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EBF White Paper on Leverage Finance

In the view of EBF banks, the ECB supervisory approach to Leverage Finance (LF) is excessively conservative and discourages bank lending to a vast range of clients, mainly European businesses, as it does not sufficiently take into account the specificities of the underlying risks.

This has had the consequence of leveraged lending moving to non-regulated institutions, foremost private credit funds, and creating a competitive disadvantage for SSM banks.

Against this backdrop, the EBF would like to draw the attention of the SSM to key features involved in the ECB supervisory expectations on leveraged transactions (LTs) and highly levered transactions (HLTs) according to the ECB definition.

This White Paper contains a series of suggestions to address the most relevant issues. The main one is that leveraged lending does not constitute a well-confined asset class, which as such does not support a specific supervisory approach. Leveraged Buyout (LBO) finance is closest to such a confined asset class, while the rest of LF under the SSM scope is composed of various types of corporate loans that are typically not originated as leveraged but become such as the customer's financial condition deteriorates. Such cases are already subject to close supervisory scrutiny in the context of high risk and defaulted customer management and exposure restructuring, as well as non-performing loans (NPL) provisioning expectations.

The paper concludes that the most appropriate way to avoid the consequences of the overly restrictive SSM approach would be to apply it only to genuine leveraged transactions, i.e. LBOs. An alternative would be to separate clearly the expected treatment of LBOs as opposed to leveraged corporate loans (i.e. non-LBOs) and adopting the mitigating measures suggested in this paper.

The paper is structured along these sections including a specific request for change in every section:

- The scope of ECB's approach is too broad
- Ongoing leverage is a better measure of credit risk
- The leverage ratio disregards credit risk mitigation / capital structure specifics

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu

Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany

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- LT and HLT regime should provide for exemptions for sectors which are of strategic importance to the EU (for example, the Defence sector, industries relevant to the Savings & Investment Union)
- Comparison with US and UK
- Concerns on ECB's benchmarking approach
- Clean up the definition of LF and HLT across various ECB frameworks

The scope of ECB's approach is too broad

We consider that the following products and activities should be excluded from the definition of LF:

- Fallen angels
- Trade Finance (TF): in principle excluded, however we observed an inconsistency because TF is only excluded if it is the only exposure with the counterparty; however, TF is typically part of a global relationship with the client.
- Asset based lending products (with borrowing base mechanism and appropriate monitoring in place)
- Overdrafts
- All non-lending exposure
- Leasing Activities: in principle excluded since this activity does not relate to debtor risk but to residual value risk. However, the ECB seems to push to include leasing in the LF scope. The Leasing risk profile, both in terms of default and recovery level, is much better than loans and an inclusion would be irrelevant.

While the EBF recognises the concerns about LF, the scope of which as defined under the ECB Guidance does not correspond to a coherent set of exposures, it cannot be seen as an asset class and does not allow for a real differentiation of risks.

An asset class typically refers to a group of financial instruments that exhibit similar characteristics and behave similarly in the marketplace. The classification of asset classes is essential for regulatory purposes, particularly in the context of credit risk and capital requirements. Contrary to the ECB Guidance in which the terminology "asset class" is not used, the ECB expectations included in the "Dear CEO" letters, stress that "LTs represent an Asset Class "AC" that requires a centralised and specific risk management."

The industry is struggling with the scope as applied by the ECB on LTs and to manage them as a homogeneous asset class:

1. The primary concern of EBA on LF relates to LBOs and financing of borrowers owned by financial sponsors usually structured as syndicated loans and its subsequent indirect exposures, including Collateralised Loan Obligations (CLO) (EBA/REP/2020/21). The ECB Guidance on the other hand includes any

leveraged borrower, including bilateral loans to domestic borrowers with elevated EBITDA over debt. While the industry recognises the concerns EBA and ECB have regarding leverage for typical LBOs, it is less the case for just any leveraged transaction which is in scope of ECB's Guidance. So even with the multiple (and complex) scope exclusions provided in the ECB Guidance, the resulting scope is still much broader than the scope of which the industry would concur with EBA's and ECB's concerns.

2. The resulting broad scope of LTs according to the ECB does not result in homogenous asset class, and consequently, the industry is struggling with treating the LT book as an asset class. Lending to Leveraged Finance as per ECB Guidance, is generally not restricted to a business line with a uniform approach yet spans over multiple business lines from LBOs to traditional mid-corporate relationship banking, making it impossible for the industry to respond to ECB Guidance in a consistent matter. One member bank formulated it as follows: Would a LT in Argentina behave similarly compared to a LT in Spain? Both transactions would probably very much behave according to their respective economies. As a result, managing these two transactions as an asset class, e.g., considering this pool of assets for the purpose of internal and IFRS9 modelling, does not make sense. The risk drivers are different.

We call ECB to reduce the scope of the Guidance to obtain a homogenous asset class.

Ongoing leverage is a better measure of credit risk

The ECB Guidance requires financial institutions to perform the leverage test either at origination or at any contractual modification in time. At the same time in the Dear CEO letter on LT, ECB asks to monitor ongoing leverage (so not linked to the events of origination, modification, and refinancing) and even to limit exposure to LT when appropriate. This may create a dissonance between LT Guidance, Dear CEO letter, and reporting especially when there is expectation to have limits based on ongoing leverage.

We believe that the reporting of leverage should be on an ongoing basis. A report concerning exposures makes no sense to rely on historical data. Leveraged multiples as measured according to the ECB Guidance, are not stable in time. Hence borrowers enter and leave the scope of the ECB Guidance as the leverage ratio fluctuates over time. While Investment-Grade exposures are out of scope of the Guidance, they are only to be included following a) downgrade to Non-Investment Grade (the so-called Fallen Angels) and b) modification, e.g., forbearance. The reverse is not true. Thus, the growth of the Leveraged Finance portfolio according to the Guidance behaves semi-pro-cyclically and the obligor that did improve their rating or delivered are not (immediately excluded) unless terms are modified.

The Guidance penalises prudent companies that chose, as a precautionary measure, to secure liquidity during the pandemic or to lock in medium-term facilities at low interest rates, without fully drawing them. The ECB Guidance requires financial institutions to perform the leverage test at any contract modification. This inherently skews the Leverage Finance portfolio financial institutions hold towards problem loans. Non-leveraged exposures will in most cases enter the LT portfolio upon financial difficulties, thus eventually ending as non-performing. This is an inherent feature in the ECB Guidance: borrowers with financial difficulties are likely to have low EBITDA, hence a high leverage ratio, when applying for credit extension or forbearance measures. As the leveraged test must be performed when granting such measures, these borrowers will at that moment enter the LT or HLT (highest leverage) book, even when they were not part of the LT or HLT book before. The result is that the NPL ratio of LT book is artificially inflated.

We call ECB to simplify the scope of the Guidance towards the ongoing measurement of leverage.

The leverage ratio disregards credit risk mitigation

- Cash
- Guarantees of Export Credit Agencies (ECAs)
- Collateral

The ECB definition takes into consideration all granted debt, independently of the seniority of the debt. Subordinated debt is included even when the bank only has a position in the senior debt. We suggest excluding the subordinated debt (quasi-equity, non pari passu) from the ECB LT ratio, otherwise a bank debt free company with some LT trade finance / credit card exposure and significant shareholder loans would lead to (H)LT classification.

The total debt amount used in the ECB leverage test is a gross amount, including undrawn exposures and without netting allowed for cash collateral or cash held on the balance sheet. This deviates from established market practices and rating agency standards. This approach inflates the ratio of debt to EBITDA and, in turn, the perimeter of leveraged lending. It hence penalises prudent companies that chose, as a precautionary measure, to secure liquidity during the period of distress on financial markets (e.g., due to pandemic) or to lock in medium-term facilities at low interest rates, without fully drawing them. Considering normal variations in a borrower's EBITDA and debt levels over the life of a credit facility, the binary character of the leverage test is not considered adequate to measure credit risk.

A leverage test by itself is insufficient to determine the actual debt repayment capacity of a borrower, which also depends on the specific cashflow profile of the borrower and the characteristics of the industry in which the borrower operates (e.g., capital intensity, vulnerability of revenues to economic cycles, (contractual) predictability of cash flows, etc.). Borrowers with a mixed profile, including operational activities and (often stock-listed) financial investments, are penalized

in the leverage test as the financial holdings do not contribute to EBITDA at consolidated level.

The definition of leveraged lending does not allow for differentiation based on the purpose of facility (e.g. revolving credit facilities for liquidity purposes vs term loans for investments) and even more importantly ignores collateral and other key risk mitigants.

For financial planning reasons, borrower groups are often capitalized with a (thin) layer of real equity and a substantial layer of shareholder-provided contractually subordinated debt. This approach is detrimental to the application of the leverage ratio as defined by the ECB. Due to the reasons mentioned above (also under subordinated debt section), a high leveraged ratio according to the ECB definition does not necessary imply a high (poor quality) PD, as the PD is determined at the debt seniority level as provided by the financial institution. The leverage test ignores the financial strength of the parent and its potential willingness to support of the borrower. Even when this relates to government-owned borrowers. Considering normal variations in a borrower's EBITDA and debt levels over the life of a credit facility, the binary character of the leverage test is not considered adequate to measure credit risk.

We call ECB to make the Guidance risk sensitive.

Exemptions for sectors of strategic importance to the EU

LT and HLT regime should provide for exemptions for sectors which are of strategic importance to the EU e.g., the Defence sector, industries relevant to the Savings & Investment Union. The current framework restricts our ability to fully support the economy within Europe and also hampers the significant role expected from banks in rebuilding Europe's defence industrial base and promoting the Savings & Investment Union.

Concerns on ECB's benchmarking approach

The benchmarking applied by the ECB causes concern regarding the level playing field among financial institutions.

The ECB's proposed measure to rank Significant Institutions on LT, i.e., nominal volume of LT over CET1 capital, should also consider the nature of business model of the institution. In fact, the proportion of CET1 capital that is used for lending varies depending on the business model of the institution. Institutions with significant capital market/trading activities will need to hold additional CET1 capital to cover the risk related to these activities. Institutions mainly active in lending use relatively more CET1 capital for lending. The ECB's benchmark ignores this effect, which disadvantages Significant Institutions, as the benchmark used is biased.

Additionally, the aggregated nominal volume of LT over CET1 ignores the quality mix of such exposures, as the nominal volume includes exposures of a different risk profile (Leveraged Buyouts versus Leveraged Corporate Transactions versus Underwriting Pipeline).

The concern is that not all competitors in the main markets are subject to similar increased scrutiny of the supervisor regarding LT. In case specific supervisory measures on LT were to be applied, financial institutions may be faced with an unlevel playing field in its markets based on metrics that are considered not to be adequate in terms of credit risk management. In case financial institutions were to be unduly curtailed in its business generating capability in its home markets, this might be detrimental for its standing as important financial institution, to its ability to participate in attractive and acceptable financial transactions and its business model as a relationship-driven corporate/commercial bank.

Our view is that the ECB definition includes not only large syndicated transactions and LBO (this last one typical leveraged products) but also any bilateral and business as usual facilities with clients, who has temporary deteriorated, or they belong to sector or countries with lower rating and higher leverage (this would include bilateral credits of EUR 5-20 MM with modes commercial banking clients). We believe that it does not make sense for a regulation to cover these last cases and therefore to compare them in similar circumstances with vocational largest transactions.

We call ECB to revise its benchmarking approach.

Clean up the definition of Leverage Finance and HLT across various ECB pieces

The 2017 ECB Guidance has been subject to a public consultation. Meanwhile, ECB extended its Supervisory Expectations fundamentally as detailed in the 2022 and 2024 Dear CEO letters, adding to the complexity of the expectations raised by ECB which have not been subject to any public consultation.

Additionally, through the STE templates, ECB additionally finetuned its instructions, yet also adjusted fundamental concepts of the 2017 ECB Guidance. One example is that as of the 2Q24 STE reporting, shareholder loans should not be taken into account for calculating a borrower's Total Debt according to the ECB LT definition.

Below, there is a description of the type of debt (very close to equity) that PRA allows to exclude from the Leverage ratio calculation:

In the UK sponsor backed LBO market, Private Equity (PE) will typically invest their equity contribution towards the Buy-Out via loan notes – this is widespread market practice. PE could provide their equity contribution via Ord Shares or Redeemable Preference Shares, however, loan notes are the overwhelming instrument of choice due to their tax advantages.

Whilst in accounting terms Loan Note instruments are undeniably debt, LBO debt structures are structured in such a way that the rights of the Loan Note instrument are to all intents and purposes reduced to the equivalent of an Equity instrument:

- PE loan notes are subordinated to the Senior Debt in terms of rights to enforce
- PE loan notes rank behind Senior Debt in terms of rights to proceeds on enforcement,
- PE loan notes right to yield or payment of capital is subordinated to the rights of Senior Debt
- PE loan note yield if payable would be subject to bank control and would require material deleveraging to have occurred first
- PE loan notes are usually unsecured. On rare occasions where they are secured (in the lower mid-market) then the security is subordinated to the rights of the Senior Debt. The documentation will be structured such that the PE security will not be able to frustrate the Senior Debt Lenders ability to enforce (e.g. we will have a Power of Attorney to release their security if required)
- The contractual documentation used to achieve the above protections is LMA standard
- LMA Financial Covenant definitions treat PE Loan Notes as equity consistent with the above

Another example is need for clarity if the NPL exposures are in scope of the LT Guidance (including on-going leverage) only when exposures are originated / modified in NPL.

Moreover, the ECB in the SREP methodology¹ refers to the Dear CEO letter and thus indirectly to the ECB Guidance on LT.

We call ECB to review, integrate and simplify the ECB Guidance and all subsequent supervisory expectations.

In addition, the LF and HLT identification must consider additional factors different than the leverage ratio *per se*:

- **Borrower's industry**

The analysis of the solvency of the borrower cannot be performed without considering the borrower's industry, as higher leverage is inherent to specific sectors based on capital intensity however with predictable / stable (often regulated) earnings/ long term cash flows . Following two sectors (as an example) that due to its activity imply high leverage ratios but with groups rated Investment grade by rating agencies

- Utilities. Please find some examples of groups belonging to this industry: Nextera (GFD/EBITDA > 5; Fitch & S&P: A-), Tennet (GFD/EBITDA > 8; S&P: BBB+), CFE (GFD/EBITDA > 6; S&P: BBB), National Grid (GFD/EBITDA > 6; S&P: BBB), China Three Gorges (GFD/EBITDA > 6; S&P: A+), China General Nuclear Power (GFD/EBITDA > 8; S&P: A).

¹ [ECB's 2022 letter on leveraged transactions and supervisory expectations.](#)

- Concessions. Please find some examples of groups belonging to this industry : Ferrovial (GFD/EBITDA: >8; S&P: BBB), ASPI (GFD/EBITDA>5; S&P: BBB), Indigo (GFD/EBITDA>7; S&P: BBB)

- **Transaction structure**

Identification should be based on the final risk assumed by banks and not only borrower conditions. It is not fair to qualify an exposure as concerning or not only based on borrower information. Bank exposure between banks should also be considered:

- **Guarantees**

- Exposures guaranteed by entities rated investment grade or with gross leverage ratios below 4 should not be considered Leveraged Finance as banks are not only assuming double default risks but also the characteristics of the final guarantor don't qualify as leveraged finance. Based on these exposures guaranteed by banks, sovereigns or other entities (like borrower's Group) that don't qualify as LF should not be included in the perimeter.
- Exposures guaranteed by liquid financial assets should not be considered Leveraged finance exposures considering them equivalent to non-guaranteed exposures. In this category we can find credits guaranteed by cash collateral, liquid bonds (sovereign or IG corporates bonds) that should not be considered as concerning at any moment.

- **Priority of payments**

When calculating LF and HLT leverage ratios, junior ranking debt (both structural and/or contractual) should not be required to be included in the calculation. On a similar basis, super senior exposure in the priority of payments cannot be considered LF in the same way as other more subordinated exposures

- **Baskets, undrawn debt and cash**

Leverage ratios for the purpose of LT and HLT transactions currently require all undrawn basket capacity (even if subject to a Net Leverage incurrence-based test) and undrawn debt to be added to the day one debt position when calculating leverage, whilst also not giving any benefit to the cash position of the borrower. This results in lowly levered transactions, sometimes with tight financial covenant profiles, as being regarded as not only LTs, but also HLTs and utilising limit which should not actually be required given the risk-profile of the wider transaction is not reflective of those aims set out by the regulator in insuring the financial stability of the financial system in Europe.

ANNEX:

We suggest a Level 1 (CRR3) change, specifically adding a definition of “leverage entity”, as a means to limit the effects and scope of the ECB guide.

Even though there is no dedicated opportunity to review the CRR3, with the European Commission expected to focus on its EU banks competitiveness report (now due 2026, as per today’s SIU announcements), this could be an opportunity for the European Commission to pick up this point on leverage lending, as well as other points that that industry has been raising.

We propose adding the following definition to Article 5 [and also in the corresponding paragraph of the ECB Guideline on Leveraged Transactions]:

(12) Leverage transaction means any transaction that meets at least one of the conditions below:

1. all exposures where the borrower’s post-financing level of leverage exceeds a Total Debt to EBITDA ratio of 6.0 times
2. all types of loan or credit exposures where the borrower is controlled by an investment firm that undertakes private equity investments in and/or leveraged buyouts of companies with the intention of exiting those investments on a medium-term basis

The following transactions are not expected to be covered by the leveraged transaction definition:

1. loans with natural persons, credit institutions, investment firms, public sector entities and financial sector entities [for the purpose of clarity: including leasing companies];
2. loans where the own consolidated exposure of the credit institution is below €5 million;
3. loans to small and medium-sized enterprises (SMEs);
4. loans classified as specialised lending;
5. trade finance [for the purpose of clarity: including borrowing base facilities];
6. loans to investment-grade borrowers

For the purpose of this point, exposure refers to all gross direct commitments to a leveraged borrower, including drawn and undrawn facilities, term loans, bridge loans or revolving credit facilities, committed exposures not yet syndicated or distributed, and exposures being warehoused for a later sale. Exposure that is collateralized (i) by guarantors that do not fall under the LT definition above or (ii) cash, is excluded.

For the purposes of this point “Total Debt” refers to total debt (i.e. excludes undrawn debt and shareholder loans). (Unrestricted) Cash may be netted against debt. For the purpose of leverage multiple, when calculated at transaction

origination, the pro forma financial statements of the resulting company after the transaction has taken place should be considered.

The designation of a financing as a “leveraged transaction” is made at loan origination, modification or refinancing.

The leverage multiple should be calculated at the consolidated borrower level, unless group support cannot be assumed in case the borrowing entity is experiencing financial difficulties. Any deviation from the calculation at consolidated level should be justified and documented on a case-by-case basis.
