



**Single
Rulebook
Q&A**

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Legal act	Regulation (EU) No 575/2013 (CRR)
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Article	128
Paragraph	2
Subparagraph	c
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	EBA/GL/2019/01 - Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of CRR
Article/Paragraph	Chapter 4, paragraph 2
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Disclose name of institution / entity	No
Type of submitter	Competent authority
Subject matter	Treatment of loans for LBO financing according to the GLs on high risk items
Question	<p>How should loans which constitute leveraged buyout (LBO) financing be treated according to the Guidelines on specification of types of exposures to be associated with high risk?</p> <p>Should information, that a loan is collateralised by shares in an unlisted company, have decisive impact on its treatment as potentially being "debt exposure with economic substance similar to non-debt exposure" according to the paragraph 2 of section 4.1 of the Guidelines?</p>

Background on the question

A commercial bank intends to grant a loan to the unlisted company (company A/acquiring company) for the purpose of the leveraged buyout (LBO) of another unlisted company (company B/target company/acquired company). After the transaction the company A will have a majority stake in the company B. According to information provided by the bank, loan is going to be repaid by the borrower's (company A) own cash flow from its core business activity and optionally by dividends received from company B as well. The company A intends to have a long-term strategic relationship with the company B. We have concerns that such kind of loans could be treated as investments in private equity. According to the clarification in the background of the Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013 a definition of an investment in private equity in paragraph 2 of section 4.1 applies to direct investments of the bank in private equity and whenever the look-through approach is used for exposures in the form of shares or units in collective investment undertakings (CIUs). We understand that condition under point (a)(ii) of that paragraph includes only structured debt instruments ("debt exposures and other securities") with the characteristics comparable to non-debt exposures" which conveying a subordinated, residual claim on the assets or income of an enterprise and where a repayment of a debt and profitability are closely linked to economic performance of unlisted company). These characteristics cannot be attributed to loans, contractual obligations of which represent solely payments of principal and interest, including loans given for the purpose of LBO financing if there are no special clauses in a loan agreement (e.g. that give a bank option to participate in profit sharing) which would allow similar treatment as for equity instruments. However, to treat a debt exposure as a private equity investment the condition under point (b) (i.e. bank's intention of an investment is generating a profit through LBO) should be met as well. In our opinion the main goal of an investment is not generating interest revenues for the bank, or this goal is of secondary importance, but the bank is primarily looking for gains and profit after LBO, initial public offer (IPO) or any other way of disposing its debt exposure, resembling similar economic content as private equity. We understand as well that for classifying an exposure as investment in private equity it is not decisive whether the bank's exposure (loan) is collateralised by the shares in an unlisted company (e.g. acquired company), creating an indirect exposure. To sum up, in our view paragraph 2 in section 4.1 of the Guidelines (defining criteria for investments in private equity) is not applicable for loans, granted by commercial banks, with the purpose of LBO financing, when the characteristics of debt exposure are not comparable with non-debt exposure. However, the bank should individually assess whether such exposures should be classified as high risk items in accordance with the provisions laid down in paragraph 5 of section 4.2 of the Guidelines (i.e. paragraph 5(a) - financing of speculative investments in financial or non-financial assets and paragraph 5(b) - any exposure to unrated company,

	<p>established specifically for the purpose of financing or operating physical assets other than immovable property, or economically comparable exposure). Taking into account our example, according to the information presented by the bank the conditions specified in the paragraph 5(a) would not, in our opinion, be met. Namely, the obligor (company A) does not have the intention to resell the assets for profit (the company A intends to have a long-term strategic relationship with the company B) and there are sufficient other sources of repayment from the core business available from the business operations of existing company A (target company's cash flow or anticipated dividends paid out to acquiring company are not crucial for the loan repayment). Consequently, we consider that the loan for LBO financing described in our example, should not be treated as high risk exposure.</p>
<p>EBA answer</p>	<p>Under the standardised approach (SA) for credit risk, investments in private equity, shall be assigned to the high risk exposure class (“exposures associated with particularly high risk”), according to Article 128 of Regulation (EU) No. 575/2013 as amended (CRR), except where those investments are treated in accordance with Article 132 of the same regulation.</p> <p>“EBA Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013” clarify the notion of investments in private equity referred to in point (b) of Article 128(2) of CRR. In particular, according to paragraph 2 of the Guidelines, investments in private equity are considered by nature as equity exposures, as already defined under Article 133 of CRR, with the additional condition that they are not listed on an exchange. Hence, loans not conveying a subordinated, residual claim on the assets or income of the debtor shall not be considered as investments in private equity, regardless of their intent (e.g. loans granted for the purpose of leverage buyout (LBO) financing). However, such loans could still be associated with particularly high risk, based on the individual risks assessments performed by institutions and on the fulfilment, if any, of conditions set out in section 4.2 of the Guidelines.</p> <p>Also, the assignment of an exposure to a specific exposure class as listed under Article 112 of CRR, including “exposures associated with particularly high risk” but excluding “exposures secured by mortgages on immovable property”, is not dependent on any credit risk mitigant, such as collateral. Against this background, the CRM effects are considered according to the applicable CRM framework.</p>
<p>Link</p>	<p>https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2019_4952</p>

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