transactions, and to capture all the relevant aspects of the ECB guidance |

## Appendix 1

This will cause a serious competitive disadvantage for the significant credit institutions, especially for Belfius, which is a locally anchored autonomous banking and insurance group, with a clear focus on its core business in Belgium and without any intention to expand internationally:

- The institutions outside the scope of the ECB guidance will be a major beneficiary, because they will benefit from reduced competition in highly leveraged deals which could allow them to increase their margins;
- Competition amongst affected credit institutions will intensify; downward pressure on their margins/fees will increase, and, at the same time, lead to an even greater erosion of documentary protection for those lenders (*perhaps not quite what the ECB guidance has in mind*);
- This ECB guidance may help unregulated players, including shadow banks, to grow in this market segment.

## Appendix 2

The ECB clarifies that financial sponsor refers to an investment firm that undertakes private equity investments with the intention of exiting those investments on a medium-term basis, i.e. more than six months. In the Belgian market, the shares of companies are often controlled by financial holdings (*the latter often family owned).* **These holding companies have no short or medium term exit strategy**. What's more, their track record often proves their willingness and financial ability to support the companies which they own. For that reason, Belfius Bank considers the fact that a borrower is owned by a financial sponsor as non-relevant for the detection of real leveraged transactions.

A good working definition of leveraged transactions should in our opinion be more tangible. It should only apply when the specific purpose is (1) the financing of a company purchase, through the acquisition of shares or the purchase of industrial assets or business unit, and/or (2) the financing of capital distribution, such as dividend distributions, share buy-back, repayment of subordinated debts, etc.

And this of course in combination with a clearly defined threshold regarding the post-financing level of leverage. The draft version of the ECB guidance proposes to apply as a threshold a Total Debt to EBITDA ratio of 4.0 times. This raises the following concerns:

- The Debt definition commonly used in LBO financing (*cf. documentation of the Loan Market Association*) is the one after subtraction of (1) surplus cash, (2) a variety of 'off balances sheet agreements' and (3) subordinated (*shareholder*) loans and/or other junior financial liabilities (*i.e. a Net Debt*). The Total Debt definition used in the draft ECB guidance differs from this common market practice and will cause a lot of transactions being labelled as leveraged.
- Furthermore, it is generally appropriate to exclude loans, secured by tangible collateral (*e.g. accounts receivable, inventory, property, plant & equipment, real estate etc*.) because in such a case the lender has additional sources of repayment beyond the cash flow from the operations of the borrower.
- The draft ECB threshold does not take account of the individual risk profile of the borrower, neither of the industry/sector in which the borrower is active. However, it's quiet obvious that a borrower with an excellent risk profile will be able to support a higher leverage.

- Taken at face value, the EBITDA definition used in the ECB draft guidance (*no adjustment should be made for non-recurring expenses, exceptional items or other one-off items*) appears to be significantly more restrictive than the market-based approach favored by Sponsors and Lenders. Indeed, in many financial covenant calculations ‘non-recurring’ items are added back to EBITDA.

Finally, the draft ECB guidance states that the designation of a financing as ‘leveraged transaction’ is made at loan origination, modification, extension or refinancing. Market participants will no doubt worry about the fact that the **ECB guidance could endanger the ability of borrowers - whose credit standing has deteriorated - to refinance their debt**.

## Appendix 3

These SMEs are clients of our retail banking network and their financing is based upon lending principles and guarantee structures common to this market. Furthermore these SMEs will usually not be able to provide the information requested according to the guidance. For that reason, Belfius Bank proposes a substantial increase of the above-mentioned threshold.

## Appendix 4

- Loans with public sector entities or non-profit organizations (*hospitals, elderly homes, schools etc*.). Their main aim is not to generate profits, and thus their net worth is often rather limited. Furthermore, they typically seek a LT financing for their infrastructure, and this in line with the (*longer*) economic life span of this infrastructure. Finally we would like to underline that **EBITDA** - indeed a popular measure commonly applied in various financial ratios to compare companies with each other **- cannot be used for PSEs or NPOs**.
- The financing of commercial receivables through factoring. This kind of financing is typically linked to a pool of underlying receivables on which a ‘haircut’ has been applied. The repayment has to be made on a fixed short-term maturity, in a self-liquidating manner.