Let there be credit!

A GROUP OF LARGE ENTERPRISES HAVE LAUNCHED THE CORPORATE FUNDING ASSOCIATION PROJECT TO CREATE A LENDING FACILITY THAT WILL BE RUN BY CORPORATES, FOR CORPORATES. **PHILIPPE ROCA, ARNAUD CHAMBRIARD** AND **HUGUES DELAFON** PUT THE PROPOSITION.

The financial crisis has shown the need for corporates to develop new and supplementary sources of funding. According to HM Treasury research, UK companies still rely heavily on banks to meet their borrowing needs. Bank debt represented 76% of their borrowing structure in 2007 (and that does not take into account the undrawn committed credit lines) compared with 21% for the corporate bond markets.

In the context of an anticipated shrinkage in the amount of bank credit on offer as a result of fewer banks being around and higher regulatory capital constraints, the historically high number of corporate loans granted in the years 2005–07 will undoubtedly have a strong impact on the bank credit market in the years 2012–14 when these loans come to maturity. Of course, larger companies also have access to the corporate bond markets, and 2009 witnessed record corporate bond issuance. But experience demonstrates that the debt capital markets can be closed for relatively long periods, even for high-grade issuers, or just too expensive, as was the case for most of 1998, 2001–03 and 2008–09.

Accordingly, a group of 16 large corporates from six countries, including three from the UK and one from the US, have joined forces to investigate the creation of their own bank. The group believes there could be an opportunity to co-create a new source of funding that would supplement efficiently the traditional bank lending and capital markets. The interim name for this private initiative is the Corporate Funding Association (CFA) project.

WHEN THE MARKET IS SUPPORTIVE, CFA WILL LEND AT LOW MARGINS. WHEN MARKET CONDITIONS WORSEN, THE CREDIT MARGINS PAID TO CFA BY MEMBERS WILL INCREASE.

PROPOSED STRUCTURE. CFA's sole business purpose will be to finance its corporate members (and only them) through euro-denominated credit facilities with long tenors (from five to 10 years). The only shareholders will be the corporate groups themselves, which will be accepted into membership by their peers with a proposed two-thirds majority vote, subject to the bank's credit committee authorisation.

CFA will apply for a banking licence in France and will therefore be supervised by the French banking authorities. This will give CFA access to the refinancing operations of the European Central Bank (ECB) for the full benefit of its corporate members. CFA will itself obtain debt funding from the markets based on its own credit strength.

The FDs and corporate treasurers of the group of 16 have decided to pursue this initiative on the basis that the proposed business model employs simple, yet efficient, credit enhancement features aiming at preserving their equity investment, while achieving funding diversification as well as a possible cost reduction.

FINANCIAL INTEGRITY. So how can a new consortium achieve financial soundness and credit protection from day one? The CFA structure will have three principal pillars:

1. Credit diversification. This is the Gordian knot faced by corporate borrowers, and a challenge in itself for the CFA project, as its lending operations will only start when it has more than 100 corporate members from many different countries, sectors and sizes. This breadth of membership will enable a strict application of the banking regulations, under which the credit exposure towards a single counterparty will not be allowed to exceed 10% of the equity.

2. Tier 1 capital. CFA's "equity call" mechanism will ensure that the bank meets its regulatory capital target (Tier 1 ratio) at all times. CFA will grant credit lines to members, the size of which will be a function of their equity contribution and their credit rating. As an example, a BBB (or equivalent) rated member will benefit from a €1,000 credit facility for a €55 equity contribution (after the ramp-up period, and once CFA has been authorised by the regulator to apply Basel II's internal ratings-based foundation approach for capital adequacy).

If downgraded, a member wishing to keep the size of its committed facility unchanged will have to make a further equity contribution to restore CFA's regulatory capital. Alternatively, it could decide to reduce voluntarily the size of its committed facility. Conversely, if a member is upgraded, it can elect to increase its committed facility or keep it unchanged by asking for a partial repayment of its equity investment in CFA.

3. Credit margin resetting. CFA proposes that the credit margin paid by each member to CFA is reviewed every quarter based on:

- the credit rating of the member;
- the residual maturity of its facility; and
- prevailing credit market conditions.

When the market is supportive, CFA will lend at low margins. When market conditions worsen, the credit margins paid to CFA by members will increase. CFA's operational profit will therefore increase, improving its capacity to absorb a higher cost of defaults. This original pricing mechanism, which avoids the risk of CFA suffering a net accounting loss for the year and having to call for a recapitalisation, cannot be applied by traditional banks as their borrowers are not their shareholders.

COST OF FUNDING. So how does CFA intend to improve the cost of funding for its members? Basic banking principles mean that credit margins are calibrated to cover three elements:

- the cost of the banking infrastructure and its refinancing;
- the cost of defaults on its credit portfolio; and
- the shareholders' remuneration.

The lower the first two elements are, then the higher the third element will be!

On the first point, CFA will benefit from a refinancing cost lower than the average of its members and from a cost/income ratio well below 8%, which is particularly low for the sector. Because CFA's sole business purpose is to grant plain-vanilla credit lines to a few hundred corporate members, it will not have to pay for a large infrastructure, sales force or trading desks: its primary focus will be liquidity and process management operations.

On the second point, the resetting margin mechanism means that CFA should always collect credit margins in excess of the actual cost of default. According to S&P's 2008 global corporate default study,

Box 1: The member's story

AN INTERVIEW WITH JOHN JONES, GROUP TREASURER OF IMPERIAL TOBACCO GROUP, A CFA MEMBER.

WHY HAVE YOU DECIDED TO JOIN THE CFA PROJECT?
I heard of CFA for the first time in late 2008 when the focus was very much oriented towards liquidity. People have now realised that CFA is not just about liquidity, but also about managing funding costs. After a full year of structuring and informal discussion between the CFA project team and various experts from the regulatory and banking areas, I thought the CFA proposition had become attractive enough for Imperial Tobacco to join and contribute to the project development.

It is important to understand that the decision is not yet to establish the bank, but simply to take the next steps in structuring the CFA, with the formal involvement of corporate groups, rating agencies and legal counsels. Early joiners will of course have a greater influence than others to decide the governance of CFA and other important areas such as the key terms of CFA's credit documentation and infrastructure.

If successful, this could well diversify a portion of the funding base away from traditional sources, without jeopardising the core banking relationships for other lending and ancillary business.

WHO ELSE IS IN THE GROUP OF 16?
The group of 16 still needs to define more precisely the membership criteria. So far the only companies to have been approached are investment-grade or equivalent, meet a minimum €300m gross indebtedness threshold, and do not belong to the banking or insurance industries.

Of the 16 existing CFA participants, turnovers range from €1bn to more than €50bn, market caps go from less than €1bn to more than €20bn, and ratings go from the BBB- to AA, and they span a very diversified range of industries.

WHO IS BEHIND THE PROJECT?
The CFA project is a private initiative, by and for corporate groups. No third parties, state money or banks are involved. An advisory committee was put together to supervise the execution of the initial study phases and contribute to the definition of the future bank, thanks to its vast experience in the regulatory, banking and corporate area.

This advisory committee is very hands on and meets twice a month with Philippe Roca, Arnaud Chambriard and Hugues Delafon to discuss the progress made and the next steps to be taken. They all work on a voluntary basis on the project, as they are all convinced that the CFA proposition is a true opportunity for corporates to develop a new long-term diversified source of committed funding.

the one-year default rate over the 1981–2008 period is 0.06% on average for an A credit (with a record level of 0.49% in 2001) and 0.28% on average for a BBB- (with a record level of 1.33% in 1983), which is well below the actual level of spread required by the market. As the sole shareholders of CFA, corporate members would receive in dividends any excess portion of their credit margin and therefore ultimately pay the "true" cost of credit.

DIVERSIFICATION. Thanks to a simple and conservative structure, CFA will be able to supply supplementary funding diversification options for members.

CFA will rely on a conservative balance sheet and asset/liability management policy, avoiding any currency or interest rate risks. Its credit risk profile will be easy to analyse for investors, as the bank will be able to communicate – within the constraints of banking secrecy, of course – the name of its shareholders that are also its debtors and its entire credit risk portfolio. All these factors, together with the regulatory supervision, will contribute to the "flight-to-quality" status of CFA in troubled markets.

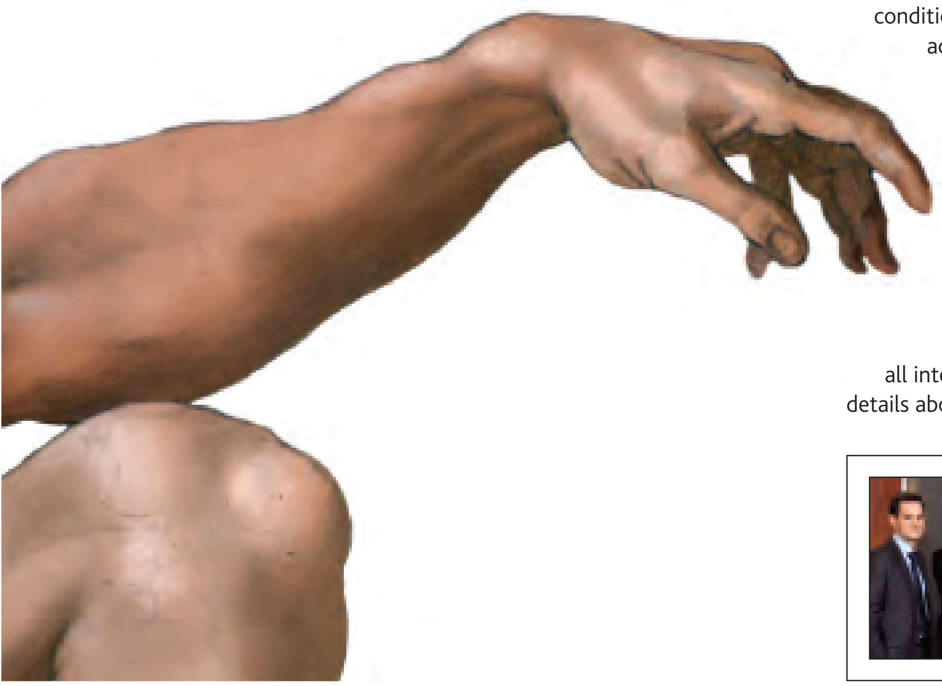
Based on its strong credit profile, CFA will raise funding on an ongoing basis in the interbank and capital markets. In case of market disruption, CFA will also rely on direct access to the ECB refinancing operations. Unlike traditional banks, all of CFA's assets will be eligible for ECB open market operations, for the sole and direct use of its corporate members. Based on the standard pre-crisis ECB operations rules, CFA would be able to triple the size of its loans to members within one month through an iterative process of using loans to members as collateral for ECB financing.

EXECUTION PLANNING. The CFA project is already well advanced after one year of informal studies and a growing name recognition following several press articles. The CFA project team has designed an operational and governance structure based on a thorough analysis with corporate treasurers and CFOs as well as with experts from the banking, regulatory and corporate areas throughout Europe. Informal discussions with the French regulator have also been taking place since July 2009.

In January 2010, the group of 16 corporates launched the formal setup and analysis phase of the project, during which terms and conditions will be finalised under the supervision of CFA's senior advisory committee. The founding members aim to incorporate the structure that will formally apply for the banking licence around October of this year. These members will appoint the board members and key executives, who will recruit the operational team.

CFA will initiate lending operations progressively six months after that, and its minimum objective is to recruit at least 100 members. At the end of the ramp-up period, the project anticipates having a minimum of 200 corporate members.

The CFA project team and its corporate sponsors invite all interested corporate groups to contact them for further details about the project.

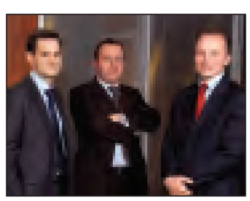


Box 2: CFA Advisory Committee

- **Christian de Boissieu**, economist and professor at the Sorbonne
- **Jean Cedelle**, former member of Credit Lyonnais and Credit Agricole senior management
- **Emmanuel Hau**, former deputy CEO of EdF and SNCF, member of the advisory board of Compagnie Financière E de Rothschild, and board member of STEF-TFE
- **Gérard de La Martinière**, chairman of the Finance Commission of the Confederation of French Industry and board member of L'Air Liquide and Schneider Electric
- **François Poncet**, Managing director of Sonepar Group in charge of finance
- **Didier Ribadeau-Dumas**, former head of the bank/insurance practice of the Boston Consulting Group in Paris, and currently board member of La Banque Postale
- **François Schlumberger**, former group treasurer of PSA Peugeot Citroën and ex-chairman of the French Association of Corporate Treasurers (AFTE)

Special adviser

- **Sylvain de Forges**, former head of Agence France Trésor and head of risks and markets at Veolia as well as board member of La Banque Postale



Hugues Delafon, Philippe Roca and Arnaud Chambriard comprise the CFA project team.
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