TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

PP15+ working group on developing a UK Private Placement market

Interim report December 2012

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1 Executive summary

1.1 Background

1.1.1 The Breedon review group reported in March 2012 (Boosting Finance Options for Business[1]) on increasing the range of financing options available to mid-sized UK businesses given the large funding gap indentified. As proposed in the report the ACT took up the challenge to lead an industry initiative to "Increase the number of UK-based Private Placement investors" (Breedon recommendation 4). A working group was formed bringing together professionals from a range of backgrounds and industries taking in banks, insurers, US private placement investors, pension fund advisors, actuaries, lawyers, rating agencies, borrowers and representative bodies.

1.1.2 In order to achieve the primary objective:

- to increase the number of UK-based Private Placement investors,

several subsidiary objectives were identified as the practical means for assessing the problem and moving towards solutions, namely:

- Review current markets
- Determine the barriers to the achievement of the goal (to achieve "willing buyer: willing seller" objective)
- Rank the barriers in order of critical importance (scope the problem)
- Identify practical solutions to the barriers (identify solutions)

1.2 Findings

1.2.1 There is a clear demand for a UK Private Placement (PP) market from borrowers as evidenced by the number of UK issuers making use of the US market, despite some less than ideal attributes there. It is perfectly possible for a major financial centre to be able to support a PP market, witness the US and German equivalent markets. In the past there has been less need for a UK market given the numerous alternative funding techniques available to companies, but with the shrinkage in the traditional banking market a very real need has arisen.

1.2.2 For investors the instrument theoretically provides an attractive interest-bearing investment with a medium term maturity (typically 5 to 12 years) and assuming new issuers are attracted to borrow it provides a diversification of credit risk away from the larger mainstream issuers of international bonds. On the negative side PPs are not particularly liquid but arguably for insurance firms and pension funds who have longer term investment horizons this should not be too large a problem.

1.2.3 The working group has uncovered numerous small issues or barriers to the development of the market. Each one may seem trivial and therefore not worth addressing, particularly since the market will not take off until most of these small barriers are removed. It can be likened to Gulliver being tied down by the many tiny treads of the Lilliputians – the threads are easy to break but there seem so many that it is not worth the effort to make a start. However we believe that

[1] http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf

with a concerted push from borrowers, the investors already active in this space and from Government the barriers will prove insubstantial.

1.2.4 The embryonic UK private placement market is just too private with lack of visibility on new transactions and indeed some confusion even exists as to what forms of borrowing come under the heading of PPs. In some respects the definitions are irrelevant and in the widest sense any non bank borrowings not covered by the Prospectus Directive could be called a PP, be that in loan format or securities format. Some of this confusion and lack of familiarity flows through into uncertainty over the regulatory treatment for insurance companies – perceived as the major category of potential investors.

1.2.5 There is a significant inertia with the impression widely held that because the market doesn't exist it doesn't need to exist so it is not worth any the effort to make it exist. Efforts to improve the visibility of the product, profile raising and public debate and comment are needed to encourage those myriad small barriers to be broken down.

1.2.6 There appears to be some inbuilt caution on the part of issuers, investors and in particular the regulators, yet a significant PP market exists in the US and Germany without causing problems or excessive risk to financial systems. The Breedon Report noted that in the US only 0.2% of institutional funds are invested in PPs. Translating that to the UK was equivalent to £15bn. While this would be a very welcome contribution for UK borrowers, in terms of the wider market and financial systems it is insignificant. Regulators should be encouraged to take a pragmatic view of the riskiness and materiality for investors and take a suitably pragmatic view to the application of regulation, as is done elsewhere.

1.2.7 In order to bring the UK in line with overseas PP markets some work is needed to create a more standardised off the shelf product that would be more straightforward to sell to both issuers and investors. A distinct asset class could be created and with much improved visibility.

1.2.8 A further disincentive to move forward with a UK PP market is its potential pricing competiveness against alternative borrowing sources. Subsidised funding schemes such as the Funding for Lending scheme, although welcome in themselves, distort the market and can make PP borrowing uncompetitive. With this particular scheme set to run until January 2014 we do not envisage any significant growth in the UK PP market for at least 18 months. This sort of timescale does nonetheless leave a window for further work to be undertaken to breakdown other of the small but numerous barriers.

1.3 What's holding back a UK PP market compared to other markets?

Features	UK	US	Germany
PP market with significant new issue volume	X	✓	✓
Clear, straightforward and pragmatic regulatory treatment for insurance company investors	X	✓	✓
Standard or relatively standard documentation	X	✓	✓
Some readily available information about market activity, despite its "private" nature	X	✓	✓
Track record of performance and defaults built up by individual investors	X	✓	✓
Investors prepared to set up internal resources to participate in the market	X	✓	✓
Issuer demand to be able to raise funding	✓	✓	✓

Capable of being resolved relatively easily
Capable of being resolved but some hurdles
Capable of being resolved but expected to be difficult

1.4 Key barriers and recommendations

<table>
<tr><th>Barriers</th><th>Recommendations</th></tr>
<tr><td colspan="2">The Borrower and investor approach</td></tr>
<tr><td>As one would rightly expect of professional investors any new investment must meet rigorous criteria in order to be accepted as suitable for that investor and these create barriers, but equally there are many benefits from diversification into a new instrument and new borrower names. The difficulties for investors come from:

• Lack of track record for defaults and performance of the asset class both for initial and ongoing performance assessment
• Lack of liquidity and secondary markets
• Lack of price reference points in particular to compensate for illiquidity
• Lack of external credit ratings for many potential issuers, although at the same time investors maintain that they want to perform their own credit evaluation
• Lack of a standardised documentation to ease the review process
• Costs of employing personnel to review and assess new issues
• The need for pension funds to take advice combined with the reluctance of advisors to give that advice since while there is no market there is not seen to be any need to evaluate this asset class.</td>
<td>Almost all the barriers here fall into the chicken and egg category. For investors it is not worth ramping up their resources and skills to assess and monitor a new £ PP instrument and the new names because of the lack of current volume and the fact that many of the potential new issues could be of modest size so again not justifying the overhead of participating in this market. However these arguments seem weak in that all the skills and resources probably already exist within major investing firms who are already active in the international bond and equity markets. The lack of liquidity is a valid point that is unlikely to change even if new issue volumes increase, but then there is a class of investor that tends to have a buy and hold need.

There are some parallels with the development of the UK retail bond market. Here investors were keen to move into bonds but the costs of dealing were high, information not readily available, issuers were not making smaller denominations available, brokers were not publicising the instrument and nothing was happening. Even after the London Stock Exchange launched the ORB platform it took a while for the visibility and attractiveness of the instrument to filter through to corporate issuers and their advisors.

Accordingly it would help if:

• Market data could start to be accumulated by an existing data and information company and if some form of Small Cap bond index could be created.
• Historic data from those firms which have over the years already been active in a small way in the putative £PP market were prepared to pool their data for the benefit of the market as a whole.</td></tr>
</table>

Decision support tools	
The costs of decision support tools and the overheads involved in being a player in the PP sector is a barrier that could be eased at the margins through the use of external pooled resources through an outsourced provider	It is not reasonable to expect outsourced providers to create a live service when the volume and need is so small at the moment. The chicken and egg problem. However • Analysts and service providers should be engaged in the discussions around an evolving PP market and be encouraged to commit to enter the market as and when it develops
Legal	
Lack of standardised document is not an absolute barrier but like so many of the elements that need to come together to foster a new £ PP market it is at the margins a problem that should ideally be removed**.**	The development of a standardised form of loan/note documentation would be welcomed by all parties. At this point it is not possible to determine the exact form. However: • If market experience of current £ deals that are being done could be evaluated and some amalgam of US and LMA formats be drafted this would ease one complication
Tax	
The risk that withholding tax will apply to interest payments to non UK investors that cannot benefit from a double tax treaty is a significant disincentive for issuers if the terms and conditions throw the risk back on the issuer through a gross up clause. However a similar risk exists on US$ PPs and issuers nonetheless learn to accept and manage it. This is therefore not a fundamental barrier but is yet another complication at the margins.	Interest paid on bank loans and interest paid on Quoted Eurobonds enjoy a favourable treatment for withholding tax purposes. In order to encourage the development of a new borrowing market it would be fair to provide borrowers in that market with an equivalent position. • It is recommended that tax law be changed to provide £ PP with a withholding tax exemption akin to the Quoted Eurobond Exemption.
Regulatory	
• Solvency II is designed to make insurance companies safer but has the side effect for insurance companies as investors that it presents a serious regulatory limitation on the attractiveness of PP instruments.	• It would be very helpful if the FSA issued some guidelines as to treatment of private placement products by insurance companies. • It would be helpful if the FSA had some simplified methodology for assessing the capital requirements of unrated paper, perhaps along the lines of BaFIN in Germany or the NAIC in the US. Specifically it is recommended that the FSA tests the borrowers against a set of financial

• Big insurers prefer to use an internal model to calculate risk for regulatory purposes rather than rely on the standard formula which limits non rated paper to 10%. However in order to have their model approved by then FSA a 10 year data set on PPs is required. For most firms this is just not possible – the chicken and egg problem. • The cross subsidies on bank loan rates generated by banks from their ancillary business lines makes it difficult for PP lending rates to come out at attractive rates by comparison. • The various government schemes to encourage and subsidise bank lending also make it difficult for PP lending rates to come out at attractive rates by comparison.	ratios and deems those that pass as investment grade even though they are not formally rated • A loosening of the arrangements for ten years backup information to calibrate internal models for regulatory purposes would be helpful to many potential investors in a new private placement market. • Government needs to adopt a joined up approach to incentive schemes and regulation so that they do not act as a disincentive towards PP lending.
Behavioural issues	
Summing up, the barriers that appear to be genuine are that regulation is a real barrier for investors, that issuers fear the terms will be onerous and inflexible while for intermediaries there is no real commercial incentive to get involved. All the perceptions revolve round the lack of any current market.	• The lack of any current market causes a reluctance to get involved. Provision of greater publicity around deals that do currently get done would help dispel this perception. Publishing a deal list and history of deals would help make the market less “private”. • On the back of deal publicity there needs to be a general publicity drive and provision of information about the market. • The reluctance of investors to build up the resources and skills to participate in the market should be countered by pressure from government, borrowers, shareholders and other stakeholders in the investors to encourage the investors to see the profitable opportunities that exist. Indeed some categories of investors may owe a fiduciary duty to their end investors to be investigating and exploiting the investment potential of PPs as a new and rewarding market.

2 Review of current position and markets

2.1 Corporate borrowing

Key messages

- *Borrowers have seen bank lending decline and need an alternative funding source*
- *Other markets exist for PP style funding in particular in US and Germany, suggesting that a UK market is perfectly feasible*
- *A domestic UK PP market would have various advantages for UK borrowers and would certainly be welcomed*

2.2 Funding strategy

It is accepted treasury good practice that the funding arrangements for a company will be more robust, reliable, appropriately structured and indeed competitively priced if the company has access to a diverse range of financing opportunities. The range of suitable funding methods will depend in part on the characteristics of the company – the nature of its business, its size and geographic spread, its target capital structure and its overall credit worthiness. Smaller companies may fund themselves from family and friends, but as they grow in their needs may move on to sources including bank overdraft or loans, invoice discounting, leasing. Larger companies (bigger mid sized and mid-sized+) may meet their needs from larger groups of banks coming together to lend via syndicated loan facilities including a range of options as regards maturity, currency, fixed rate or floating rate or with more involved structures such as asset backed loans. For the largest of companies the range of sources expand to include fund raising in the international markets or in foreign domestic markets using bond issues, perhaps officially listed on an exchange and a variety or structures and features be they short term through to ultra long term, index linked, convertible, subordinated, and of particular relevance to this report, through private placements.

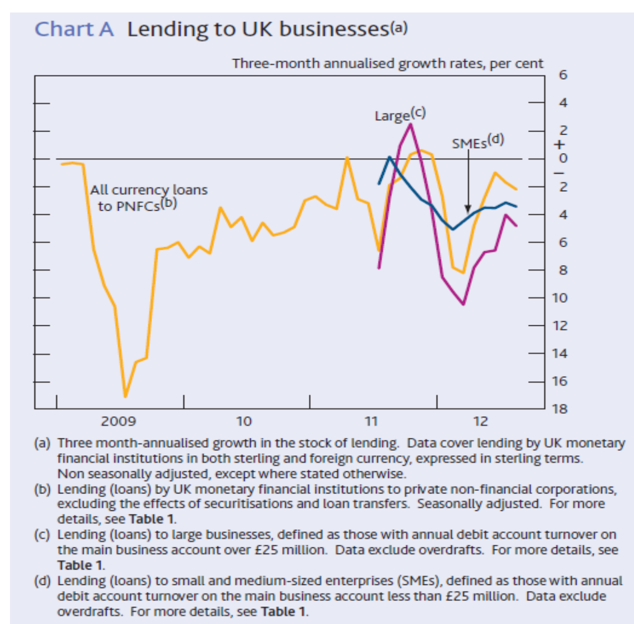
2.3 Private placements

("PPs") are a form of direct lending between non-banks and corporates. PPs can be widely defined but some of the characteristics they may include but do not necessarily feature are:

- Private Placements are a debt product which is sold to sophisticated investors. Typically buyers are large insurance and fund management companies but never retail investors.
- The lenders can be classed as non-banks.
- The loans are not publicly listed and subject to any public reporting and disclosure obligations
- The loans may be structured as a loan but equally, and perhaps more often, may be in the form of a tradeable security
- The loans may not include a credit rating from one of the international rating agencies
- The loans are fully drawn and do not include an revolving element, although some may have a short delay period for the first drawdown
- The private placement markets tend to form national characteristics, even though borrowers and lenders may be drawn from countries outside the relevant nation

2.4 Bank lending

Source: Bank of England, trends in lending October 2012[2]:



(a) Three month-annualised growth in the stock of lending. Data cover lending by UK monetary financial institutions in both sterling and foreign currency, expressed in sterling terms. Non seasonally adjusted, except where stated otherwise.
(b) Lending (loans) by UK monetary financial institutions to private non-financial corporations, excluding the effects of securitisations and loan transfers. Seasonally adjusted. For more details, see **Table 1**.
(c) Lending (loans) to large businesses, defined as those with annual debit account turnover on the main business account over £25 million. Data exclude overdrafts. For more details, see **Table 1**.
(d) Lending (loans) to small and medium-sized enterprises (SMEs), defined as those with annual debit account turnover on the main business account less than £25 million. Data exclude overdrafts. For more details, see **Table 1**.

Amongst the borrower community it is accepted that the availability of bank funding has reduced and will reduce further as banks seek to repair their balance sheets following the financial crisis. [3] Accessing non bank finance to fill the gap is an objective for those who can. Treasurers of companies able to access the international bond markets have been taking advantage of the current investor appetite for corporate bonds which together with the low interest rates available make this an attractive time to come to market. As a matter of policy companies in the UK and continental Europe are planning to raise a higher proportion of their borrowing needs from non-bank markets.

2.5 International comparisons

2.5.1 United States

In the US, the PP market is very well developed. In 2011, the value of traditional PP issued in the US (usually in the form of 'loan notes') amounted to nearly $45bn of which 35% was made by US issuers[4]. The US PP market is open to large as well as smaller corporates, and issues tend to vary in size from around $25m to $1bn+ transactions. Investors include insurance companies and pension funds, which often originate deals directly.

A key feature of the US market is the existence of a number of deeply rooted mechanisms facilitating investments. The National Association of Insurance Commissioners (NAIC), a central body for state-level insurance regulators, provides ratings services to the investors (for which the issuers are not charged). These ratings are less granular than those provided by traditional ratings agencies.

Another important feature of the US market is the Model Note Purchase Agreement, a standardised contract maintained by the American College of Investment Counsel. This document is widely used in the USPP transactions (both domestic and cross border), which significantly reduces the legal costs on both sides and brings comfort to the first-time issuers unfamiliar with the market practices.

Foreign (non US) issuers have been tapping the US PP market over the years and in 2012 the volume of UK issuers taking funding from the US has increased dramatically. Of particular note is the fact that some of the new UK names coming to market are relatively smaller companies and include some rather less well known names, implying that the US

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[2] http://www.bankofengland.co.uk/publications/Documents/other/monetary/TrendsOctober12.pdf

[3] Bank lending to non-financial corporations fell by 1.4% across Europe in the year to September 2012 according to the European Central Bank http://www.ecb.europa.eu/press/pdf/md/md1209.pdf

[4] US Private Placements for European Issuers - Slaughter and May, July 2012 https://www.slaughterandmay.com/what-we-do/publications-and-seminars/publications/newsletters-and-briefings/2012/financing-briefing---us-private-placements-for-european-issuers.aspx

investors are willing to invest the time and resources to consider and analyse new issuers to achieve some diversification.

2.5.2 Germany

The German Schuldschein industry is another established PP market: in 2011 the aggregate value of Schuldschein transactions amounted to EUR 8.6bn[5]. Traditionally, it has been a source of long term capital for the German mittlestand companies (and some issues can be as small as EUR 1m), but it is proving increasingly popular with German and foreign large corporates. Investors include banks, corporates, local authorities and, to an extent, investment funds. Insurance companies are permitted to invest in Schuldschein as long as they are rated investment grade or alternatively meet certain financial ratios. The German Insurance Association (Gesamtverband der Deutschen Versicherungswirtschaft e.V. – GDV) has published principles for the granting of corporate loans by insurance companies with special emphasis on Schuldschein loans ("Grundsätze für die Vergabe von Unternehmenskrediten durch Versicherungsgesellschaften – Schuldscheindarlehen", 4th edition, December 2006).

Target ratios are set such that at least one ratio must be complied with in each category.

- Category I: Debt service coverage indicators:
  - EBIT Interest Coverage (EBIT/interest expenditure) >3.0x
  - EBITDA Interest Coverage (EBITDA/interest expenditure) >4.5x

- Category II: Debt indicators:
  - Total Debt/EBITDA <3.0x
  - Total Net Debt/EBITDA <2.5x

- Category III: Capital structure indicators:
  - Risk Bearing Capital (liability capital/modified total assets) >27%
  - Total Debt/Capital (total financial liabilities/(total financial liabilities + equity)) <50%

Legally speaking, a Schuldschein is a certificate of indebtedness evidencing a loan (or a cash deposit) and is not a debt security. Thus, a Schuldschein is constituted by the underlying loan agreement entered into between the issuer of the Schuldschein as the borrower and the initial holder of the Schuldschein as the lender. Of particular note is the fact that they are not marked to market in the hands of the investors. Interestingly, Schuldschein are considered as collateral eligible for Eurosystem monetary policy operations and may also be used as underlying assets for intraday credit[6].

There is no PP model agreement in the German Schuldschein market, but the documentation is nonetheless relatively standardised.

[5] Ernst & Young Spring 2012 CFO INSIGHT

[6] German Schuldscheine - Norton Rose, December 2008 http://www.nortonrose.com/knowledge/publications/18587/german-schuldscheine

3 The borrower and investor approach

3.1 Borrower demand

Key messages:

- *Whilst the US PP market already provides a good funding source an equivalent UK market would be preferable.*
- *It is expected that the US market will become marginally less attractive following changes to the regulation of derivatives – the swaps required to convert $ to £*
- *Theoretically one would expect a £PP market to be attractive to investors but in practice the lack of a market track record makes it hard for them to evaluate the asset class*
- *Pricing parameters are uncertain partly because of lack of track record and partly because of the illiquidity of the instrument*
- *For pension fund investors the need for advisors to recommend the instrument (Section 36) is a barrier and the advisors have little motivation to consider and assess the instrument*

3.1.1 Demand from borrowers to fund from the international bond markets exists. Likewise UK borrowers are actively tapping the US PP market. We believe that a corresponding demand exists from borrowers unsuitable to tap these markets, for something equivalent in sterling in the UK. Furthermore there are strong drivers that would tempt traditional UK issuers in the US$ market away from that market in favour of a UK PP market.

3.1.2 For all its benefits the US PP market comes with some less attractive features which could make a domestic UK market be favoured. US placements are often issued under US law (although English law issues are becoming more prevalent) and there is a need for issuers to make US representations at issue, both of which are unfamiliar to them and potentially more onerous. US investors have the reputation for being distinctly inflexible should any variations or waivers be required once the PP securities are in issue. And generally the costs and complications, particularly for new issuers, are a disincentive.

3.1.3 Of particular relevance is the currency. For a UK issuer seeking sterling funding an issue in US $ will necessitate a cross currency swap from $ to £. Such a swap is currently not difficult and is readily available and indeed the current pricings can provide a basis pick up that creates a rate benefit so that the end £ interest cost is attractive. However any swap generates a credit risk for both parties and uses up the company's credit capacity with the banks doing the swap. The imminent regulation of derivatives in Europe (EMIR) and in the US (Dodd-Frank) combined with the capital requirements on banks arising from the Basel III international accord will make cross currency swaps more expensive or may drive the banks to seek collateral to mitigate the credit exposures. Either way the swap is likely to be less attractive and less cost effective providing an added driver in favour of companies funding themselves in their own domestic markets and currencies were such funding to be available.

3.1.4 Several US PP issues by UK borrowers have included a sterling tranche which is helpful in that it removes the swap requirement from the borrower and instead leaves that risk with the lender who may execute a swap for themselves. On the negative side for borrowers there will be a reduced investor demand for £ denominated tranches as compared to $ issues and in any case the terms will normally impose a make-whole provision on the borrower should the issue be redeemed or go into default prior to maturity. If the PP borrowing comes to

an end before its final maturity the make-whole provision requires the borrower to compensate the investor for any costs it takes on unwinding its own swap from £ back into $.

3.1.5 Overall we believe that significant UK borrower demand exists for a UK sterling PP market.

3.2 Investor appetite

3.2.1 Analysis in the Breedon final report noted that "In the US approximately 0.2% of institutional funds are invested in PP instruments. While some adjustment would need to be made reflecting differences between US and UK institutions, if a similar percentage of UK institutional funds invested in PPs, then as much as £15bn could potentially be available in the UK PP market."[7]

3.2.2 Theoretically one might expect investors to be interested in the establishment and growth of a new market. In the same way that borrowers benefit from diversity of funding sources, investors can benefit from a diversity of asset classes and extending the range and diversity of individual credits that they invest in. However institutional investors will be constrained by a rational and prudent objective to be sure that the nature and characteristics of their investments are suitable.

3.3 The investor approach

3.3.1 PPs are private transactions in that the details of an issue, and also its subsequent performance, are not published unless an issuer elects otherwise. It is this private nature which causes some potential investors, who buy public bonds, to be wary of investing in PPs.

3.3.2 That there is a persistent and strong demand for PPs is evidence that certain investors have got comfortable with the asset class. They took time to reach this conclusion, though. Publicly available performance data on the PP market is very limited and out of date. Many issuers do not even have a public credit rating. Ultimately, though, PP investors continue to be attracted by the relative outperformance of the asset class when compared to similar credit investments. This outperformance has been demonstrated by Society of Actuaries, see 3.5.4 below. (They are also attracted by other harder to quantify factors such as being able to diversify their portfolios into sectors and companies not included in public bond indices, and the benefits that stem from having a direct relationship with a lender.)

3.3.3 It is worth noting that even if a new investor decided to invest in PPs it would take some time to accumulate a portfolio. This is because there is only very limited secondary trading - the PP market is essentially a new issue market. Further, investors attracted to PPs tend to have long-term defined liabilities and so want assets to match them – they are commonly referred to as 'buy and hold' investors. PPs are often seen to offer diversification in a larger public bond portfolio, with the latter providing any necessary liquidity.

3.3.4 When considering a new PP investment, or any investment, it is necessary to evaluate the relative value it offers. This is arrived at by considering the credit strength of the issuer, the structural protections in the documentation, and the pricing. A brief outline of the considerations facing an investor is set out below.

Credit Each investor must separately assess the credit quality of the offering. Few PP issuers have public credit ratings

[7] Boosting finance options for business chapter 5, paragraph 14 http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf

and, even if they do, most (if not all) investors have in-house credit analysts to perform this work. A fundamental analysis of the issuer's credit is undertaken, usually including a meeting with company management. A comparison is then made between the issuer and publicly rated companies from the same sector and which have similar operating and financial profiles. A credit rating is assigned to the issuer, commonly using a credit scale which parallels that of the credit rating agencies. (An issue may be rated differently to an issuer. Commonly this is because an issue benefits from documentary protections, such as security or subordination.)

Default probability Investors will generally asses this risk within the context of a credit rating they assign, and in the light of rating agency studies and default probabilities. Each investor will monitor credit performance and default record of their investments, although this will clearly vary between institutions, based on their relative risk appetites, need for liquidity and desire to diversify away from other credit products. Credit performance, including default experience, would be measured on a rating, sector / sub-sector and asset class level; but typically a private investor's credit portfolio would be significantly smaller than its public bond assets and would often be looked as a complementary sub-section of credit investing function.

Structure To the uninitiated PPs tend to be regarded as being a variant on a public bond. However, the financial covenants which are typically present, as well as other documentary protections, lend more to bank documentation than they do to public bond documentation. This has been proven out in some distressed company restructurings where the banks and PPs enjoyed a superior position to the public bonds. It is primarily these protections which PP investors look to in order to outperform public bonds if issuers suffer distress.

Pricing Having arrived at a rating for the PP issue under consideration, it is possible to find publicly traded bonds from the same sector and with a similar rating, often the same benchmarks which were used in assessing the issuer's credit. (Exact matches are not usual, so this part of the process can be more of an art.) So, the premium over public bonds can be established.

Personnel Requirements
Credit research – to carry out analysis assign own rating
Portfolio management - to decide on relative value vs other private credit assets and public bonds; typically new issue markets, or secondary markets where size is available
Legal – although outside counsel is appointed, investors generally have their own legal team to review documentation associated with each investment
Banking / Broker relationships – most deals are syndicated by investment banks / brokers to existing investors so it is essential to foster relationships

3.3.5 But, whether a particular PP offers relative value to an investor is a specific determination of that investor. Even if one accepts that investors will generally agree about a credit rating and so about what relevant public pricing comparisons should be, there are still factors for each investor to price. For instance, investors do not all agree what value should be attributed to the protections which PPs have and which public bonds do not. The 'illiquidity premium', being the anticipated higher cost to sell a PP over that to sell a similar public bond, moves over time and from investor to investor. The benefit of diversification is another factor which few (if any) investors can accurately quantify.

3.3.6 So, whilst there are marked deficiencies in the data which is publicly available to be able to evaluate the PP market over time, there are sensible ways

for sophisticated investors to be able to gain comfort as to whether a particular PP offers value or not. This model has been tested over economic cycles. Demand for the PP product continues to grow amongst these investors.

3.4 Pensions fund investors

3.4.1 For pensions funds the investment decision making process is more tortuous. All the previously mentioned elements of credit structure and pricing are fundamental but in addition there will typically be a governance and approval mechanism to work through. Before investing in a £ PP Pension Trustees will need to agree it to be an approved instrument and put it onto the mandate given to their investment managers. The trustees will need to take advice from their actuarial pension advisory firm and within these firms there will be some Committee process to ratify £PPs as an acceptable asset class.

3.4.2 Amongst other things, pension fund trustees are prohibited from engaging in "day to day investment management activity". In this context, a direct lending structure under which the trustees may be required to become involved in active decision-making, is liable to be problematic for pension funds. Additionally, section 36 of the Pensions Act 1995 requires the trustees of a pension fund to take advice from an investment adviser on the suitability of any proposed investment and how it relates to the fund's statement of investment principles. The opinions of the investment consultancy community as to the attractiveness of any private placement product will therefore be critical to the willingness of pension funds to invest.

3.4.3 Before even considering specifics of individual names they will seek to compare the PP asset class with the performance against LIBOR or some other benchmark. This raises the question of track record and past performance data which has also been raised as a more general concern by all types of investors. There is a lack of historic data on yields and default rates given this is a private market. The lack of liquidity and the premium required to offset this is another difficulty.

3.4.4 Taken together there is little incentive for any parties to initiate this review of PP investments as an acceptable asset class. The trustees may have a duty to act in the best interests of the fund but the board may not have the expertise within its membership to be aware of the opportunities. The advisors have little evidence to work on so remain silent. Arguably the investment managers should be aware of the instrument and may have a commercial interest in promoting it, but to date this has not been much in evidence.

3.5 Performance and valuation issues

3.5.1 This lack of access to performance data both from the past and on an ongoing basis presents a barrier for many potential investors

3.5.2 Investments need to be considered in the context of other assets the investor is currently investing in or considering investing in. Hence performance and loss history needs to be in a form comparable to other asset classes. Information is collected in other areas by the likes of Bloomberg and Markit and in the case of private equity the BVCA define a framework and collect the data.

3.5.3 When making investment decisions the normal process used by investors would be to look at valuations either a) looking at spreads over external comparatives or b) through some matrix pricing method or secondary trading grid. This is done on a name by name basis and not on a portfolio basis.

3.5.4 The main selling point for PP is the recovery on default, which tends (anecdotally) to be higher than

comparative assets even though the default rate is itself higher. An extensive study was undertaken by the US Society of Actuaries "1986-2002 Credit Risk Loss Experience Study: Private Placement Bonds by the Private Placement Committee, April 2006".[8] Overall, their study concluded that private placement portfolios offer incremental value vs public bond portfolios. Specifically saying:

- During the period studied, private placements had materially better loss experience than publicly issued bonds, even after controlling for differences in aggregate portfolio quality.
- Privates with internal credit ratings that equate to AAA/Aaa through BB/Ba at the start of each year had loss experience over one-year horizons similar to that for publicly issued bonds. Incidence or default rates were worse, but loss severities were better.
- Private placements with a most recent quality rating of B or riskier offered superior experience relative to public bonds. Incidence or default rates, loss severities, and economic loss rates were all better.

3.5.5 In the US www.privateplacementmonitor.com does collate data for its subscribers and publishes a newsletter. In order to compile his database the author Anthony Napolitano monitors any news announcements as they happen but the bulk of his information comes from investors and agents in the market. www.privateplacementletter.com provides similar newsletters on market new issues. So notwithstanding the private nature of the market a picture can be built up over time albeit this data does not capture defaults or valuations.

3.5.6 Feedback as regards attitudes to private placements and investing revealed:

- In PP market valuations are not really tested as there is no secondary market. This raised the question whether PP should be treated like bank loans (however PPs are a fixed rate product and bank loans are generally floating rate).

- New entrants to investing in the PP market are held back by the work required (credit analysis) compared to investing in public companies. It was also thought that investors struggle with selling the product internally as there is difficulty in quantifying the value in the PP market.

- The diversification benefit was given as a strong reason to invest in PP

- In the US the NAIC rating determines regulatory capital for insurers, therefore PP is recognised as an asset class

- PP is usually buy to hold. The illiquidity premium is important but how is it measured? It was thought that different investors took different views.

- Market entry point - you must know the expected overall yield relevant to other products.

- Covenants are good for credit analysts but the value ascribed to covenants is subjective.

- To an extent some might regard covenant triggers as reducing the need for an illiquidity premium, but they could not be regarded as a perfect substitute.

- Track record data was relevant for the general strategy or asset allocation decision or on getting the instrument onto fund mandates but ultimately the credit

[8] http://www.soa.org/Research/Experience-Study/Credit-Risk/research-1986-2002-credit-risk-loss-experience-study-private-placement-bonds.aspx

decision and current comparables became the key factors. Investors took an intense interest in the PP covenants since in the absence of liquidity they regarded it as essential to have a seat at the table alongside the banks if their investments got into trouble.

- Illiquidity premium is still important even for buy and hold investors. PP performance information remains private so there is perception of needing +50bp for illiquidity

- Size – issues need to be of the right size. There is a tendency to assume that it is only large investors that have the resources to invest, therefore they want large issues.

- Maturity – sought after maturity depends on investor so there may or may not be a mismatch of expectations

- Month End Valuations – required by regulation for some investors.

- Performance Measurement – month-end valuations not so critical – but default risk more important
  Pensions require quarterly reporting to trustees

- Valuation impacted by the name, default risk and covenants

- Value can be derived from diversification, new issue premium and illiquidity premium

3.6 Investors: The barriers

As one would rightly expect of professional investors any new investment must meet rigorous criteria in order to accepted as suitable for that investor and these create barriers, but equally there are many benefits from diversification into a new instrument and new borrower names. The difficulties for investors come from:

- Lack of track record for defaults and performance of the asset class both for initial and ongoing performance assessment
- Lack of liquidity and secondary markets
- Lack of price reference points in particular to compensate for illiquidity
- Lack of external credit ratings for many potential issuers, although at the same time investors maintain that they want to perform their own credit evaluation
- Lack of a standardised documentation to ease the review process
- Costs of employing personnel to review and assess new issues
- The need for pension funds to take advice combined with the reluctance of advisors to give that advice since while there is no market, there is not seen to be any need to evaluate this asset class.

3.7 Recommendations

Almost all the barriers here fall into the chicken and egg category. For investors it is not worth ramping up their resources and skills to assess and monitor a new £ PP instrument and the new names because of the lack of current volume and the fact that many of the potential new issues could be of modest size so again not justifying the overhead of participating in this market. However these arguments seem weak in that all the skills and resources probably already exist within major investing firms who are already active in the international bond markets. The lack of liquidity is a valid point that is unlikely to change even if new issue volumes increase, but then there is a class of investor that tends to have a buy and hold need. Nonetheless it would help if:

- Market data could start to be accumulated by an existing data and information company and if some form of Small Cap bond index could be created.
- If historic data from those firms which have over the years already been active in a small way in the putative £PP market were prepared to pool their data for the benefit of the market as a whole.

4 Decision support tools

Key messages:

- *Market awareness of the concept of PPs is good amongst larger companies for whom the $ market is suitable but for smaller companies there is little awareness*

- *External credit ratings or analysis would assist investors but is not a pre-requisite.*

- *The costs of decision support and admin generally is a strong disincentive to engage with the PP sector*

4.1 Although probably not fundamental to an investor's decision to invest in a PP it was perceived that at the margins there may be barriers from procedures and processes to be gone through that act as a discouragement. The hypothesis to be tested was that streamlining the decision process through technology and support tools or outsourced providers would help investors get comfortable with making use of PPs. Likewise from the issuer point of view a simple lack of awareness and familiarity with the market may be a barrier.

4.2 Market awareness/ education of participants

4.2.1 The collective view was that awareness of the US Private Placement market is fairly strong within larger corporate issuers due to strong product marketing by Agent banks and Advisors for 30+ years in the UK, but awareness was less strong in asset backed or structured sectors (Real Estate, Project Finance).

4.2.2 However for those borrowers that do not necessarily meet the "criteria" for the US PP market, for example in the <NAIC2 category, those companies with no demand/natural need for US dollars or those "below the radar" corporates from an ancillary business perspective for banks, there is thought to be a lack of awareness of non-bank lending as an alternative to relationship banks. While the market profile with the larger corporate issuers is not considered a major barrier, it is felt that awareness efforts need to be focused on those companies not suited to the US PP market and those who do not require US Dollars.

4.3 Credit analysis (in house or outsourced)

4.3.1 Clearly a cost effective out of house credit analysis service would be beneficial as an incremental resource for investors. It is unlikely that credit analysis would be entirely outsourced due to negotiated and relationship nature of private placements. Yet a third party opinion can only help make more people interested in the space and promote more deals. Co-investment agreements with existing market participants may help to get more sterling investors into the space, as a cost effective way for new investors to get comfortable with the market and build up a portfolio without having to fully invest in the infrastructure on day 1. The size of institution and depth of existing resource available to it is likely to determine the weighting between in-house and outsourced credit analysis.

4.4 Availability of existing good quality credit analysis

4.4.1 Independent credit analysis for the sorts of smaller companies who could benefit from a UK PP market is currently inadequate with a lack of cost-effective credit analysis offerings. There is a clear need for a solution providing credit analysis on smaller potential issuers and this could be added to existing equity brief for equity research houses. Investec Securities, Numis Securities, and Peel Hunt were ranked the top three Brokerage Firm for UK Small & Mid Caps in the 2012 Thomson Reuters Extel Survey and would be candidates to expand their service.

4.5 Role of credit ratings

4.5.1 Third party credit opinions (formal or informal) will always be welcomed by investors though the subjective elements in the ratings process (as opposed to financial metrics) may deter issuers. Investor feedback is that direct management interaction with investors would be more valued as compared to reliance on the ratings agencies to assess management. However investors recognise that this would be most expensive to provide. For growing the market and encouraging new investors rating analysis would be very helpful. Private ratings are likely to be more popular with issuers.

4.6 Cost of decision support versus perceived benefit:

4.6.1 Credit ratings may be off-putting to some issuers, however if the cost is lower than the saving in basis points in a similar manner to the public market then issuers should generally accept a rating. However there remains a possible reticence of issuers to confirm a sub-investment grade rating due to unintended consequences with creditors, suppliers and banks. This could be a matter of education, as it is not an issue in the US. Unlisted private companies may have concerns on disclosure.

4.7 Role of technology –

4.7.1 The unlisted, illiquid and negotiated nature of PPs makes them less suited to incorporation in indices and frequent mark to market (MTM) could be unwelcome due to introducing volatility. Technology is not seen as a major barrier to entry and it is difficult to see market expansion being technology led.

4.8 Linkage to benchmarks/valuations

4.8.1 Incorporation in indices would add to portfolio interest, however, may not be workable due to private nature of transactions and confidentiality.

4.9 Possible government and regulatory incentives

4.9.1 Government incentives such as partial credit insurance or tax relief would naturally add great interest to asset class and stimulate demand. Clarity is required around Solvency II. Any support would bring good publicity and focus but it must be questioned whether Government firepower is really appropriate for what is not likely to be a mainstream market? Any encouragement or incentives would be beneficial but would need to be substantive to bring significant focus to the asset class.

4.10 Barriers: decision support tools

The costs of decision support tools and the overhead involved in being a player in the PP sector is a barrier that could be eased at the margins through the use of external pooled resources through an outsourced provider

4.11 Recommendations: decision support tools

It is not reasonable to expect outsourced providers to create a live service when the volume and need is so small at the moment. The chicken and egg problem. However Analysts and service providers should be engaged in the discussions around an evolving PP market and be encouraged to commit to enter the market as and when it develops

5 Legal

Key messages

- *There is strong evidence that a standardised form of loan agreement / note agreement is helpful in simplifying and making more efficient the process of negotiating, documenting and reviewing the terms and conditions, at least for the more routine elements.*

- *There will always be certain commercial elements that are subject to individual tailoring.*

5.1 US lessons

5.1.1 Investors attribute the success of the US PP market, in part, to the establishment of the Model Form documents that provide template terms and conditions for the loan notes. Although it is the starting point for the loan documentation, individual issuers will introduce variations which will often be marked up for potential investors to show those changes from the Model Form.

5.1.2 Within the US, PPs are documented in the form of a tradeable security whereas many of the non bank loans made by insurance companies in the naissant UK PP market have been documented as loans with characteristics similar to the LMA standard bank facility as the starting point for negotiations.

5.2 UK approach

5.2.1 Potential US investors in a UK PP market might prefer the PP to be in note form whereas UK investors and borrowers might be more comfortable with a loan format. There can be other repercussions from the legal format not least whether or not there is a need for the investor to revalue the assets for accounting and /or regulatory purposes.

5.2.2 Fundamentally there is no reason why the term PP should not apply to both securities and loans formats.

5.2.3 Using the precedents of the US Model Form and the LMA (Loan Market Association) documents for bank loans some form or forms of standardisation were seen as attractive for the UK market. Although standardisation was seen as beneficial for the development of a UK PP market care would be needed to gain widespread acceptance. For this reason any moves towards standardisation should aim to reflect existing market practice rather than to lead it. Although financial covenants could be seen as an area for intense borrower / lender negotiation, some suggested covenants could be included in square brackets in any template agreements.

5.3 UK Documentation template

5.3.1 The appropriate documentation template for the market is likely to depend on the target investors and target borrowers. We consider the main opportunities:

(A) Adapt the model form of documentation used for US private placement deals to make it more suitable for UK borrowers and investors. This has the advantage of replicating a process commonly followed by UK borrowers entering the US private placement market and (it is to be hoped) preserves the attractiveness of the product for US investors. It may also facilitate wider access of UK borrowers to the US private placement market. However, the suitability of a US model as a recommended form (explicitly or tacitly endorsed by BIS and the ACT) to stimulate a UK-focused market may be questioned. The US model form documentation is originally designed to be governed under US law, follows US drafting and covenant conventions which may be unfamiliar and off-putting to UK borrowers, and, in several areas (such as taxation), is not well-tailored to UK borrowers and therefore requires amendment;

(B) Adapt documentation used for UK bank facility agreements (such as the LMA standard forms, endorsed by the BBA and the ACT) to make it appropriate for non-bank investors and BB borrowers. This is the approach taken by the Prudential/M&G fund. This has the advantage of adopting a template designed for UK borrowers and familiar to many of them. However, it may preclude investment by US investors.

(C) Devise a hybrid form of documentation capable of appealing to both UK and US investors. This could potentially maximise the investor base, but risks being insufficiently familiar to be attractive to either constituency of investors. It would also involve significantly greater use of resources at the drafting stage.

5.3.2 There would remain further detailed work to investigate the investment criteria applied and the contractual terms normally required by US investors, UK investors and the borrowers, in particular BB rated borrowers.

5.3.3 A form of documentation that allows the option for the investor to lend in either a securities form or in a loan form has been suggested with the right to convert the format from one to the other to facilitate preferences on a sale. Care would be needed in developing this concept since there are concerns that such a “convertible” form might taint the treatment in the hands of the investor and result in a sub-optimal treatment.

5.4 Barriers: legal

Lack of standardised document is not an absolute barrier but, like so many of the elements that need to come together to foster a new £ PP market, it is at the margins a problem that should ideally be removed.

5.5 Recommendations: legal

The development of a standardised a form of loan/note documentation would be welcomed by all parties. At this point it is not possible to determine the exact form. However:

If market experience of current £ deals that are being done could be evaluated and some amalgam of US and LMA formats be drafted this would ease one complication.

6 Tax

Key messages:

- *Withholding tax on interest payments is a complication for issuers and lenders alike and, through the normal gross up provisions, can throw an unacceptable uncertainty and possible cost back onto the borrowers.*
- *The borrower position can be improved though restrictions on transfers and tradability but this has a corresponding disadvantage for investors*
- *Ideally a change in tax law should be introduced to provide £ PP with a withholding tax exemption akin to the Quoted Eurobond Exemption*

6.1 Investor expectations

Investors in international capital markets generally expect that interest payments on debt securities will be paid gross without any withholding of tax. Similarly, investors in the UK private placement market are likely to require a borrower to "gross-up" interest payments which are subject to withholding or other deductions for tax.

6.2 UK Experience

The withholding tax regime for non-bank lending in the UK is not straightforward and is heavily influenced by the tax residence and legal nature of the lender. The general rule is that the UK requires withholding at the basic income tax rate (currently 20%) from payments of "yearly interest" (*i.e.*, interest payable for a period of a year or more) arising in the UK. There is an exemption from withholding on interest payments to UK-resident companies and non-UK lenders may be entitled under double taxation agreements to reclaim any withheld amounts. However the transferability of the debt could still produce potential tax exposure for a borrower/issuer which is required to "gross-up" such payments to certain non-UK lenders.

The possibility of a specific and straightforward tax regime for UK private placement investments should be considered.

Further detail around taxation is provided in Appendix 3

6.3 Possible solutions and US precedents

6.3.1 **Restrictions to the gross-up**. Although securities issued in the US PP market are transferable, the US model documents do not completely deal with tax risk on subsequent assignments of the securities from a borrower perspective and the tax provisions are therefore usually negotiated. The US model documents restrict the gross-up so that the borrower will not be required to pay an amount to a transferee in excess of what it would have been required to pay to an original investor. In effect, the borrower takes the risk of a changes in both US fiscal law and also the relevant double taxation treaties in the US and the original investors' jurisdictions but not risks directly stemming from the change of investor.

6.3.2 In negotiating the allocation of risk under the model documents, borrowers in the US often take comfort from the fact that, in practice, investors intend to hold securities to maturity and there is extensive domestic demand for securities. Accordingly, the US precedents may not be appropriate for the UK market – particularly if securities in the UK PP market are intended to be freely transferable and it is likely that non-UK investors will be involved in transactions. In practice, territorial restrictions to the gross-up may reduce the attractiveness of the securities to potential transferees.

6.3.3 In the UK, where a borrower is relying on treaty relief to pay gross, transfers of securities to a non-UK investor close before a scheduled interest payment may not leave sufficient time for treaty clearance to be obtained and so would require that borrower to gross-up the payment. The borrower might therefore

request a restricted period prior to scheduled interest payments during which, on any transfer of the securities, the transferee would not benefit from the gross-up if an HMRC treaty clearance had not yet been received.

6.3.4 **Remedies where a borrower is required to gross-up.**
If a borrower is required to gross-up, it is usual for the investors to agree to reimburse the benefit of any subsequent treaty relief to the borrower. Also, a borrower would normally expect to be able to prepay the securities prior to maturity in the event of being required to gross-up for tax but, following the US experience, the circumstances in which prepayments for tax reasons will be permitted are likely to be negotiated.

6.3.5 **Possible legal reform**.
Alternatively, as the development of a UK PP market was recommended by the Breedon report, the Government might consider a legislative change to support the new UK PP market. The Government has recently consulted on proposed changes to the withholding regime (including the "quoted Eurobond" exemption), so it may be possible to incorporate into that process some provisions to allow securities in the PP market to be freely transferable without withholding tax risks for borrowers.

6.4 Barriers: tax

The risk that withholding tax will apply to interest payments to non UK investors that cannot benefit from a double tax treaty is a significant disincentive for issuers if the terms and conditions throw the risk back on the issuer through a gross up clause. However a similar risk exists on US$ PPs and issuers nonetheless learn to accept and manage it. This is therefore not a fundamental barrier but is yet another complication at the margins.

6.5 Recommendations: tax

Interest paid on bank loans and interest paid on Quoted Eurobonds enjoy a favourable treatment for withholding tax purposes. In order to encourage the development of a new borrowing market it would be fair to provide borrowers in that market with an equivalent position.

- It is recommended that tax law be changed to provide £ PP with a withholding tax exemption akin to the Quoted Eurobond Exemption.

7 Regulatory

Key messages:

- *The proposed Solvency II regulation of insurance companies, who are a prime target investor base for PPs, provides an unfavourable treatment of PPs such as to make this form of investment unattractive for insurers.*
- *The Solvency II complications act as a fundamental barrier for insurance company investors such that without some loosening of the regulatory burden a £PP market is unlikely to develop much volume in the near term.*
- *Foreign regulators appear to have a simplified and more favourable approach such that their insurance companies do not suffer what is in effect a bar to investing in PP*
- *The regulatory requirements on insurance companies and the favourable capital treatment allowed to banks for loans under the Funding for Lending scheme mean that during the life of this scheme it will be impossible for a UK PP market to provide funding that is competitive with other lending markets.*

7.1 Target investors

The target investors in UK PPs were identified as largely insurance companies and pension funds. Their appetite to invest will to an extent be driven by the treatment of such investment under the regulations applicable to them. In particular regulation could even create an absolute barrier to investment. Regulation was seen as a critical area for review not least because it was expected that the treatment and its impact for good or ill would be fairly definitive and therefore amenable to specific actions to correct any deficiencies. In the event even regulation appears to be shrouded in some uncertainty since insurance regulation is currently in a state of flux with the introduction of Solvency II.

7.2 The regulatory treatment of insurers under Solvency II

7.2.1 Introduction

There are a number of aspects to the regulatory treatment of non-bank lending by insurers under Solvency II. This review considers the position of an authorised insurance undertaking providing credit directly to a BB rated corporate entity on an unsecured basis. It discusses:

- the investment rules – is non-bank lending a permitted investment for an insurer under Solvency II?
- valuation of bonds and loans under the current rules and under Solvency II
- capital requirements – what is the impact on the insurer's regulatory capital position of the provision of non-bank lending?
- governance – are there any governance requirements which have an impact on the ability of an insurance undertaking to provide non-bank lending?
- interaction with the matching adjustment.

7.2.2 The investment rules

- Under the current regime, only "admissible assets" can be held by an insurer to cover technical provisions and to meet capital requirements. GENPRU 2 Annex 7 sets out a list of admissible assets. Under Solvency II, the concept of "admissible assets" will no longer apply. Instead, insurers will have to comply with the "prudent person principle" in respect of <u>all</u> their investments (regardless of whether the assets are held to meet capital requirements). Consequently, non-bank lending will be a permitted investment for a particular insurer provided that it satisfies the prudent person principle for <u>that</u> insurer.
- The prudent person principle mean that Insurers will need to be able to show that

they have the expertise to assess properly the counterparty risk to which they will be exposed by making this type of investment.

- Ideally, insurers will also be able to match the duration of and return on the investment with a set of insurance liabilities; however, it is worth noting that strictly this is only a requirement where the asset is held to cover technical provisions. Assets held through the shareholder fund, as part of working capital or to meet the SCR would not need to comply with this requirement.

- Except where assets are held to cover unit-linked liabilities, there is a requirement to limit the levels of assets held which are not traded on a regulated market. This rule may limit the amount of non-bank lending in which an insurer can invest, given that the relevant loan or notes would not be an asset traded on a regulated market.

7.2.3 Valuation rules

- Under current rules investments in debt securities, bonds and other money and capital market instruments and in loans under GENPRU 1.3.41R are required to be marked to market or model regardless of whether the assets are valued at market or fair value under the relevant accounting rules.

- Irrespective of whether the PP is documented as a loan or a security the FSA practice would be to mark to market

7.2.4 Solvency II

- The level 1 directive provides that assets must be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction (i.e. on a market consistent basis) (Article 75).

- Application of the level 2 measures (see Appendix) to bonds and loans: the effect will be:
  - if there is an active market for the bond or loan (or similar assets), quoted market prices should be used for the valuation. To be considered an "active market" the market must satisfy the criteria for active markets defined in IFRS. The legal form of the investment will not necessarily determine whether or not there is an active market – even if structured as a bond, there is a strong likelihood that no active market will develop for assets arising out of non-bank lending (although it may be possible to identify sufficiently similar assets for which there is an active market)
  - if there is no active market then an alternative valuation method should be used. Under Article 6(2) this should be the valuation method prescribed by IFRS provided it meets the Article 75 requirements. To the extent that IFRS treats bonds and loans differently, the valuation under Article 6(2) may therefore be different; however, if IFRS does not require a market consistent valuation in respect of either bonds or loans it will not apply and instead an alternative valuation method should be used. This will need to comply with the requirements of Article 75 of the level 1 directive.

- We understand that BaFin is believed to be taking the view that Schuldschein can continue to be valued under Solvency II in the same manner as under the current regime, which does not involve marking the instruments to market. Without further details, it is not clear how this meets the valuation requirements of Article 75 of the directive.

7.2.5 The SCR (Solvency Capital Requirement)

- The regulatory capital required to be held against non bank lending by insurers will impact the attractiveness of this as an asset class.

- Under Solvency II, capital requirements can be calculated either: (i) using a "standard formula" provided for under the Level 1 directive and Level 2 measures; or (ii) using an "internal model" (which must be approved by the supervisor). In either case the SCR must cover a number of core risks including market risk (arising from the level or volatility of market prices of financial instruments) and credit risk(to reflect potential losses due to unexpected default by or deterioration in the credit standing of counterparties) (Article 101(4)L1).

- Investment by an insurer in a bond issued by or a loan to a BB corporate would attract a relatively high capital charge due to the relatively low rating. Loans or bonds with a longer duration would also attract a higher capital charge than more short term instruments.

- The capital requirements for the majority of UK insurers by number will be calculated using the Standard Model but for those who might be interested in investing in size in a UK PP market it will be based upon the internal model method. The FSA will require to calibrate the model used for PP based on a 10 year track record of data for that asset class. Given that most firms will not have that sort of data there is an immediate problem that PPs cannot be dealt with under an internal model. The FSA would have no objection to pooling of information between firms in order to generate the track record for model purposes although this is unlikely to be a commercial reality. In the alternate standard model unrated paper is treated quite punitively and in any case there will be a restriction that no more than 10% of the portfolio may be in unrated paper. One of the consequences of this is that there is a real squeeze on products being made available to mid-cap companies who are unlikely to have a rating.

US comparison

- By stark contrast in the US the regulator, the National Association of Insurance Commissioners (NAIC) reviews the papers after closing of an issue and issues a stamp on the transaction grading it on a scale of 1 through 6. In the Schuldschein market BaFin operates a practice requiring either a rating or, in the absence of a rating, the attainment of certain ratios and certain other criteria. Both these approaches are helpful as they set out a clear regulatory treatment. It is thought that BaFin were intending to continue this approach on capital in the Solvency II world.

7.2.6 Recommendations: Solvency etc.

- It would be very helpful if the FSA issued guidelines as to the regulatory treatment of PP products in the hands of insurance companies.

- A loosening of the arrangements for ten years backup information to calibrate internal models for regulatory purposes would be helpful to many potential investors in a new private placement market.

7.2.7 Governance

- If good governance arrangements are in place within an Insurer then there should not be any barriers investing in PPs. Solvency II requires undertakings to have in place an effective risk-management system comprising strategies, processes and reporting procedures to identify, measure, monitor, manage and report the risks to which they are or could be exposed (Article 44 L1). This includes being able to demonstrate compliance with the prudent person principle.

- Undertakings will need to perform regularly an "own risk and solvency assessment" taking into account the specific risk profile, risk tolerance limits

and business strategy of the undertaking (Article 45 L1).

- For the UK, this is consistent with the existing approach of the FSA to the management of risk. It will be important that firms investing in non-bank lending are able properly to assess and monitor the associated risk.

- It is worth noting that Article 37 of the Level 1 allows a supervisor to impose a "capital add-on" if it concludes that the system of governance of an undertaking deviates significantly from the required standards and that those deviations prevent it from being able properly to identify, measure, monitor, manage and report its risks.

7.2.8 The matching adjustment

- Solvency II recognises that good risk management and proper ALM practices reduce the need for a firm to hold capital. The matching adjustment is the mechanism to include this within regulation but the rules set limitations on when and how the matching adjustment can be invoked depending on the extent to which the cash flow profiles and characteristics of the insurance liabilities and the assets held are genuinely matched.

- If it is possible to include non-bank lending assets within the portfolio of assets to which the matching adjustment provisions apply, the return on those assets can be used for the valuation of the technical provisions for the corresponding insurance liabilities. The assets themselves will still also need to be valued under Article 75 and, since there is no carve out for these assets in the draft level 2, a capital charge for the assets will still need to be calculated under the market risk (or counterparty default risk) module. However, the potential volatility in the asset values which may arise as a result of the need to mark the assets to market would be offset by the application of the matching premium: as asset values fall, spreads will increase, increasing the matching premium and therefore the discount rate, and the value of the relevant insurance liabilities will also therefore fall.

Non-bank lending assets and the matching adjustment

It may be possible for assets arising from non-bank lending to form part of the portfolio of assets used to cover the insurance liabilities to which the 'matching adjustment' is to be applied (assuming that the matching adjustment is in the final set of Solvency II rules). There are, however, a relatively stringent set of requirements for assets to be included in the portfolio under the current draft level 2. These include:

- the assets must be bonds or "other assets with similar cash-flow characteristics"

- the cash-flows of the assets must be fixed

- it must not be possible for the cash-flows to be changed by the issuers of the assets or any third parties (presumably this means that early repayment should not be possible)

- the assets must not have a credit quality of step 4 or worse. Credit quality steps are to be mapped to ratings agency credit assessments by EIOPA. The QIS5 technical specifications suggest that step 4 will be equivalent to a BB credit rating. If this is the case, a bond issued by or loan to a BB rated entity would not qualify as an asset which could be within the portfolio for the matching adjustment provisions.

7.3 Interaction with other regulatory and governmental initiatives

7.3.1 Insurance company lenders who have already started to provide loans to

companies, in effect PPs, have found that it is difficult to price their loans so as to make them attractive for a borrower, as compared to the cost of bank loans. This disparity can arise because a bank may choose to use the rate charged on its lending to a customer as a loss leader to gain the relationship. It then is able to make up an adequate return through the charges and fees levied on other business such as derivative, transaction banking or advisory work.

7.3.2 This lack of competitiveness versus bank loans is now being aggravated by the Government's Funding for Lending scheme which provides cheap funding for banks and very significantly exempts such loans from the regulatory capital requirements. It is almost inevitable that funding from PPs will look expensive for the borrower as compared to Funding for Lending loans. The Funding for Lending scheme is currently set to run until 31 January 2014. Although a new UK PP market is therefore unlikely to gain much momentum until after that date, work can nonetheless be done in this period to dismantle other of the barriers to the market development.

7.3.3 As described above the capital prudential requirements being imposed on insurance companies and the anomalies in treatment of insurance liabilities as relatively short term act as counterproductive towards the growth of a UK PP market.

7.3.4 The impending regulation of derivatives, on the other hand will act in the opposite direction. By making currency swaps more expensive / difficult the US $ PP market will become less attractive for borrowers and incentivise them to seek to issue in the UK.

7.4 Barriers: regulatory

- Solvency II is designed to make insurance companies safer but has the side effect for insurance companies as investors that it presents a serious regulatory limitation on the attractiveness of PP instruments.
- Insurers who are likely to be interested in a UK PP product prefer to use an internal model to calculate risk for regulatory purposes rather than rely on the standard formula which limits non rated paper to 10%. However in order to have their model approved by then FSA a 10 year data set on PPs is required. For most firms this is just not possible – the chicken and egg problem.
- The cross subsidies on bank loan rates generated by banks from their ancillary business lines makes it difficult for PP lending rates to come out at attractive rates by comparison.
- The various government schemes to encourage and subsidise bank lending also make it difficult for PP lending rates to come out at attractive rates by comparison.

7.5 Recommendations: regulatory

- It would be very helpful if the FSA issued some guidelines as to the regulatory treatment of private placement products in the hands of insurance companies.
- It would be helpful if the FSA had some simplified methodology for assessing the capital requirements of unrated paper, perhaps along the lines of BaFIN or the NAIC
- A loosening of the arrangements for ten years backup information to calibrate internal models for regulatory purposes would be helpful to many potential investors in a new private placement market.
- Government needs to adopt a joined up approach to incentive schemes and regulation so that they do not act as a disincentive towards PP lending.

8 Behavioural issues and survey

Key messages:

- *There exist many widely held perceptions regarding any potential UK PP market which act as a disincentive for would be market participants to take any initiatives towards developing a market.*

- *Many of these perceptions are trivial or unfounded but nonetheless have a profound effect on behaviours. The market doesn't exist therefore it doesn't need to exist.*

- *Transactions are happening but the market is too "private" so no momentum builds up.*

8.1 Complacency; "reasons" not to go ahead – a survey

8.1.1 UK borrowers and lenders have been able to take advantage of a variety of different markets, structures and instruments that have served all parties well for many years. To some extent neither side has been too worried about the absence of any reasonable volume of activity in a UK PP market since their needs were being adequately served through the existing markets and arrangements.

8.1.2 We now reach a time when the reduction in bank lending would make the existence of a UKPP market attractive to the borrower community. The non existence of a UK PP market has allowed many perceptions to develop that are put forward as to reasons why it does not exist and why it is unlikely to develop. Some of these perceptions may be valid, others sound rational but there is little data to substantiate them. They are in fact myths that get perpetuated through repetition and justified by the fact that there is no real UK market. Now is the time to challenge the myths and to propagate the real facts.

8.1.3 Although merely perceptions these views on PPs can have a disproportionate influence on behaviours which then become entrenched. Many of these behaviours take root or are based on the premise that since there is no £ PP market therefore there is no justification in building up resources to take part in the market, and there is not even the resource to consider whether it is a market that is worth building the resource to enter. It doesn't exist therefore it doesn't need to exist. A chicken and egg situation.

8.1.4 In an attempt to discover what perceptions are widely held and may therefore be inhibiting the market development the ACT has undertaken a survey of issuers, investors and intermediaries. In all cases all the categories of participants were asked to give their perceptions as to how they viewed PPs and also their perception of how the other categories of market participants might be expected to view the barriers.

8.2 Survey results from the investor perspective

Perceived barriers which were widely held:

1. Regulation (eg Solvency II) is not favourable to unrated issuers

2. We can't compete with the clearing spreads shown to US PP investors

3. Brokers seem incentivised to push UK issuers to the US PP market for swap returns

4. There just is no liquidity

5. Our 3rd party fund mandates/benchmarks effectively prohibit us from investing in PPs

6. The UK market lacks issuers/investors

7. No point in putting time and effort in if the deal doesn't materialise in the right size

8. We don't have a real perspective on what historic returns have been made on PPs

9. My advisors are not recommending PP's

10. There isn't a reliable external source of credit analysis history for smaller/medium sized companies

Posited barriers which were strongly NOT felt:

1. There is a high default rate/low recovery rate

2. PPs are "risky assets" - the US investor understands them better than the UK

3. There just is no demand from borrowers for PPs- they prefer bank loans they understand

4. Deal sizes or our allocation of an issue are too small to bother

5. The pricing for issuers is uncompetitive with bank loans

8.3 Survey results from the issuer perspective

The topmost barriers were

1. It is a nightmare to negotiate amendments or early repayments when something goes wrong

2. I never hear any UK PP good news stories.

3. It is expensive relative to bank debt.

4. The documentation for US PP is costly, complex and unwieldy

The posited barriers that were NOT accepted as barriers:

1. I don't know what a PP is.

2. Aren't PPs just a US product? I'm a UK company.

3. It will damage my bank relationships

4. My board are risk averse and wouldn't understand PPs

8.4 Survey results from the intermediary perspective

The market ranked the topmost barriers / perceptions:

1. More money can be made on a public bond issue

2. The bank intermediaries prefer the US PP market given the ability to earn from the linked swap deals

3. Bank intermediaries may have a perceived conflict of interest on a UKPP deal

4. There are just too few UK PP examples that can be used as sales pitches

5. Investors and issuers are suspicious of intermediaries with no "skin in the game"

8.5 Making the market attractive

Survey participants were also asked to rank the most important future factors or conditions which if they existed would in your opinion materially increase the attractiveness of the UK PP market for issuers and investors.

8.5.1 Attractive possibilities from an **investor perspective**:

1. Deal structure, diversification potential and pricing returns outweigh liquidity concerns

2. Regulatory treatment of instrument comparable with those in competing markets

3. Low default rates/high rate of recoveries

4. Proof there is demand from investors

5. Quick and cheap to do

8.5.2 Attractive possibilities from the issuer perspective:

1. Deals are quick and cheap to do
2. Deals are longer term fixed/floating funding than a traditional bank loan
3. Covenants are usually the same as bank deals
4. Ratings are not required (no expense/ongoing monitoring)
5. Standard low cost documentation available

8.6 Barriers: behavioural

- Summing up the barriers that appear to be genuine are that regulation is a real barrier for investors, that issuers fear the terms will be onerous and inflexible while for intermediaries there is no real commercial incentive to get involved. All the perceptions revolve round the lack of any current market.

8.7 Recommendations: behavioural

- The lack of any current market causes a reluctance to get involved. Provision of greater publicity around deals that do currently get done would help dispel this perception. Publishing a deal list and history of deals would help make the market less “private”.
- On the back of deal publicity there needs to be a general publicity drive and provision of information about the market.
- The reluctance of investors to build up the resources and skills to participate in the market should be countered by pressure from government, borrowers, shareholders and other stakeholders in the investors to encourage the investors to see the profitable opportunities that exist. Indeed some categories of investors may owe a fiduciary duty to their end investors to be investigating and exploiting the investment potential of PPs as a new and rewarding market.

Appendix 1

Solvency II

The level 1 directive provides that assets must be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction (i.e. on a market consistent basis) (Article 75).

The draft level 2 measures supplement this with additional rules on the valuation of assets and liabilities. The basic position, as set out in Article 6(2) of the level 2, is that unless otherwise stated valuation of assets should be carried out in accordance with international accounting standards, provided that those standards include valuation methods which are consistent with the Article 75 valuation approach. If they are not, other valuation methods must be used.

In addition to this basic position, the draft level 2 includes a "valuation hierarchy" and valuation methods for certain specific assets. Since Article 6(2) is subject to other express provisions of the level 2, these provisions should be applied in priority to Article 6(2) if there is a conflict.

Under the valuation hierarchy (Article 7):

- the use of quoted market prices in active markets for the same assets shall be the default valuation method, regardless of the position under IFRS. Clearly, therefore, where quoted market prices are available these should be used to value the relevant assets

- where the use of quoted market prices for the same assets is not possible, quoted market prices in active markets for similar assets, with adjustments to reflect differences, should be used

- if quoted market prices in active markets are not available, alternative valuation methods consistent with Article 75 should be used. Article 75(5) states that in these circumstances "The use of alternative valuation methods shall make maximum use of relevant market inputs and rely as little as possible on undertaking specific inputs".

The provisions for valuation of specific assets relate to the valuation of:

- goodwill and other intangible assets

- deferred tax assets

- holdings in related and subsidiary undertakings.

Application of the level 2 to bonds and loans

The effect of the level 2 will be:

- if there is an active market for the bond or loan (or similar assets), quoted market prices should be used for the valuation. To be considered an "active market" the market must satisfy the criteria for active markets defined in IFRS. The legal form of the investment will not necessarily determine whether or not there is an active market – even if structured as a bond, there is a strong likelihood that no active market will develop for assets arising out of non-bank lending (although it may be possible to identify sufficiently similar assets for which there is an active market)

- if there is no active market then an alternative valuation method should be used. Under Article 6(2) this should be the valuation method prescribed by IFRS provided it meets the Article 75 requirements. To the extent that IFRS treats bonds and loans differently, the valuation under Article 6(2) may therefore be different; however, if IFRS does not require a market consistent valuation in respect of either bonds or loans it will not apply and instead an alternative valuation method should be used. This will need to comply with the requirements of Article 75 of the level 1 directive.

We understand that BaFin is believed to be taking the view that Schuldschein can continue to be valued under Solvency II in the same manner as under the current regime, which does not involve marking the instruments to market. Without further details, it is not clear how this meets the valuation requirements of Article 75 of the directive.

Appendix 2

The SCR (Solvency Capital Requirement)

The regulatory capital required to be held against non bank lending by insurers will impact the attractiveness of this as an asset class. Under Solvency II, capital requirements can be calculated either: (i) using a "standard formula" provided for under the Level 1 directive and Level 2 measures; or (ii) using an "internal model" (which must be approved by the supervisor). In either case the SCR must cover a number of core risks including market risk and credit risk (Article 101(4)L1).

Standard formula – general

Under the standard formula, market risk and credit risk are captured by:

(i) the market risk module, which is intended to reflect "the risk arising from the level or volatility of market prices of financial instruments which have an impact on the value of the assets and liabilities of the undertaking" (Article 105(5)L1); and

(ii) the counterparty default risk (CDR) module. The CDR module is intended to reflect potential losses due to unexpected default by or deterioration in the credit standing of counterparties. It is expressly intended to cover risk-mitigation contracts and receivables from intermediaries as well as "any other credit exposures which are not covered in the spread risk sub-module" (Article 105(6)L1).

The market risk module includes the following sub-modules: interest rate risk; equity risk; property risk; spread risk; currency risk; and market risk concentrations. Most debt instruments will be covered by the spread risk sub-module, as discussed below.

Which risk module applies?

It was acknowledged in the CEIOPS advice to the Commission on level 2 measures that there is the potential for overlap between the spread risk sub-module and the counterparty default risk module. At paragraph 4.58 of the advice CEIOPS comments:

> "The definition of spread risk in the Level 1 text allows a certain amount of freedom in setting the boundary between the spread risk sub-module and the counterparty default risk module. However, wherever the dividing line between these two modules is drawn, the principle should be that no risk is left unaddressed and no risk is double-counted."

In the case of bonds and loans, the treatment seems relatively clear from the level 2 measures, as described below. The position was less clear for loans under the QIS5 technical specifications, which made no specific reference to loans in relation to either the spread risk sub-module or the counterparty default risk module.

Article 155 of the draft level 2 measures sets out the formula for the calculation of the capital requirement for **spread risk**, which is based on the capital requirements for:

- **bonds and loans** other than certain mortgage loans
- tradable securities or other financial instruments based on repackaged loans
- credit derivatives.

Article 174 of the draft level 2 measures sets out the formula for the calculation of the capital requirement for **counterparty default risk**, which is based on a capital requirement for type 1 exposures and a capital requirement for type 2 exposures.

Type 1 exposures are exposures in relation to: risk-mitigation contracts; cash at bank; some categories of deposits with ceding undertakings; some categories of called up but unpaid commitments (e.g. called up but unpaid share capital); and guarantees, letters of credit and similar commitments which depend on the credit standing of another party.

Type 2 exposures are exposures in relation to: receivables from intermediaries; policy holder debtors; certain mortgage loans; other categories of deposits with ceding undertakings; and other categories of called up but unpaid commitments.

It is worth noting that default risk is intended to be captured within the spread risk sub-module. This is not clear from the face of the level 2 measures; however, the CEIOPS advice comments that: “The spread risk sub-module will not explicitly model migration and default risks. Instead, these risks will be addressed implicitly, both in the calibration of the factors and in movements in credit spreads” (para 4.70).

Treatment of bonds and loans in the spread risk sub-module

Article 156(1) (SR2(1)) of the draft L2 provides:

> “The capital requirement for spread risk on bonds and loans…… shall be equal to the loss in the basic own funds that would result from an instantaneous relative decrease of *FUPi* in the value of each bond or loan *i*.”

FUPi is the “risk factor” and the value of *FUPi* varies depending on the duration of the bond or loan and the credit quality step assigned to it. The values for *FUPi* are set out in a matrix in Article 156(3) (SR2(3)) L2. *FUPi* is lowest for highly rated bonds or loans with a duration of 5 years or less and highest for low rated bonds or loans with a duration of more than 20 years. Therefore, investment by an insurer in a bond issued by or a loan to a BB corporate would attract a relatively high capital charge due to the relatively low rating. Loans or bonds with a longer duration would also attract a higher capital charge than more short term instruments, although this might cut across other regulatory requirements such as the prudent person principle – as discussed above.

Internal models

The SCR must cover the risks specified in Article 101(4) of the Level 1 regardless of whether it is calculated using the standard formula or an internal model. The specified risks include market risk and credit risk. In addition, the SCR must be calibrated “so as to ensure that all quantifiable risks to which an insurance or reinsurance undertaking is exposed are taken into account” (Article 101(3) L1).

Where an insurer uses an internal model it may therefore choose to calculate the market and credit risk arising from the provision of non-bank lending on a different basis from that set out in the standard formula. It must, however, address the risk properly and it will require supervisory approval for its model. Such approval will not be forthcoming if the regulator does not think that market risk is adequately addressed by the model.

Appendix 3

Tax

Introduction

Investors in international capital markets generally expect that interest payments on debt securities will be paid gross without any withholding of tax. Similarly, investors in the UK private placement market ("PPM") are likely to require a borrower to "gross-up" interest payments which are subject to withholding or other deductions for tax.

This memorandum broadly summarises the relevant aspects of the UK withholding tax regime. Following US precedents, we assume that "vanilla" loans in the PPM would be structured as unlisted, fixed rate securities issued by a UK company, with a maturity of between three and 15 years. Any non-standard features of the securities would need to be reviewed individually from a tax perspective and are not considered here. We have assumed such securities will need to be freely transferable (of course, in practice, such debt may frequently be held to maturity by the original investors, as is common in the US).

UK withholding tax, exemptions and treaty relief

The UK requires withholding at the basic income tax rate (currently 20%) from payments of "yearly interest" (*i.e.*, interest payable for a period of a year or more) arising in the UK. Interest paid by a UK company usually has a UK source. A UK corporate borrower is therefore likely to be required to withhold tax from interest payments, unless the interest is non-yearly ("short") interest or an exemption applies.

<u>Summary</u>. In summary, whilst an exemption for payments to UK companies and permanent establishments may be available to corporate investors in the UK PPM who are subject to UK tax, a non-UK holder of the securities (whether as an original investor or a transferee in the secondary market) would result in tax risk to a borrower under an unrestricted gross-up obligation.

<u>"UK corporate" exemption</u>. A payment may be paid gross if the borrower reasonably believes that the person beneficially entitled to the payment (normally, the investor) is either: (i) a UK resident company; (ii) a non-UK company trading through a UK permanent establishment (*e.g.*, a branch) that is subject to UK tax on the interest; or (iii) a partnership comprised <u>only</u> of partners falling within (i) and (ii) above. However, if the borrower's reasonable belief subsequently proves to be incorrect, the obligation to withhold (and hence the gross-up risk) remains with the borrower.

Any investors in the UK PPM of the types listed at (i) to (iii) above are not likely to present UK borrowers with withholding tax issues. However, there remains a tax risk to the borrower that, assuming that they are to be freely transferable, the securities might be transferred to a non-UK investor to which the UK corporate exemption would not apply.

<u>Other usual exemptions unavailable</u>. In the case of payments to any non-UK investor(s) not of the types listed above, on our assumptions, other usual exemptions relied on by debt capital markets issuers would not be available (other less common exemptions are not listed here, as we would not expect them to be relevant):

(A) "Quoted Eurobonds". Unless the securities were to be listed on a recognised stock exchange, this exemption (normally the most important for debt capital markets issuers) would not be available.

(B) Exemptions for financial institutions. There are important exemptions for interest paid by banks, building societies and certain "deposit-takers" and for interest on advances from banks and building societies, but these would not apply to non-financial corporate borrowers in the UK PPM.

Treaty relief. A borrower (or, in the case of syndicated loans with a majority of qualifying corporate lenders, a nominated "syndicate manager") may apply for a direction from HMRC entitling it to pay gross if the recipient(s) of the payment is entitled to relief under a relevant double taxation treaty. Investors in the UK PPM may apply for a "treaty passport" from HMRC entitling them to receive payments gross in accordance with the relevant treaty. Although the application process will be quicker if an investor holds a passport, a direction from HMRC is still required under the passport scheme before a borrower may pay gross.

In our experience, the process of obtaining an HMRC direction (particularly in the case of a non-passport investor) can be lengthy. If a non-exempt interest payment is made to an investor at a point when a direction has not been received, the borrower would be required to withhold. This problem would be particularly likely to arise if the securities were transferred to an investor in a treaty jurisdiction in the period just before a scheduled interest payment. Although investors may also agree to reimburse the additional amounts received to the borrower if any treaty relief is obtained, in the interim the borrower suffers a cash-flow disadvantage and takes credit risk on the relevant investor(s).