12 May 2015

RESPONSES TO BE SENT VIA ONLINE QUESTIONNAIRE

Response to European Commission Green Paper: "Building a Capital Markets Union" ("Green Paper")

Question 4

Is any action required by the EU to support the development of private placement markets other than supporting market-led efforts to agree common standards?

Private placements are medium to long-term financing transactions entered into between a listed or unlisted company and a small number of institutional investors. However, the precise legal form that a private placement takes (e.g. whether it takes the form of a loan or a security) is very much deal specific and dependent on the preference/requirements of the parties to the transaction. As a result, documentation is negotiated on a case-by-case basis between the borrower and the investors, occasionally with the participation of one or more bank intermediaries as arrangers.

Although challenges exist to further deepen the market (please note our comments in relation to tax and Solvency II below), from a pure product perspective, we do not believe that these are of a nature to necessitate regulatory intervention. For example, one clear challenge for the market is the present lack of clear and transparent market data and evidence of product track record. However, this is a challenge that may be overcome over time as the product matures, and more participants enter the market.

In addition, both issuers and investors have already demonstrated a clear desire to widen and diversify the private placement market and it is hoped that this will bring about a natural evolution for the product. In addition, documentation standardisation has already been achieved via the production of standard form LMA private placement templates, enabling participants to operate under a recognisable framework. It is hoped that increased use of this documentation will also lead to improved transparency and less fragmentation between domestic markets. The documents, which consist of both a loan and bond format (along with an accompanying term sheet and confidentiality agreement) are based on existing LMA loan templates, and as such will be immediately recognisable across the EU financial markets, particularly to corporate borrowers. In addition, the note version of the document follows the loan version, save to the extent necessary to incorporate any structural variations between the two – it being felt that this would help to establish private placements as a unique and recognisable product in their own right and without any opportunity for format arbitrage.

Although we do not believe regulatory measures are required from a pure product perspective, there are certain challenges impacting the development of the private placement market which we believe warrant further consideration by the European Commission. These relate to tax and capital requirements under Solvency II.

Tax

We set out at our response to question 30, the principal factor which we consider to be the main barrier around taxation to more integrated capital markets and more robust funding structures for companies. This is the imposition of withholding taxes on interest paid between EU member states. We consider this to be of particular relevance to the development of private placement markets and refer you to our response to question 30. In addition to the comments made in response to question 30, in the context of private placements in particular we would like to make the following observation.

Many EU member states and non-EU countries currently do not impose withholding tax on typical private placement interest (such as the United States, Ireland, France, Germany, The Netherlands, Luxembourg, Sweden and Denmark) and the UK is introducing a new exemption from UK withholding taxes on privately placed debt. The abolition of withholding tax on interest paid between EU member states would therefore be important to ensure that all EU jurisdictions are competitive in the private placement market and that companies in these jurisdictions can raise private placement finance.

Solvency II

Given that one of the aims of the European Commission is to encourage greater non-bank investment across the EU, it is important to create a level playing field between bank and non-bank investors, so as to ensure that they are treated equally from a prudential and regulatory perspective. From a private placement perspective, it is therefore important to make certain that this product does not attract higher capital charges for an institutional investor, than a bank would be subject to under CRD IV if it were to invest in the same product. Such alignment would also result in more naturally competitive pricing.

Similarly, to ensure that the product is competitive from an international perspective (and thereby discourage European corporates from seeking investment from, for example, the US private placement market) it would also seem sensible to align capital charges with those of US insurance companies investing in the US market under the rules of the National Association of Insurance Commissioners (NAIC). Currently, the capital charges of European institutional investors under Solvency II are far higher than those of US insurance companies under NAIC rules for private placements that have a comparable maturity and risk profile. A solution could, however, be achieved if the European Commission were to consider revising the final calibrations for insurers of the spread risk capital weightings in the Solvency II Delegated Act (Commission Delegated Regulation (EU) 2015/35) (the "**Delegated Act**").

In addition, a further way to increase the attractiveness of a financial product is to ensure that its capital charge is not disproportionate to its risk profile. In the final (long term guarantees package) calibrations contained in the Delegated Act, there is a focus on volatility risk, as opposed to default risk. This does not align itself naturally with a private placement, since investors in this product are usually "buy to hold" (i.e. they hold the asset until maturity) and therefore the impact of market volatility on spread risk is actually immaterial. Whilst the matching adjustment in Article 77b-77d of Solvency II (2009/138/EC) recognises this issue, we do not believe that it goes far enough.

We would therefore recommend that a further consultation of these calibrations is undertaken specifically in the context of private placements, to make certain that they are appropriate for this type of product. We would also suggest that the recent request to EIOPA for technical advice on the identification and calibration of infrastructure investment risk in Solvency II be widened to include private placements as a product in their own right.

Question 5

What further measures could help to increase access to funding and channelling of funds to those who need them?

Firstly, national and multinational development banks (NMDBs) such as the EIB have had a significant role in recent times by acting as liquidity providers in certain countries and sectors – particularly regarding SME and infrastructure lending. They also have a long-standing presence in the debt markets and have achieved credibility in the minds of investors. Therefore, such banks are able to play an important role in supporting long-term financing, whether that be by providing direct lending, acting as junior lenders in the lending structure (thereby decreasing the amount of senior debt required and making the senior tranche more attractive to the private sector) offering partial or first-loss guarantees, or acting as sponsors of issuance programmes. Such involvement also gives smaller investors, who may not currently have the resources or incentive to invest, the necessary comfort to consider making such investments. Over time, it could be expected that these investors would become more confident about making such investments and would grow their internal expertise, thereby enabling the NMDBs to allocate their resources elsewhere.

In addition to the above, NMDBs could have other important roles, including:

- Enhancing the liquidity of SME and infrastructure loans in the secondary market. This could be achieved if NMDBs purchased loans in the secondary market or accepted these loans as collateral in lending/repo operations.

- Anticipating market trends and working alongside investors in implementing new financing solutions. Whilst the project bond initiative is a positive first step, NMDBs should also be open to exploring other approaches. For example, as banks and other investors face sizeable hurdles to extending long-term finance, NMDBs could complement private financing by investing alongside private investors, or providing finance with longer tenors (e.g. through a separate tranche).

- Mitigating imbalances in the ability to access funding throughout Europe. For example, some of our members felt that NMDBs could do more to promote a level playing field throughout the EU by using their credibility within the market to encourage investment into those areas which investors might otherwise be reluctant to consider as viable options.

However, notwithstanding the above, our members also felt that the role of NMDBs should be limited to attracting the initial investment, meaning that as new private investors entered the market, they could downscale their participation and allocate their resources elsewhere. Our members also felt that NMDBs should reduce their activity in times of high liquidity and act only within certain remits – otherwise they risked becoming competitors to private sector lending which could create distortion within the market.

Secondly, one of the priorities of the Commission is to unlock more investment for SMEs. The LMA is keen to emphasise from the outset that, although it may theoretically be possible for non-banks or alternative debt providers to advance finance to SMEs, 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 mid-sized or larger companies, for the reasons set out below. Nonetheless, we believe that by providing more funding at this end of the 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, CLOs[1] could be well placed to fulfil part of this role.

We would also like to highlight the fact that a fundamental requirement of SMEs is working capital finance, as well as ancillary facilities such as overdrafts and other cash management products. These types of offering are typically not attractive to institutional investors, firstly because, from the point of view of asset managers, unlike banks, which 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.

Having consulted with our members which are non-bank finance providers, many 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. 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.

Thirdly, we would urge the European Commission to revisit the current regulatory treatment of CLOs under recent proposals relating to STS Securitisations. This is on the basis that CLOs securitise the debt of sub-investment grade corporates, and provide important liquidity to that part of the corporate market.

By way of background, the EBA and BCBS/IOSCO have included a number of detailed criteria for identifying STS Securitisations. In addition a number of criteria have been put forward in the delegated acts of Directive 2009/138/EC (Solvency II). The criteria proposed and in some cases adopted thus far gives CLO market participants significant cause for concern.

The current proposals, if implemented as drafted, would exclude managed CLOs from being able to qualify as STS Securitisations on the basis that the portfolio of assets is actively managed. We do not share the view that a securitisation should be excluded on the basis that it is actively managed. This seems to be predicated on the belief that active management of a portfolio adds a layer of complexity to a securitisation which would make it ineligible for inclusion as an STS Securitisation. We respectfully disagree with this conclusion for the reasons set out in our response to the European Commission Consultation Document: An EU framework for simple, transparent and standardised securitisation which we attach at Appendix 1.

CLOs should not be disadvantaged in comparison to other securitisations because they are actively managed. The expertise of a CLO manager can add a great deal of value to a transaction through

[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

managing recoveries on credit impaired and defaulted credits. In fact, CLO managers have consistently outperformed static loan indexes. Even through the credit crisis, default rates on European CLOs remained very low at just 0.1%, better or comparable to other securitisation vehicles.

Such “managed” CLOs provide banks, pension funds, insurance companies and other institutional investors with access to investment in the European corporate debt market but with robust portfolio quality requirements, structural protections and credit enhancement built in to the transaction to reduce risk.

We remain very concerned that the labelling of certain securitisations as STS could materially and adversely affect the wider securitisation market creating implied 'quality stamps' for those that do meet the criteria and 'cliff effects' for those that don't.

CLOs are an important source of capital for corporate borrowers. The availability of capital to the corporate section is essential to promote sustained growth in Europe. The financing provided by CLOs helps corporates grow their business, employ more people thus contributing to growth. CLOs have performed exceptionally well throughout the credit crisis and to exclude CLOs from meeting the criteria would create even more hurdles to a well-functioning CLO market.

Question 10: What policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets, in particular long-term projects, SMEs and innovative and high growth start-ups?

Our members indicated that there were three principal policy measures which could incentivise institutional investors to raise and invest larger amounts in a broader range of asset classes. Taking each in turn:

1. Reducing barriers to corporate lending across Europe

It was considered that facilitating corporate lending by institutional investors across the EU would be a huge step forward, particularly given the banking monopoly/licensing barriers currently in place in certain EU countries, such as France and Germany. It was also felt that removal of these barriers would encourage greater deployment of funds by the non-bank investor community, many of which had a preference for direct lending as opposed to bond investment. Please see our response to Question 21 for further information on this point.

2. Removing withholding tax on interest payments across Europe

Our members stated that the removal of withholding taxes from interest payments made between EU members states (and on interest payments within those EU member states) would remove a significant barrier to more integrated capital markets. Please see our response to Question 30 for further information on this point.

3. Review institutional investor prudential requirements for relevant asset classes

The investing behaviour of institutional investors such as insurance companies is largely driven by prudential requirements; the same may hold true for pension funds following the EIOPA work on this topic. Punitive capital charges in the standard model in Solvency II can force smaller insurance companies to avoid certain asset classes, such as securitisation. Changes to these capital charges could help a wider range of institutions invest larger amounts in a broader range of assets.

Consequently, a more relevant Solvency II capital charges calibration should be considered so that it represents an accurate assessment of the risk profile of such investments. This is particularly the case for infrastructure and SME investments. In the case of SME loans, however, the Solvency II treatment should reflect the higher recovery rates and the importance of risk mitigation such as security or collateral.

Finally, looking specifically to the regulatory treatment of securitisations, no longer requiring investors to verify risk retention requirements – but still requiring them to conduct due diligence – and providing better information to investors would help asset management investment in securitisation. Further information on this point is included in our response to the European Commission's consultation on an EU framework for simple, transparent and standardised securitisation, which we attach at Appendix 1.

Question 11: What steps could be taken to reduce the costs to fund managers of setting up and marketing funds across the EU? What barriers are there to funds benefiting from economies of scale?

The approval process to market an alternative investment fund (AIF) throughout the EU has become particularly problematic in certain jurisdictions, notably France, Italy and Germany. Whilst the passporting rules for an EU fund managed by an EU AIFM work well (this involves a simple approval process by the home regulator of the AIFM) difficulties arise for both non-EU funds and/or non-EU managers. In this scenario, applications have to be made to each individual country where the fund is to be marketed. In some countries, such as the UK and the Netherlands, this process is reasonably straightforward. However, for other countries, our members considered the process to be far too onerous, and it can also take many months. This has resulted in managers not marketing these funds in such countries – ultimately resulting in investors in such countries being prevented from diversifying their investment portfolios.

Furthermore, AIFMD currently requires non-EU managers to submit detailed reports to each country where they successfully market a fund. Each country has different requirements, which again makes this an expensive and onerous process. Our members could see no reason why reporting requirements should not be identical in each country within the EU.

Question 21: Are there additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest?

Both bilateral and syndicated lending are a vital source of capital for corporate borrowers. This basic form of finance, traditionally provided by banks, but increasingly offered by other types of non-bank lender (including funds, insurance companies and CLOs) enables corporates to grow their business, increase employment and thus contribute to economic growth.

One way in which this could be achieved is via the removal of barriers to corporate lending by non-bank lenders. Whilst in some EU countries such as the UK, Spain and the Netherlands, there are no meaningful barriers to corporate lending, in other countries, such as France and Germany, banking monopoly or bank licensing requirements have proven to be a significant barrier to lending by non-bank investors (as well as by banks that do not benefit from a passport (e.g. non-EU banks lending cross-border into the EU or through an EU branch)). These very basic restrictions affect the ability of a huge range of lenders to deploy capital in the EU to fund investment by corporates and, in particular, act as a severe disincentive to non-banks seeking to lend funds to borrowers in these jurisdictions. As a result, non-bank investors and fund managers will seek to deploy capital in more "favourable" countries, which obviously deprives companies in other countries of a potential source of non-bank liquidity.

Given that the vast majority of European investment (particularly in the SME space) is deployed via loans, finding a way to create a level playing field for different types of investors to lend to corporates across the EU (thereby also enabling greater bank disintermediation) would undoubtedly be very beneficial to the non-bank investor community. Our members also highlighted the fact that lenders often wish to benefit from the flexibility to invest by way of either loans or bonds. In many cases the distinction between bonds and loans is simply one of preference, and the parties choose whichever they are most comfortable with or whichever most closely matches their investment needs at that time. In other cases, there are legal or commercial factors which necessitate a loan or a bond. In our view, non-bank investors should not be disincentivised from lending directly to corporates if this is the manner in which they would prefer to invest, particularly if the underlying risk profile is identical.

Question 22: What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

Our members raised two key measures, as follows:

1. The third country provisions in current and prospective EU legislation need to be workable, with a clear impact assessment considered as part of the initial legislative discussions. Operating on a system of reciprocity, as is the case in AIFMD and EMIR, also means that the bi-lateral Memorandums of Understanding need to be agreed well in advance of implementation by the European Commission / ESAs.

2. Transparency and standardisation of information disclosure/reporting should be encouraged in order to improve comparability, and help investors to better assess investment opportunities.

Question 27: What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

The Financial Collateral Arrangements Directive has been very helpful to add legal certainty in the areas of collateral and close-out netting. A few gaps remain which continue to cause difficulty and therefore add to the expense and friction involved in financial transactions. These can be summarised as follows:

- The Directive does not include a clear test to identify the “relevant account”. It would be helpful to add this or to have the relevant part of the Securities Law Legislation brought into force. Particular difficulty arises in a case where the collateral-taker is also acting as account-provider to the collateral-provider. This situation should ideally be clarified by stating that the only relevant account is the account on the books of the collateral-taker (not any other intermediary).

- The Directive requires the collateral-taker to obtain “possession or control” of the collateral to obtain a valid qualifying security interest in book entry securities collateral. Unfortunately the Directive does not define “possession or control”. In some Member States very complex legal debate has ensued, in particular suggesting that a custodian (account-provider) does not have “possession” of securities solely by virtue of holding the securities in a CSD or with a sub-custodian, and must therefore have some additional "control"; what this extra "control" might be is not defined by the Directive and so gives rise to very significant legal uncertainty. Additional definitions in the Directive would go some way towards clarifying the position.

- The Directive does not ensure that a close-out netting clause has effect in accordance with its terms except where part of a financial collateral arrangement. This means that in some Member States it is still not possible to guarantee the effectiveness of close-out netting at all, unless a financial collateral arrangement is also used; and in many Member States the availability of effective close-out netting is limited to certain transaction types notwithstanding that the parties are "eligible" parties within the meaning of the Directive.

Question 29: What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European market?

The LMA agrees with the Commission's approach in the Green Paper on a new approach to business failure and insolvency, to encourage Member States to adopt minimum standards to promote the efficient restructuring of viable businesses and provide a second chance where failure arises as a result of external market forces or circumstances.

However, we already believe there has been a natural convergence in the development of insolvency laws at a national level, therefore we do not consider any further harmonisation is required at an EU level. Furthermore, individual Member States have a better understanding of the requirements of their domestic creditors and debtors and are best placed to review their national regimes and adapt them where necessary.

We do, however, hope that there is further natural convergence at a national level in a number of areas. Firstly, we think that it would be useful to have a standard threshold in relation to voting during the course of restructuring proceedings. Secondly, we think a standard approach to insolvency triggers and director's liabilities may go some way to creating a more coherent cross jurisdictional environment. Finally, we consider that an alignment of procedures on enforcement and consistent approach to the implementation of the Financial Collateral Directive, and in particular its application to the enforcement of share pledges, would also be useful. Natural convergence in these areas will assist with the emergence of a pan-European market.

Question 30: What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

The main barrier to investment from a taxation perspective is, in the LMA's view, the imposition of withholding taxes on interest paid between EU member states.

Withholding taxes on interest payments made between EU member states currently act as a bar to efficient cross-border financing of companies between certain jurisdictions. Taking the UK by way of example, although there are wide-ranging domestic exemptions from withholding tax on interest payments made by UK borrowers to UK lenders, withholding taxes on interest payments made to lenders in other EU states do apply as a matter of UK domestic law. In the majority of cases, finance providers can benefit from exemptions from these withholding taxes under a double taxation treaty, subject to the completion of onerous UK treaty formalities, but there remain EU jurisdictions where the treaty between the UK and the finance provider's country of residence does not reduce withholding taxes to zero (for example, Portugal, Italy and Cyprus). Similar issues apply to interest payments made between other EU member states. The removal of withholding taxes from interest payments made between EU members states (and on interest payments within those EU member states) would remove a significant barrier to investment for two reasons. First, it would facilitate investment by finance providers who can already benefit from an exemption from withholding taxes (whether under domestic law or under a double tax treaty) in jurisdictions where the treaty formalities or formalities required to benefit from a domestic exemption are very onerous. Second, it would allow for finance to be provided between jurisdictions where under current law, withholding taxes apply (increasing, in least in cash flow terms) the cost of financing. We consider that the abolition of these withholding taxes would remove an important tax-related barrier to cross-border financing in the EU.

Question 32: Are there any other issues, not identified in this Green Paper, which in your view require action to achieve a Capital Markets Union? If so, what are they and what form could such action take?

Our members have indicated that regulation is one of the greatest barriers currently inhibiting lending. In order for regulation to be truly effective, it must be accepted that there is simply no such thing as a risk-free environment and that regulation has the ability to do harm, as well as good. We believe regulators also need to consider the following points:

Undertake a thorough risk assessment which looks at the cumulative impact of regulation on the industry, across all financial markets. The cumulative impact of the interaction of different regulatory measures is often overlooked, even on an intra-European level. Unless a detailed impact assessment is carried out, there is a real risk of significant unintended consequences – including the creation of perverse incentives within the regulatory system as a whole. Efforts should therefore be directed away from individual policy silos and towards the construction of a comprehensive assessment of the totality of these proposals on the global economy and its financial services industry. Only once this assessment has been carried out, should further appropriate and targeted regulation be considered for specific banking activities.

Implement regulation with the benefit of global consensus to avoid regulatory arbitrage. The composite effect of national and EU regulation must be assessed in the context of global legislation, including both significant national legislation of non-EMEA countries (Dodd-Frank and FATCA) and supranational initiatives (such as the G20 and the FSB). This is a vital exercise which, if ignored, could put certain jurisdictions at a competitive disadvantage and lead to borrowers within those jurisdictions being unfairly affected.

Appendix 1

European Commission (the "Commission") Consultation Document: An EU framework for simple, transparent and standardised securitisation (the "Consultation Paper") – LMA response