

1 February 2012

Thomas Gelderd
Department for Business Innovation & Skills
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Sent via email: thomas.gelderd@bis.gsi.gov.uk

Dear Thomas

Response to Department for Business Innovation & Skills ("BIS") Call for Evidence URN 11/1454 : Improving Access to Non-Bank Debt ("Call for Evidence")

The Loan Market Association ("LMA") welcomes the opportunity to provide a response to BIS in respect of the Call for Evidence and hopes that its comments will be useful in its upcoming review.

The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 470 across EMEA and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA has gained substantial recognition in the market and has expanded its activities to include all aspects of the primary and secondary syndicated loan markets. It sees its overall mission as acting as the authoritative voice of the European loan market vis à vis lenders, borrowers, regulators and other interested parties.

The LMA is also aware that the Association for Financial Markets in Europe ("AFME") intends to submit a response to this Call for Evidence. Since we have members in common with this organisation, we would be happy to work alongside them, as well as other trade associations where appropriate, to support this, and other SME funding initiatives going forward.

The Call for Evidence has as its objectives, *inter alia*, to examine structural and behavioural barriers to the development of alternative debt markets in the UK, and to make evidence-based recommendations to the Government relating to practical measures to facilitate the development of these markets. We are writing to provide BIS specifically with our recommendations as to what could be done to improve the non-bank lending landscape in respect of the provision of syndicated loans to medium sized businesses (i.e. those with turnover between £25m-500m) ("**Mid-Caps**") as well as general feedback relating to issues associated with lending to smaller businesses generally.

Summary

It is our view that the syndicated loan product is an important way of enabling non-bank lenders to provide Mid-Caps with a large and, most importantly, flexible source of capital and we would encourage BIS not to overlook it during its review. Other sources of debt funding are of course important, for example, commercial paper and bond issuances. However, whilst the high yield bond market or the IPO market could fill a proportion of the funding gap, it is our view that some borrowers will be unable to access these markets for a number of reasons, whether down to enterprise value, size or credit profile. As a result, these sorts of debt product tend to be viable for only the larger and more sophisticated companies. For Mid-Caps, the syndicated loan market is likely to be one of the more attractive, simple and flexible sources of funding and efforts should be directed into encouraging non-bank lending into this area, in addition to developing other appropriate debt markets.

The LMA is also keen to emphasise from the outset that, although it may theoretically be possible for non-banks to lend to SME and micro businesses in addition to Mid-Caps, in practice, non-bank finance providers, particularly institutional asset managers, are not set up to finance these kinds of borrower and will therefore realistically only play a part in financing larger Mid-Cap companies, for the reasons set out in our response. Nonetheless, we believe that by providing more funding at the larger end of the Mid-Cap spectrum, non-bank investors can help banks free up capital to lend at the other end, where they are arguably more efficient, due to existing networks and credit histories with borrowers. In particular, provided certain regulatory hurdles could be overcome, CLOs¹ could be well placed to fulfil part of this role.

We would also like to highlight that a fundamental requirement of Mid-Caps is working capital finance, as well as ancillary facilities such as letters of credit and overdrafts. These types of offering are typically not attractive to institutional investors, firstly because from the point of view of asset managers, unlike banks, who redeploy deposits, asset managers have to source funding from institutional investors and are therefore not in a position to offer these types of facilities. Secondly, the funding sources of the non-bank lending sector generally mean that it is better suited to providing term funding which is fully drawn from the outset. This suggests that it would be difficult to disintermediate the banks entirely and therefore, banks will have to continue to play a key role in the provision of working capital finance for the foreseeable future.

The syndicated loan market

A syndicated loan facility may be a term loan, a revolving loan, a standby letter of credit facility, a guarantee facility or some other similar arrangement. In each case, it involves two or more institutions contracting to provide credit to a particular corporate or group. Under a syndicated loan, the borrower will typically appoint one or more lenders as "arranger(s)" which will then proceed to sell down parts of the loan to the other lenders, whilst retaining a proportion of the loan itself/themselves. The arrangement is put together under one set of terms and conditions, but each institution's liability is limited to the amount of its participation. As a result, the syndicated loan market facilitates the sharing of credit risk, and it is therefore possible for a large number of investors to participate in facilities of various amounts, well in excess of the credit appetite of a single lender. Although syndicate lenders were traditionally banks, they now increasingly include other types of non-bank lenders including funds, insurance companies and CLOs. Whilst borrowers of syndicated loans span a variety of sizes and sectors, due to the nature of the product, borrowers in this market tend to have minimum turnover of £50m and minimum EBITDA of £10m. This is because lending to smaller businesses tends to be for lesser amounts and on bespoke terms. As a result, it is more likely to be on a bilateral, rather than a syndicated basis.

Appropriateness of the loan product to Mid-Caps

The syndicated loan product is a particularly attractive financing tool for Mid-Caps due to its flexibility. For example, a typical syndicated loan includes both a term loan² and a revolving credit facility³ ("RCF"). RCF facilities are particularly useful because they enable businesses to obtain cash injections to support general working capital requirements. Syndicated loans also offer borrowers flexibility on the amount of any drawing – for example, loans typically have no penalties for prepayment or cancellation. Furthermore, under an RCF, borrowers are not obliged to borrow the full amount of the commitment. This is in contrast to other debt products where the full amount of the debt is issued on day one and is not repaid until maturity. In addition to flexibility, syndicated loans are attractive for the following reasons:

- **Credit analysis need not be linked to public ratings.** Lenders arranging a syndicated loan carry out their own credit analysis and due diligence prior to commitment and disseminate full DD materials to each potential lender.
- **Full service product.** The execution of a syndicated loan forms a core banking relationship group. Often, ancillary facilities such as overdrafts and other cash management products can be linked to a lender's loan commitment.
- **Confidentiality.** Loans are a private product, and therefore maintain a high degree of confidentiality. They are therefore often suitable for acquisitions and mergers, where certainty of funds is required from a regulatory or tactical perspective.
- **Speed of implementation.** Loans may be implemented at short notice, which is particularly valuable if borrowers have to react quickly to events e.g. unexpected investment opportunities.

Structural and behavioural barriers to increased non-bank lending in the syndicated loan market

We consider that the loan product is a valuable financing option for Mid-Caps and as such, we would urge BIS not to overlook it when considering the development of debt markets for such businesses in the UK. In addition, as BIS has rightly stated, as major UK banks are deleveraging, it is important that other non-bank investors are found to plug the gap and ensure that the funding requirements of UK businesses continue to be met. This is particularly pertinent given the regulatory capital treatment of European credit institutions following the implementation of CRD IV (Basel III), which will make lending to the sub-investment grade sector generally less attractive for such institutions. Whilst non-bank investors are already present in the syndicated loan market, we believe much could still be done to broaden this valuable investor base and give it a meaningful diversity.

Call for Evidence responses

In responding to the Call for Evidence, we have consulted with those of our members who are non-bank finance providers within the syndicated loan market.

We would therefore respond to the following questions, having the benefit of their input:

1a Are there any business sectors which you currently cannot access and would like to?

Our members indicated that they have access to most business sectors. However, as discussed above, many of our members required corporates to be of a particular size (circa £75m turnover) to be

considered viable investment opportunities. This was due to the fact that institutional lending generates a certain number of fixed costs (e.g. due diligence, reporting etc), making it very difficult for fund managers to attract capital from institutional investors which could be lent to SMEs at rates which were comparable to bank lending rates. Furthermore, since larger corporates tend to require more capital, an investment in a large corporate is viewed as providing greater capital investment for the same amount of due diligence, but at a lower risk. For smaller businesses to attract investment, it was felt that a premium (or other additional upside) as well as lower leverage, would be required to compensate for these factors.

1b What are the key issues preventing you from lending to mid-sized businesses and/or SMEs?

Since the start of the financial crisis, non-bank investment in the syndicated loan market has fallen dramatically. Whilst some of this may be attributable to current market conditions, it is clear that other issues have also played a part. As an overarching point, it should be highlighted that the single biggest challenge is not how to lend once capital has been raised, but rather how to raise the funds which may be invested in this sector. Our members have indicated that some of the barriers currently stifling access to non-bank capital include:

i. Lack of origination network

Two key points were raised. Firstly, some of our members indicated that the lack of origination network was a problem regardless of the size of the borrower, since the vast majority of transactions are currently sourced from banks. This meant that, given current platforms, it would be difficult from a resource perspective to disintermediate the banks and provide direct funding. Secondly, for those members who were in a position to lend direct, in the case of smaller Mid-Caps, SMEs and micro businesses, it was felt that banks were uniquely placed to provide the necessary origination network, especially given the regional nature of their network and their existing relationships/credit histories with borrowers.

ii. Lack of in-house credit assessment capacity

Feedback from our members suggested that non-banks did not consider this to be a problem for larger Mid-Caps, but most were not equipped to process/screen hundreds of lending requests from SMEs and micro businesses. In addition, poor reporting and accounting procedures was flagged as a disincentive against investing in smaller businesses (although it was felt that this was more prevalent in Europe than in the UK). Finally it was felt that, whilst credit assessment capacity could be developed, this did not remedy the perception that larger companies tend to be more robust in a downturn as they are seen to have a stronger market position for their products. As a result, the case for investment in larger corporates is seen to be more attractive unless a premium is charged to compensate for small company risk.

iii Regulation

All of our members agreed that regulation currently presented a huge barrier to non-bank investment in Mid-Caps.

A. Regulatory hurdles for CLOs

Prior to the financial crisis, CLOs were the primary source of non-bank investment in the syndicated loan market. This investment has now fallen away almost entirely, primarily due to the introduction of amendments to the CRD⁴, which has resulted in the CLO model no longer being viable.

Article 394 of the CRD provides that a European credit institution will suffer a punitive capital charge if it invests in a securitisation, unless the originator, sponsor or original lender holds a minimum 5% of the net economic exposure of the transaction. The underlying objective of Article 394 is to ensure appropriate origination standards in the securitisation market and ensure that interests between originator and investors in a securitisation are aligned. However, the definition of "securitisation" used in the regulation catches independently managed CLOs, despite the fact that (unlike traditional asset-backed securities) the underlying portfolios of CLOs are typically not purchased from one originator or seller but are sourced from the primary or secondary syndicated loan market by regulated investment managers who are independent of any originator or seller of the loans. In addition, the CLO investment manager is able to independently assess the quality of the portfolio and is free of the negative incentives which can arise in an "originate-to-distribute" securitisation model. Finally, CLO investment managers are already incentivised to act in the best interest of the CLO investors through the structure of their fees. The majority of management fees are performance-based and as such the CLO investment manager will only receive these fees if the CLO is performing. This compensation structure ensures that the interests of CLO asset managers are appropriately aligned with those of investors in CLOs throughout the life of a transaction.

The LMA and a working party of its members are currently engaging with various UK and European authorities and politicians on the problems caused by the drafting of Article 394 of the CRD and have proposed a series of amendments. We believe that incorporation of these amendments is crucial in order to achieve the re-opening of the CLO market and, by association, the provision of increased liquidity targeted at Mid-Caps. By way of illustration, according to Thompson Reuters LPC, CLO issuance in the US (which does not currently have equivalent retention rules to Article 394) is expected to be between \$15bn-20bn in 2012, up from \$13.24 bn in 2011. By contrast, there were no new CLO issuances in Europe in 2011 (save for a handful of balance sheet transactions in CLO format). We do not expect to see an improvement on these figures in 2012 unless amendments to Article 394 are implemented.

B. Non eligibility of loans within retail funds

Unlike the US, where loans are a mainstream investment for a variety of investors, including retail investors, by contrast, in Europe, retail investors do not have the ability to invest in loans. Allowing retail money to be invested in this asset class would be helpful, since this would broaden their access to a greater number of investors. This could be achieved by widening the range of eligible assets which the European and UK retail investor framework (UCITS) can invest in, to include assets which are not classed as securities, such as loans.

Despite not being securities, the LMA considers that loans are, in practice, sufficiently negotiable to satisfy the practical concept of being traded on the capital market – albeit not a regulated market. By way of background, secondary loan market liquidity is facilitated by "market makers", providing two way pricing and by more than 20 institutions which could be considered regular market participants. Volumes in the secondary market were €64bn in 2010 and achieved similar levels in 2011. This demonstrates that loans are regularly traded through a market, which despite not being a regulated market, is clearly a regularly functioning, effective means of trading, with a large number of dealers and depth of liquidity.

The secondary syndicated loan market is also relatively mature, with well established and widely used standard documentation and procedures, provided by the LMA, which are further supported by guidelines, also issued by the LMA.

The LMA therefore considers that there is an available and active capital market for the trading/transfer of loans and as a result, loans should be considered sufficiently transferable to be included as eligible assets within a UCITS fund.

iv. Different business models

Given the modest amounts required by smaller businesses, if non-bank debt were to be provided to SMEs, it would need to be part of a much larger asset management model.

v. Other factors

Some of the other points raised by our members that are seen as inhibiting non-bank investment to Mid-Caps include:

- Difficulties arising from currency. Since the capital of certain funds is denominated in US Dollars or Euros, these funds encounter the extra cost of hedging Sterling FX risk which needs to be compensated. In addition, Sterling assets trade at a discount historically because of the finite capital available in that currency. This means that Sterling assets are considered more illiquid than those denominated in US Dollars or Euros. Whilst illiquidity of an asset was not necessarily felt to be a stumbling block, certain funds required a premium as an incentive to invest in Sterling assets.
- Difficulties arising from the global perspective of investors. Since many fund investors are based outside the UK, when pitching UK loans, returns will be compared, from a relative value perspective, to all other global investment opportunities. As a result of low margins historically offered by banks, loans are not necessarily seen as attractive investments to global institutional investors.

1c How important is an active secondary market in any investment you make?

Many of our members commented that active two-way markets, the involvement of major bank trading desks to generate trade flow/revenue and asset liquidity were all important factors for short-term capital investment and for those who invest via open-ended funds (i.e. funds where investors have redemption rights). In addition, UCITS are based around the concept of daily liquidity. Whilst this can be facilitated by adding liquidity facilities to UCITS funds, secondary market liquidity is important to attract retail funds to the sector, as has been the case in the US.

By contrast, many closed-ended funds and long-term capital investors (e.g. limited partnerships) do not depend on active secondary markets. However, whilst such investors are more likely to be interested in investing in less liquid assets, the return would need to be considered sufficient. Since smaller companies are currently perceived to be less liquid investments, this implies that SME debt would need to be priced at a premium if meaningful inflows of capital were to be channelled into this sector by these investors.

1d How important is the role of the ratings agencies in any investment you make?

This varies between members. Whilst most funds do not use rating agencies to assist with the evaluation of credit worthiness, it is often essential for some long-term investors such as insurance companies and pension funds. Indeed, some investors require ratings in order to calculate their applicable capital charges.

Many Mid-Caps do not have a rating, due to the expense involved in obtaining one. Those that do are almost always rated below investment grade (i.e. below Baa3/BBB-). Although insurance companies typically have small "baskets" to invest in sub-investment grade or unrated assets, the regulatory capital framework based on ratings often acts as a powerful disincentive to lend to this type of corporate. In addition, corporate debt often attracts a similar capital charge to private equity or hedge fund investment, despite lacking the potential for similar returns. This also acts as a disincentive to insurers who might otherwise consider increasing their unrated corporate loan allocations. The implementation of Solvency II, which imposes capital requirements for the insurance industry, is likely to worsen this issue.

Finally, it should also be highlighted that CLO investors do not require that the underlying borrowers be rated since the CLO itself is a rated vehicle. CLOs can therefore be a means by which investors requiring a rating are able to access loans.

1e What international examples are you aware of that facilitate non-bank lending channels?

Many of our members highlighted the US loan market, where lending to US middle market businesses increased from \$71bn in 2009 to \$182bn in 2011⁵. This issuance is facilitated by loan mutual funds (a \$70bn industry⁶ which channels retail capital to corporates), CLOs and listed companies known as Business Development Companies. In particular, members felt that if the issues surrounding the CLO market in Europe could be overcome, and loans could also become eligible assets for UCITS funds, in line with the US model, they could prove to be a long-term and supportive source of capital provided to Mid-Caps.

Other members highlighted the practice of securitising pools of SME loans originated by banks, primarily in Germany and Spain, as a model which facilitated non-bank access to the sector. That said, it was also acknowledged that the regulatory hurdles surrounding Article 394 CRD has meant that this source of funding is likely to be unavailable for the foreseeable future.

3a What, if any, are the market failures in the non-bank lending landscape and where would Government's influence have the greatest potential impact?

As discussed above, funding for corporates is under severe pressure from regulatory measures for the following reasons:

- In an effort to increase core capital requirements, banks are having to de-lever. Whilst the LMA supports better bank capitalisation to increase stability in the financial system, the unfortunate side effect of the deleveraging process is that capital is driven away from smaller corporates.
- Article 394 of the CRD is currently having a severe impact on European CLO issuance. Unless changes can be made to this regime, it is difficult to see how CLOs will be able to contribute liquidity towards Mid-Caps going forward.

- The ineligibility of loan investments in UCITS funds has meant that retail investors do not have access to mid-market loans.
- The regulatory framework for insurance companies is still largely based around ratings-driven capital requirements, with most insurers having only very limited baskets for investment below investment grade risk, regardless of returns.

The LMA believes that the Government's influence would have the greatest impact by continuing to assist with lobbying activities in all of the above areas.

3b What is the role for Government in addressing the issues raised above?

Although the LMA recognises that many of the issues raised in this response need to be resolved at a European level, there is a role for the Government by continuing to assist with the lobbying efforts to:

- encourage amendments to be made to Article 394 of the CRD;
- enable assets which are not securities, such as loans, to be eligible UCITS investments; and
- review ratings-based capital charges for insurers.

Caution should also be taken to ensure that proposed regulation of the "shadow banking" industry does not result in unintended consequences for regulated institutional investors.

3c Are there other initiatives that government should explore e.g. the incentives provided by the current tax or regulatory regime?

The LMA would support Government incentives to encourage institutional investment for Mid-Cap borrowers, either enabling them to invest in Mid-Caps directly, or by channelling allocations to investment managers. However, the LMA would stress that any incentives would need to take into account the impact of regulation.

Conclusion

Assuming certain hurdles may be overcome, particularly in the regulatory space, feedback suggests that non-bank lenders are ideally placed to provide syndicated loans to larger Mid-Caps whether directly, or via structures such as CLOs. By doing this, non-bank lenders would be in a position to free up banks' regulatory capital, which could then be directed towards smaller businesses.

In the SME space, unless monies could be invested in such companies via larger asset management models which pool their exposures, it was felt that non-bank finance providers did not have the network, the resources or the incentive to lend to them on mutually attractive terms. This was particularly the case given that these types of businesses tend to benefit most from working capital finance – a product which, at the moment, banks are ideally set up to provide.

We would be happy to discuss any aspect of this response with you in more detail. If we can be of any further assistance, please do not hesitate to contact me via email at clare.dawson@lma.eu.com or by telephone on 020 7006 2216. Alternatively my colleague Nicholas Voisey may be contacted by email at nicholas.voisey@lma.eu.com or by telephone on 020 7006 5364.

Yours sincerely



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¹ CLOs are a type of close-ended fund whereby a portfolio of loans across a variety of companies is transferred to an SPV, the obligations of which are collateralised by the portfolio. The CLO is financed by the sale of a number of tranches of debt that have the rights to the CLO's collateral and payment streams in descending order. For the purposes of this letter, it should be made clear that in discussing CLOs, we are referring specifically to independently managed CLOs and not CLOs managed by the originator of the securitised portfolio.

² A term loan enables businesses to borrow a committed lump sum, for a pre-agreed period of time and is usually either repaid at the end of the term, or amortised over its life. Interest in respect of a term loan is paid at the end of each interest period (selected by the borrower). Term loans are usually drawn shortly after the facility agreement is signed, although additional tranches (in different currencies if required) may be available for future drawings.

³ RCFs allow the borrower to draw and repay sums up to a specified maximum amount throughout the term of the facility. RCF loans may be drawn at any time, and are either repaid at the end of each interest period, or "rolled over" into the next interest period.

⁴ Article 394 the Capital Requirements Directive (formerly Article 122a) (*Exposures to transferred credit risk*) of Directive 2006/48/EC.

⁵ Thompson Reuters LPC. US middle sized issuance equates to any issuance where both deal size and company revenue are less than \$500mn and includes both sponsored and non-sponsored transactions.

⁶ Lipper FMI.