

25 June 2013

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Interest Representative Register ID number:  
566455411423-81

Dear Sirs

**Response to European Commission (the "Commission") Green Paper: Long-Term Financing of the European Economy (the "Consultation")**

The Loan Market Association ("LMA") welcomes the opportunity to provide a response to the Commission in respect of the Consultation and hopes that its comments will be useful in the Commission's 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 500 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 EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties.

The Consultation has, as its main objective, the need to find ways to overcome barriers to long-term financing and diversify the system of financial intermediation for long-term investment in Europe. The Commission has emphasised two key factors for respondents to consider: 1) the extent to which Europe's historic dependence on banks to finance long-term investment should give way to alternative financing arrangements; and 2) how the long-term financing needs of SMEs may best be addressed as part of this process.

With the above in mind, we would like to respond to certain of the Consultation's questions, as well as provide some general feedback relating to our views on long-term financing solutions generally. In responding to the Consultation, we have consulted with our bank and non-bank members, all of whom are likely to be affected by any measures put in place as a result of this Consultation.

**Introduction**

We agree with the Commission that, in order to bring about a genuine economic recovery in Europe, it is absolutely key that methods be found to stimulate access to reliable forms of long-term investment (whether that be via direct investment or intermediaries such as banks and non-banks) and that this must be achieved at a reasonable cost to borrowers and at a reasonable return for lenders/investors. As the Commission emphasises, long-term investment is required:

1. to service Europe's growing infrastructure requirements; and
2. to assist companies in the initial stages of development or those looking to expand (or sustain the growth of) their businesses.

As the Commission rightly states, financing solutions need to be found to address all of the above since this, in turn, will guarantee steady job creation, and also ensure that Europe remains open and competitive in the global markets.

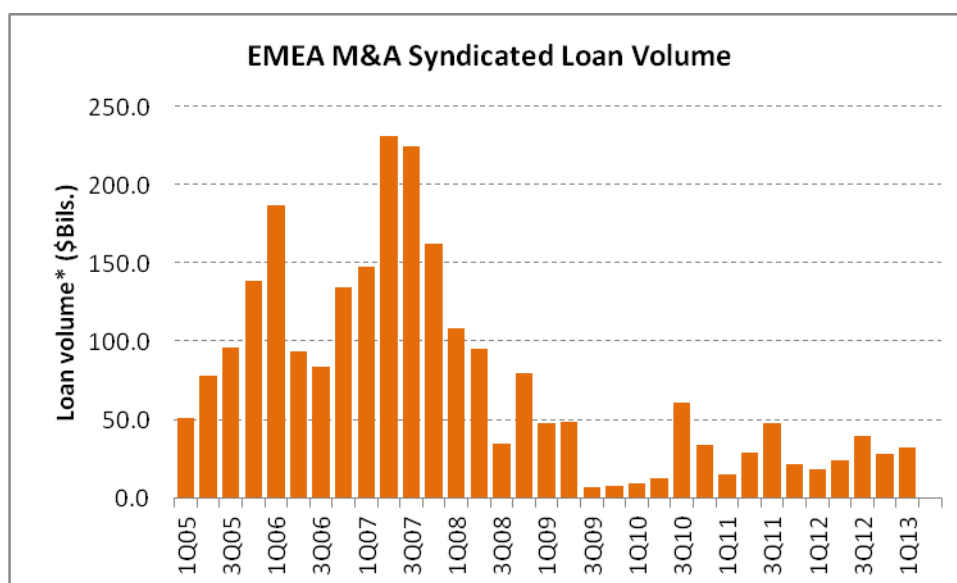
We are therefore very much supportive of the Commission's desire to overcome present barriers, without which we see few opportunities for a genuine return to economic growth in either the short or long term.

#### **Response to Consultation Questions:**

##### **1. Do you agree with the analysis set out above regarding the supply and characteristics of long-term financing?**

We agree, to a large extent, with the Commission's analysis in Section Two of the Consultation regarding the supply and characteristics of long-term financing. We would, however, like to make the following observations:

1. The Commission highlights weak corporate investment as being one of the factors impacting economic growth, highlighting how internal savings of large corporates have increased notably between 2009 and 2011. We would agree with this analysis based on an assessment of our own market – M&A activity within the syndicated loan market (an indicator of large corporate activity from which market optimism may also be gauged) has fallen dramatically since the financial crisis first began, as illustrated by the following graph<sup>1</sup>:



<sup>1</sup> Thomson Reuters LPC

We believe that subdued demand in the large corporate sector has come about, however, not as a result of a lack of liquidity (conversely, our members have indicated that desire to lend with regards to corporates of this size, particularly those that are better rated, remains high), but the continued uncertainties surrounding the eurozone. We believe that once these issues are resolved, or are perceived to have been tackled by the borrower community, large corporates will once again look to expand their businesses, whether that be via M&A or otherwise.

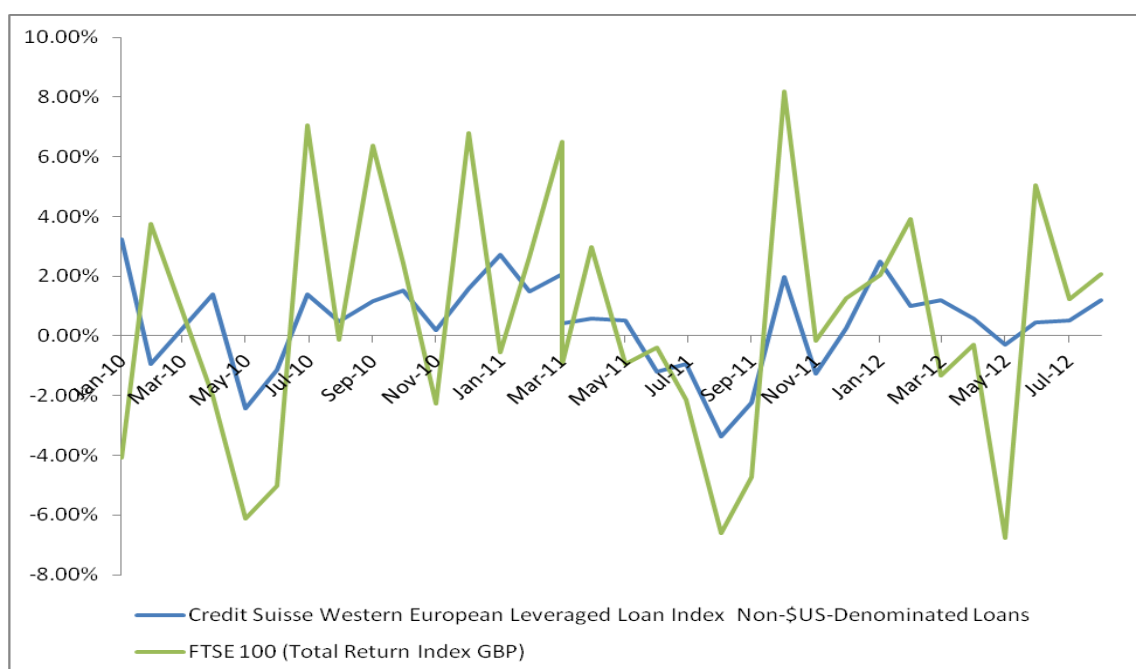
2. The Commission points out that many SMEs suffer from "a continual lack of liquidity". We would qualify this statement. Firstly, we do not think it should necessarily be implied that liquidity in this sector is unavailable - rather it is simply not available at rates at which SMEs are prepared to borrow or to borrowers with more challenging credit profiles (as is the case with SMEs). This is because SMEs are, fundamentally, a relatively high risk investment and it is simply not economically viable for an institution to lend to an SME at anything other than pricing which is reflective of this risk profile. This means that, unless governments are willing to find methods to help bridge the gap between the returns that investors require and the rates at which SMEs are willing to borrow (such as via the use of partial guarantees) it is difficult to see how SME requirements may be satisfied purely through private sector investment. Secondly, we would also stress that whilst it is true to say that financing is significantly below pre-crisis levels, this is not necessarily the case when compared to long-term averages. Therefore, pre-crisis lending amounts should not become the benchmark – instead it is important to try to achieve sustainable levels of debt, corresponding to the needs of a healthy and well-functioning economy. Finally, it is also worth pointing out at this stage that "long-term" financing alone is not an all-encompassing solution for this type of business – as we set out in further detail below, SMEs require many different forms of finance in order to develop as a business. Furthermore, prudent lending to SMEs would dictate the provision of shorter term finance. We therefore wonder whether the Commission should consider addressing the issue of SME financing as a separate policy consideration. Further views on SME lending, in particular any barriers to non-bank investment, are set out later in this response.
  
3. The Consultation highlights the need to mobilise "household" savings in order to channel retail investments into long-term savings. We would agree that more could be done to enable retail investors to make alternative types of investments generally. One such method of doing so is to increase the categories of investment available to the retail market via UCITS funds – for example, to enable retail investment in loans. Further detail on this point is set out later in this response. As an overarching point, our members feel that debt instruments have been penalised from a regulatory perspective vis-à-vis equity investments, when the former intrinsically entails lower risk. This is illustrated, for example, when comparing the volatility of non-investment grade loans<sup>2</sup> against the FTSE 100, by analysing both average monthly returns and annualised standard deviation (ASD)<sup>3</sup>. From this, it is clear that, as an asset class, loans are noticeably less volatile. For example, in the period between January 2010 and August 2012 (an extremely unstable period across the financial markets generally) monthly returns for the FTSE 100 sank as low as -6.8% in May 2012. By contrast, the lowest non-investment grade loan monthly return (looking at Western Europe) within the same period was -3.4% in August 2011. Furthermore, whilst the FTSE 100 showed an ASD of 14.4% between January 2010 and August 2012, the non-investment grade loan market in Western Europe showed an ASD of only 5.3% for the same period. Graphs illustrating both average monthly returns and ASD are set out below:

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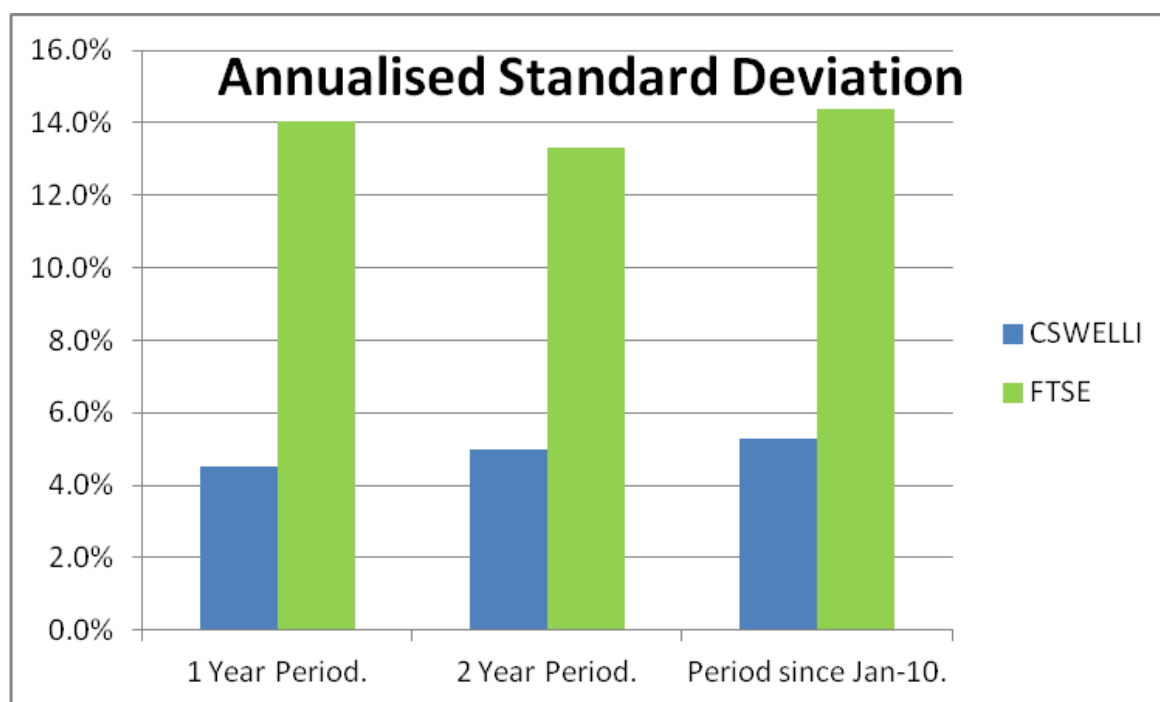
<sup>2</sup> By non-investment grade loans, we are referring to borrowers rated lower than BBB by Standard & Poors (S&P) or Baa by Moodys.

<sup>3</sup> Source: Credit Suisse WELLI Index and FTSE 100 (Total Return Index).

### Monthly Returns: Senior Secured Loans vs. FTSE 100<sup>4</sup>



### Annualised Standard Deviation: Non-investment grade loans vs. FTSE 100<sup>5</sup>



<sup>4</sup> (Credit Suisse Western European Leveraged Loan Index vs. FTSE 100 (Total Return Index GBP))

<sup>5</sup> (Credit Suisse Western European Leveraged Loan Index vs. FTSE 100 (Total Return Index GBP))

4. We agree with the Commission's point that, whilst it is correct to state that the capacity of the economy to provide long-term financing depends on its ability to "generate savings and attract and retain foreign direct investments (FDI)" it should also be emphasised that efficient channelling of such funds to end users is of equal importance and should not be overlooked. This is because, whilst it is true to say that savers and investors are currently experiencing high degrees of uncertainty and, as a direct result of this, are cautious about investing in any financial market on a long-term basis, there are also barriers in respect of the credit intermediaries themselves (whether that be barriers to new entrants or barriers thwarting historic providers of long-term credit). Credit intermediaries (by which we mean investors of savings, as opposed to entities which raise credit to immediately use funds raised to create further credit) are a vital link in the investment process, whether that be because they invest the savings which they manage or because they provide the operational capacity and platforms to enable borrowers to access finance directly.

**2. Do you have a view of the most appropriate definition of long-term financing?**

We agree that there are various difficulties in attempting to define "long-term financing", particularly if such definition is to be used to come up with specific policy recommendations designed to enable investors (whether professional, governmental or retail) to make investments on a long-term basis. However, our members felt that focusing on a pre-determined maturity (e.g. in excess of five years) was a sensible solution.

**3. Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?**

We are pleased that the Commission recognises that banks must continue to play an important role in the channelling of financing to long-term investments for the foreseeable future. We would, however, like to make the following observations:

1. Banks play a vital role in this process as a result of established origination platforms; global branch networks; existing relationships with borrowers; ability to offer a wide and flexible range of banking products and services and the capacity to carry out their own credit analysis, without the need for external ratings. All of these factors combined emphasise the fundamental role that banks must continue to play in the provision of long-term financing and indeed, any form of financing designed to bring about long-lasting economic recovery in Europe, particularly because the non-bank providers of finance are reluctant to, and indeed do not have the resources, to replicate this type of model.
2. Some of our non-bank members felt that the role of banks in the long-term investment process could, however, be developed further. In addition to their traditional role as direct lenders or intermediaries (e.g. acting as a broking intermediary between the issuer and the capital markets) banks could also act as "introducers" effecting introductions between their customers and non-bank providers of capital (and earning a fee as a result of such introduction). The latter is a model which is currently much more prevalent in the US market and is something which could, perhaps, be expanded upon further in Europe.
3. The Commission recognises that bank lending has reduced as a result of deleveraging and re-pricing (particularly for certain types of product and to those entities that are deemed to be high-risk in nature, such as SMEs and emerging market borrowers). Many banks have also retrenched to their domestic markets, which has brought about reduced liquidity in certain jurisdictions. However, it has to be recognised that this is not simply a direct result of banks undertaking "excessive use of leverage and maturity transformation" during the financial crisis. Whilst it is

true to say that banks are re-assessing their existing portfolios and implementing stricter lending criteria, it is the new regulatory regime which is in the process of being imposed on the banking industry which is the largest driver of these changes, notably requirements to increase core capital and the introduction of new leverage and liquidity ratios. For example, the net stable funding ratio (NSFR) recommended by Basel III, requires banks to hold stable funding in excess of a required amount in order to fund "illiquid" assets (i.e. those assets which are not deemed capable of being liquidated within a 12 month period). This would mean, if implemented, that many loan facilities with maturities of more than one year would need to be funded by stable funding. This would, in all likelihood, bring about an increase in banks looking to provide loan facilities of shorter duration, which may be called at any time. In general, committed loan facilities with longer tenors would become less attractive for banks to provide – something which directly opposes the Commission's objectives under this Consultation. In addition, other regulatory measures such as the potential reformation of the structure of the EU banking sector advocated by the Liikanen Report (which, amongst other things, will force banks to separate their proprietary trading and market making activities) is also likely to translate into traditional banking products becoming more expensive to provide as a result of the operational costs involved in bringing about such separation and also given that, if different services are offered by different legal entities within a banking group, it will be difficult for banks to offer a complete "package" of banking products and services – the benefit of which, historically, has meant lower overall costs for the customer. All of these measures appear counter-intuitive to encouraging banks to increase their offering of long-term financial products. In view of the above, although the LMA supports better bank capitalisation to increase stability in the financial system and recognises the need for appropriate and targeted regulation, the unfortunate side effect of the new regulatory environment is that bank capital is being driven away from those who need it most and is inhibiting growth within the wider economy. We are therefore fully supportive of the Commission's statement that there is a need for "appropriate calibration and progressive implementation" when it comes to regulation. We are hopeful that this signals a desire on the part of the Commission to undertake a review of existing bank regulation in order to ensure that it does not have an adverse impact on economic recovery going forward. Further recommendations with regards to regulation generally are set out later in this response.

**4. How could the role of national and multinational development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?**

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, even the less sophisticated ones, 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 of private sector lending which could create distortion within the market.

#### **5. Are there other public policy tools and frameworks that can support the financing of long-term investment?**

Our non-bank members have indicated that the capital treatment of assets purchased by investors is the most important factor in attracting long-term investment from institutional investors. Such investors will commit funding to long-term projects if the capital treatment is favourable and the project's risk profile is structured correctly. Unfortunately, proposed revisions to the capital treatment of assets under current regulatory proposals, such as under Solvency II for insurance companies, is actively disincentivising institutional investors from making long-term investments. Further detail on regulatory barriers is set out later in this response.

#### **6. To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?**

As the Commission has rightly stated, as major banks are deleveraging, it is important that other non-bank investors are found to plug the gap and ensure that the funding requirements of businesses continue to be met. As has already been discussed, this is particularly pertinent given the regulatory treatment of banks following the implementation of CRD IV, which will make lending on long tenors generally less attractive for such institutions. Whilst non-bank investors are already present in this space, we believe much could still be done to broaden this valuable investor base and give it a meaningful diversity. Therefore, in order to generate additional liquidity for long-term financing in Europe, appropriate non-bank vehicles, with appropriately tailored regulation, should be considered as potential viable options.

That said, all of our members agreed that regulation (both current and proposed) presents a huge barrier to non-bank investment. Key points from a regulatory perspective are as follows:

- a. **Regulatory hurdles for CLOs<sup>6</sup>.** Prior to the financial crisis, CLOs were the primary source of non-bank investment in the syndicated loan market. This investment fell away dramatically from 2009 onwards, primarily due to the introduction of amendments to the CRD<sup>7</sup>.

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 to set targets. 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.

Although a limited number of new CLOs have been launched in recent months, there is still a marked reduction in new issuance which we believe is reflective of the fact that compliance with the retention requirements is only possible for the larger vehicles. We believe that the market could be reopened in its entirety if certain amendments to the CRD were adopted, enabling the provision of increased liquidity. 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) was US\$ 54bn in 2012 and US\$27bn in the first quarter of 2013. By contrast, CLO issuance in Europe in the first quarter of 2013 was a mere \$72mn.

- 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 very beneficial, 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.

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<sup>6</sup> 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.

<sup>7</sup> Article 394 the Capital Requirements Directive (formerly Article 122a) (*Exposures to transferred credit risk*) of Directive 2006/48/EC.



The Commission has already recognised in its recent UCITS consultation<sup>8</sup> that there are certain benefits to be had from opening up the retail market to longer-term investments, viewing them as a potential "enhancement to the internal market" by enabling the asset management industry to contribute to growth, whilst at the same time offering new investment opportunities to retail investors. The LMA responded separately to this Consultation on 18 October 2012<sup>9</sup> advocating that the Commission consider expanding the list of eligible assets under Article 50 of the UCITS IV Directive to include certain types of loan.

- c. **Proposed shadow banking regulation.** Although no concrete regulatory proposals have, as yet, been produced, the Commission circulated a Green Paper on Shadow Banking, which was published as a consultation on 19 March 2012<sup>10</sup> (the Green Paper). From this paper (and subsequent reports/non-legislative resolutions by ECON and the European Parliament respectively) it is clear that the Commission and other European bodies are seeking ways to regulate the shadow banking industry.

Although more clarity and guidance from the Commission is required before it becomes possible to assess the true nature of the consequences of shadow banking regulation, it seems very likely that, at some point, shadow banking entities will be subject to a certain amount of bank-like regulation, such as limits on leverage, capital requirements, liquidity buffers and restrictions on exposures to, and receipt of funding from, banks and other financial entities. Whilst we support targeted regulation of this industry where appropriate, it must be carefully assessed to ensure that it is proportionate. The real concern with regards to such regulation is that it may inadvertently capture entities and activities which pose very little risk to the financial system and as a result, simply has the effect of reducing non-bank liquidity in the financial markets, at a time when such liquidity is vital to ensure future economic recovery.

- d. **Solvency II.** Solvency II has clear implications for the investment strategies of insurers and reinsurers, since any investments will be used, to the extent possible, to support their technical provisions and capital requirements. Under earlier legislation, insurers were only permitted to invest in assets which were on a pre-determined list of "admissible assets". Under the new Solvency II requirements, however, the rules are not so prescriptive, with assets being assessed in accordance with broader principles relating to general prudence, security and overall liquidity. Essentially, once implemented, insurers will be given greater freedom to invest provided that certain criteria are met (e.g. relating to the quality, maturity profile and diversification of the assets) and any investment risks are capable of being monitored. That said, Solvency II also introduces revisions to the capital treatment of assets by requiring insurers to assess various categories of risk in relation to the specific asset held and hold additional capital to cover such risks – for example, debt with long maturity profiles, the majority of structured finance products, real estate and investment in private equity and hedge funds will all carry higher risk charges, at least when compared to government securities and short-dated debt. Higher-rated instruments will also be given better treatment than low (less than single A) or unrated instruments. Basing capital calibrations on models which rely on credit ratings and

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<sup>8</sup> [http://ec.europa.eu/internal\\_market/consultations/docs/2012/ucits/ucits\\_consultation\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf).

<sup>9</sup> To see the LMA's response to this consultation, please go to the following link: <http://www.lma.eu.com/submissions-regulators.aspx>.

<sup>10</sup> [http://ec.europa.eu/internal\\_market/bank/docs/shadow/green-paper\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf). To see the LMA's response to this consultation please go to the following link: <http://www.lma.eu.com/submissions-regulators.aspx>.

encouraging investment in short-dated debt is likely to mean that interest in long-term financing from the insurance industry may well decrease, particularly for those loans which are to lower or unrated borrowers such as SMEs. In addition, capital calibrations under Solvency II rely on the pricing of listed securities – something which also does not favour long-term investment. This is on the basis that marked-to-market pricing is affected by volatility in the markets generally. This means that investment in, for example, bonds of longer tenors is immediately considered to be a more volatile investment since pricing is based on secondary market prices (which in turn, is impacted by the availability of liquidity in the relevant market) rather than the true credit risk of the underlying issuer and the likelihood of receiving interest and principal. In summary, long-term investment is simply not compatible with the short-term approach used in the determination of capital charges under Solvency II. All of the above would appear to be counter-intuitive to the Commission's objectives under this Consultation.

Given the challenges outlined above, it is clear that increasing the amount of long-term investment from institutional investors in the current regulatory environment is likely to be challenging since, at the very least, it increases uncertainty and acts as a disincentive to the making of long-term financial decisions. Consequently we are fully supportive of the Commission's comment that it intends to examine whether the detailed calibration of capital requirements for investments in certain assets under the Solvency II regime should be adjusted to ensure that there are no obstacles to long-term financing. We believe that a similar assessment should also be undertaken with regards to other regulation, for example in relation to shadow banking, retention requirements for managed CLOs and investments in UCITS funds.

**7. How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?**

Please see our earlier comments on Solvency II above with regards to insurers and reinsurers.

IORP prudential rules, meanwhile, are entirely model-driven, with a requirement for a 10 year track record. As such track records do not presently exist for long-term financing instruments, this makes these sorts of investment ineligible assets for IORPs. We would also like to stress that extending Solvency II rules to IORPs would only exacerbate the problem, for the reasons stated in our response to the previous question on Solvency II.

**8. What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?**

As has already been discussed, CLOs have been impacted by the retention rules affecting all securitisations under the CRD. These rules also affect the insurance industry, since under Solvency II, when it comes to making investments in securitisations, in addition to specific requirements regarding risk monitoring and assessment of the underlying assets, an insurance firm may also only invest in these assets if the originator, sponsor or original lender expressly undertakes to retain a net economic interest of not less than 5%. Given that the capital requirements also impose higher risk charges on these types of assets, it is likely that insurers and reinsurers may be less inclined to invest in structured loan products once the Solvency II measures are in place.

Therefore, whilst CLOs and other pooled investment vehicles do already exist, the regulatory treatment of such vehicles would need to be re-examined. As we have previously stated, the capital

treatment of assets purchased by investors is one of the most important factors in attracting long-term investment from institutional investors.

## **9. What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?**

It is our view that the syndicated loan product (whether that be via corporate loans or infrastructure loans) is an essential financing tool in the provision of long-term debt to borrowers. We would encourage the Commission not to overlook it during its review and should also consider ways that the product could be treated more favourably from a regulatory perspective in order to satisfy the objective of the Consultation (please see our response to Question 11 for further detail on this point).

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 long-term financing**

The syndicated loan product is a particularly attractive financing tool for long-term debt provision due to its simplicity and flexibility as a product. For example, a typical syndicated loan includes both a term loan<sup>11</sup> and a revolving credit facility ("RCF")<sup>12</sup>. RCF facilities are particularly useful facilities because they enable businesses to borrow 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 as a product, syndicated loans are attractive for the following reasons:

- **Other forms of flexibility.** A syndicated loan can offer various financing solutions regarding tenor and volume and is available for a variety of purposes (acquisitions, letters of credit etc) all of which may be set out under one loan agreement. In addition, loans can offer a variety of options

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<sup>11</sup> 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.

<sup>12</sup> 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.

to borrowers e.g. regarding currency, repayment options or interest periods. Furthermore, loans are based on floating rates and can therefore usually be redeemed at any point in time, without triggering expensive "make whole" payments. Finally, the borrower of a syndicated loan has the ability to amend its documentation (albeit with the approval of a majority of, or all, the syndicate lenders) whilst bonds, for example, offer limited or no such opportunities. This is particularly important in long-term financing where a company's requirements and circumstances may change over time.

- **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. This is also in keeping with the Commission's desire to reduce reliance on external rating agencies.
- **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.
- **Standardised documentation.** Syndicated loans are likely to be documented within a standard form LMA framework which investors are now accustomed to reviewing.
- **Active secondary market.** Loans are traded in a well-established and active secondary market, making them attractive not just from a borrower, but also a lender perspective. By way of background, secondary loan market liquidity is facilitated by "market makers" who provide two-way pricing and by more than 20 institutions which could be considered regular market participants.

Other sources of investment such as bonds are, of course, important, particularly in the large corporate space. However, whilst new and alternative financing arrangements could fill a proportion of the funding gap for long-term investment, the syndicated loan product is an established form of debt provision, which many borrowers and lenders are already comfortable with using. We therefore find it disappointing that, for example, under the Basel III recommendations, loans are not treated as favourably as other debt products, such as bonds. For example, under the NSFR, the assessment of which assets constitute illiquid assets has already been pre-determined. The effect of this is that, for example, 50% of loans to non-financial corporates with a residual maturity of less than one year must be financed from stable funding, whilst this increases to 100% for loans to those same corporates if the residual maturity exceeds one year. By comparison, bonds are treated much more favourably – for example, only 20% of corporate bonds rated AA- or higher with maturities of one year or greater must be supported by stable funding. This is the case despite the fact that loans and bonds have essentially the same cash flows – a loan has an interest cost and a principal amount to be repaid at maturity (or as per a repayment schedule) whilst a bond has an interest cost and a principal amount to be repaid at maturity (or as per a repayment schedule). If the borrower/issuer is the same corporate entity, it is difficult to see why treatment between the two instruments should differ for regulatory purposes.

It is also our view that any new forms of alternative investment will take time to set up and implement. By contrast, the syndicated loan product is an established product which both lenders and borrower are already very familiar with. Efforts should therefore be directed into encouraging more investment into loans, in addition to considering new types of investment.

**10. Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicity of aggregate long-term investment and how significant are they? How could any impact be best addressed?**

One of our key concerns in relation to the current regulatory environment is that regulators have not undertaken a cumulative assessment of the varying proposals, by which they would be tasked with assessing the combined impact of regulation on the financial industry as a whole. It is not difficult to see some worrying trends emerging, simply by looking at some of the regulations mentioned briefly above, as part of a wider "package".

Some considerations are as follows:

**1. Reduced product offering for borrowers**

The following regulations are likely to affect the above:

- **CRD IV/Basel III.** This regulation has perhaps the greatest influence on an institution's product offering. For example:
  - The increased regulatory capital charge imposed on financial institutions means that impacted lenders will be increasingly reluctant to take on a fronting role, which will impact trade finance products in particular.
  - The practical effect of the leverage ratio on netting will affect loan assets linked to designated pre-funding or cash backing (often used in trade finance structures through the offering of bonds and guarantees) as well as a borrower's general ability to access overdraft facilities which allow them to combine debit/credit balances. The number of trade finance and basic cash management products, particularly for borrowers at the lower end of the credit spectrum, could therefore decrease or become more expensive.
  - Given that under the NSFR, many loan facilities with maturities of more than one year will need to be funded by stable funding, there is a chance that this could bring about an increase in banks looking to provide loan facilities of shorter duration, which may be called at any time. In general, committed loan facilities with longer tenors are likely to be less attractive for banks or at least more expensive to provide.
- **Article 394 CRD IV and Solvency II.** From the perspective of non-bank investor access to different types of investment, both of these regulations are likely to bring about a reduction in the desire (or the ability) to invest in certain products/assets.

Although a cause for concern in general, perhaps the most worrying implications of the above are for the trade finance market. Any restrictions imposed on these products by regulators would appear to be counter-intuitive for three reasons: 1) these products, historically, have had very low default rates and good levels of recovery; 2) Governments are seeking to stimulate trade in an effort to revive the global economy and it is these types of products which are arguably most necessary to achieve that goal; and

3) the use of relatively straightforward trade products such as export confirmed letters of credit are one of the more traditional products sought by SME borrowers looking to grow their businesses internationally. These are the very businesses to which Governments are currently hoping to stimulate lending.

## **2. Increased cost and availability of funding for lenders**

The following regulations are likely to affect the above:

- **CRD IV/Basel III.** Given that capital requirements introduce a premium on exposures to other financial institutions, the LCR provisions generate a 100% liquidity requirement for facilities to certain financial institutions and under the NSFR, the majority of loans to financial entities must be funded 100% by stable funding, there is a clear disincentive for banks to lend to each other, particular if such lending is unsecured.
- **Solvency II.** Under this regulation, insurers and reinsurers will be discouraged from investing in both equity and long-term debt, which means that financial institutions may find it difficult to find ready lenders within the insurance industry willing to invest in their equity and long-dated bonds.

When combining the above factors with other proposed regulations such as potential regulation of the repo and secured funding markets and the existing difficulties which arise when attempting to use loans as collateral for central bank funding, fundamental questions arise as to exactly where lenders are likely to obtain their funding in the future. This translates to an immediate reduction in liquidity across the board (see point three).

## **3. Reduced liquidity:**

This is likely to come about automatically as a result of points one and two above. However, the following specific points should also be noted:

- **CRD IV/Basel III.** Whilst capital requirements and the leverage ratio will disincentivise banks from offering trade finance products and loans to financial institutions, the LCR and NSFR proposals will also discourage the provision of liquidity facilities, as well as facilities to a wide variety of borrower types.
- **Solvency II.** Whilst insurers and reinsurers could become more active in certain sectors of the market, the requirements could also lead to less liquidity in others.
- **Shadow banking.** Prohibitions imposed on certain non-bank lenders could lead to a reduction in available liquidity from this market.
- **Article 394 CRD IV.** The introduction of retention requirements has contributed to a reduction in CLOs. Consequently, such vehicles have a massively reduced presence in the market, resulting in a sudden loss of previously available liquidity.

Overall, the potential reduction in available liquidity to the financial markets generally is extremely concerning, particularly because it is difficult to see how any form of economic recovery is to be achieved unless funds become more readily available.

## **4. Increased costs of borrowing**

Whilst an increase in borrowing costs is often an inevitable conclusion when liquidity is reduced (except perhaps for the most highly rated borrowers) the following points should be emphasised:

- **CRD IV/Basel III.** The risk premiums imposed on financial institutions under the capital requirements, the netting implications of the leverage ratio (particularly on trade finance products), the current 100% liquidity requirements for certain loan products under the LCR and the requirement to obtain stable funding for the majority of loan activities under the NSFR is likely to mean that affected borrowers are forced to pay premiums to obtain these products going forward.
- **Solvency II.** Although investment opportunities may be created for certain types of loan facilities on the basis that there is increased interest from insurers and reinsurers to invest in them for the purposes of their capital requirements, loans with longer maturities and loan securitisations are likely to be less attractive and may therefore become more expensive to obtain.
- **Reforming structure of EU banking sector (Liikanen Report).** If different services are offered by different legal entities within a banking group, it will be difficult for banks to offer a complete "package" of banking products and services – the benefit of which, historically, has meant lower overall costs for the customer.

## **11. How could capital market financing of long-term investment be improved in Europe?**

As a general overarching point, it is difficult to see how investors will be willing to invest funds on a long-term basis whilst there remain question marks with regards to the regulatory treatment of any investments made. This is particularly relevant for project finance loans and their treatment under Basel III. If investors are to be incentivised into making long-term investments, there needs to be far greater long-term visibility on what their regulatory cost of capital will be.

In addition, it would be beneficial to the development of long-term financing if such investment attracted the same regulatory treatment regardless of product type. For example, as already stated above, under the NSFR, whilst 100% of loans to non-financial corporates with a residual maturity of more than one year must be financed from stable funding, bonds are treated much more favourably – for example, only 20% of corporate bonds rated AA- or higher with maturities of one year or greater must be supported by stable funding. Given the intrinsic value of the syndicated loan product (as set out in further detail above) we would urge that instruments with the same fundamentals are treated the same way for regulatory purposes, particularly given that a loan to a corporate and a bond issued by that same corporate will generate similar cashflows. Statistics also illustrate that, when looking at equivalent borrowers/issuers, loans tend to have comparable default rates when compared to bonds and higher recovery rates.

Whilst some local initiatives do exist with a view to aligning regulatory treatment of different products (the attempts by French insurance companies to amend the French Code des Assurances is a notable example, aimed at improving the ability of such companies to invest in loans) it would be worthwhile if further harmonisation could be achieved at a European level.

As a final point, we believe liquidity in the market would be greatly increased if SME and infrastructure loans became more widely eligible for use as collateral for central bank funding.

**14. How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?**

As a general point, we believe that, when structured correctly, securitisation is a key funding tool and a valuable and viable method of achieving increased liquidity within the financial markets.

We also believe that the single biggest hurdle preventing the securitisation market being revived in the EU is proposed regulatory reform impacting its principle investors. Our concerns with regards to regulation have already been set out earlier in this response. In addition, we would highlight the Basel Committee on Banking Supervision consultation (BCBS 236) which proposed substantial changes to the methods by which banks calculate their risk-based capital requirements for securitisations. Our bank members believe that such measures are disproportionate and could potentially be very damaging for the securitisation market in Europe.

**19. Would deeper tax coordination in the EU support the financing of long-term investment?**

We believe that the treatment of loans and bonds from a tax perspective could be better aligned. For example, in Italy, new tax rules implemented in December 2012 give favourable tax treatment (i.e. no withholding tax) to non-bank investors investing in bonds. However, by contrast, loans are still subject to very strict tax restrictions. Given the inherent benefits of the loan product (outlined in more detail above) it is our view that tax harmonisation between different products with similar fundamentals is something which the Commission should examine further.

As a general point, we would also welcome the Commission addressing withholding tax issues that arise between certain European countries – we believe that this would improve liquidity across the market and facilitate cross-border lending.

**24. To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?**

As a general point, the ability to obtain more information about a particular company enables investors to undertake more detailed due diligence and make more informed investment choices. Since the syndicated loan market is a private market, borrowers provide lenders with a larger amount of financial and non-financial information than would be provided if, for example, the same corporate were issuing a bond in the public markets. We are therefore of the opinion that the syndicated loan product is already ideally set up to provide long-term financing.

**26. What further steps could be envisaged, in terms of EU regulation or other reforms, to facilitate SME access to alternative sources of finance?**

Looking specifically to SME financing, the LMA is keen to emphasise that, although it may theoretically be possible for SMEs and micro businesses to access alternative forms of finance, in practice, these are likely to be difficult to establish. For example, looking to non-bank finance providers generally, particularly institutional asset managers, these investors are not presently set up to finance these kinds of borrower and will therefore realistically only play a part in financing larger Mid-Cap companies. 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, CLOs could be well placed to fulfil part of this role. Bank disintermediation is seen to a greater degree in the US than in Europe, with lending to US middle market businesses having increased from \$71bn in 2009 to \$180bn in 2012<sup>13</sup>. This issuance is facilitated by loan mutual funds (channelling retail capital to corporates), CLOs and listed companies known as Business Development Companies.

We would also like to highlight that SMEs also have very diverse financing requirements. For example, a fundamental requirement of SMEs is working capital finance, as well as ancillary facilities such as letters of credit and overdrafts. Although alternative products to bank loans do, of course, exist (e.g. M-Bonds or Prime Standard Bonds in Germany or retail bonds in Switzerland or Scandinavia) these are very much niche in nature with limited markets which have no reach beyond their national borders. Therefore, we believe it unlikely that these instruments will establish themselves as viable alternatives to bank financing in the foreseeable future.

In addition, the traditional forms of financing required by SMEs (i.e. working capital finance and other ancillary facilities which are typically not drawn from the outset) are usually 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 should continue to play a key role in the provision of working capital finance to SMEs for the foreseeable future.

In addition, it should be highlighted that the single biggest challenge facing institutional investors is not how to lend once capital has been raised, but rather how to raise the funds which may be lent to SMEs. Our non-bank members have indicated that some of the barriers currently stifling SME access to non-bank capital include:

1. **Inherent difficulties in lending to SMEs.** Our members indicated that although they have access to most business sectors, they often require corporates to be of a particular size (circa £75m turnover) to be considered viable investment opportunities. This is 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 may be lent to SMEs at rates which are 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.
2. **Lack of origination network.** Two key points were raised. Firstly, some of our members indicated that the lack of origination network is 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 directly to borrowers, in the case of SMEs and micro businesses, it was felt that banks were uniquely and

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<sup>13</sup> 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.

better placed to provide the necessary origination network, especially given the regional nature of their businesses and their existing relationships/credit histories with borrowers.

3. **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 (which banks find easier to overcome as a result of their existing relationships with borrowers and local branch network) was flagged as a disincentive against investing in smaller businesses (something which was felt to be more prevalent in certain European countries than others) particularly because SMEs often come in a variety of legal forms and adopt varying ownership structures which do not meet the requirements of some investors. 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.
4. **Potential need for ratings with regards to some investors.** 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. Most SMEs 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 tranches themselves are rated. CLOs can therefore be a means by which investors requiring a rating are able to access loans.
5. **Potential need for an active secondary market with regards to some investors.** 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 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. This implies that investment in long-term assets would need to be priced at a premium if meaningful inflows of capital were to be channelled into this sector by these investors.

6. **Regulation.** The impact of current regulatory proposals on alternative finance providers has already been set out above. Specifically in the SME context however, it should be highlighted that CRD IV and Solvency II actively discourage SME lending since they base capital calibrations on models which rely on credit ratings (and SME borrowers are usually unrated).

Overall, 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 terms as attractive as banks.

**28. Would there be merit in creating a fully separate and distinct approach for SME markets? How and by whom could a market be developed for SMEs, including for securitised products specifically designed for SMEs' financing needs?**

Whilst it may be possible to increase lending to this market via more favourable regulatory treatment or other incentives, SMEs are, fundamentally, a relatively high risk investment and therefore institutions are only likely to invest in SMEs if returns are reflective of their risk profile.

We would also add that if the creation of a separate and distinct approach for SMEs involves the implementation of an entirely separate regulatory framework, this will only serve to confuse both investors and the market, as well as add unnecessary complications to an already complex regulatory regime. Furthermore, a standalone initiative for SMEs would probably duplicate a large amount of regulation already in existence. It would therefore be far more beneficial to review current regulatory proposals with a view to understanding their cumulative impact on investors and the financial markets and ensuring that they do not have an adverse impact on the European economy.

**29. Would an EU regulatory framework help or hinder the development of alternative non-bank sources of finance for SMEs? What reforms could help support their continued growth.**

Please see our comments to the previous question.

**30. In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?**

Our members have indicated that regulation is one of the greatest barriers currently inhibiting lending on both a long-term basis and to SME borrowers. 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. Whilst we are very much encouraged by the Commission's statement that "in some areas new or adapted regulation may be needed", we believe regulators also need to consider the following points as a matter of priority:

- **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. Such a situation currently arises even under the CRD IV if implemented unamended in relation to Basel III (for example, the LCR requirements have not yet been brought into line with the current Basel III recommendations).

- **Recognise that financial institutions must take on some responsibility for their own regulation.** Whilst the mistakes made by financial institutions during the financial crisis cannot be denied, and the need to curb excessive risk taking should be accepted, responsibility for basic investment decisions must ultimately rest with the institutions themselves and this is not something which can, or indeed should, be governed by extensive legislation. In many ways, the financial services sector has already made substantial progress since the start of the financial crisis to strengthen its lending criteria, legal due diligence and credit/risk assessment processes and it is this, along with balanced and considered regulation, which will ultimately establish the foundations for a safer financial system.
- **Consider education, in addition to regulation.** As has already been discussed, too much regulation is likely to have the ultimate outcome of stifling economic recovery. Regulators should therefore accept that, in certain circumstances, a better regulatory proposal would be for regulatory authorities to take on an educational role. This could be achieved simply by explaining the risks associated with certain products and to offer greater access to dedicated training in order to enable businesses and other consumers to make informed investment decisions.
- **Ensure that banks are not prevented from offering basic loan products which are vital for small and growing businesses.** Although it may theoretically be possible for non-banks to lend to SME and micro businesses, 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 companies. In addition, a fundamental requirement of smaller businesses 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 lenders, firstly because, unlike banks, who redeploy deposits, asset managers have to source funding from institutional lenders and are therefore not in a position to offer these types of facilities. Furthermore, the funding sources of the non-bank lending sector generally means 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. If banks are discouraged by regulation from offering certain types of product, it seems unlikely that other lenders will be available to fill the gap.
- **Ensure non-bank investment not constrained.** Much has been publicised about the need to stimulate the credit markets and, with banks continuing to shrink and delever, non-banks are likely to become a much more important source of credit in future. If their activities become unduly constrained, or the costs of compliance become excessive, these vehicles will have neither the resources nor the incentive to invest.

## Conclusion

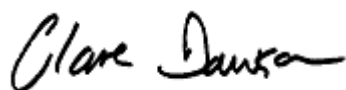
We are fully supportive of the Commission's view that, ultimately, measures must be taken to encourage growth, not curtail it, especially given that the economic situation remains fragile. Whilst targeted and proportionate regulation to guard against excessive risk in the financial system is

welcome, this must ultimately be balanced against the need to bring about a healthy economic recovery. It should also be emphasised that actions at the policy level have the ability to bring about fundamental changes to the availability of liquidity within the financial markets. Up until now, the degree of regulation which has been put in place since the financial crisis first began has resulted in banks retrenching from the market and uncertainty for many other types of investor. Therefore, the Commission's wish to promote long-term funding and the SME market is welcomed. However, as our submission highlights, this is not without difficulties, some of which arise from the intended and unintended consequences of recent regulatory proposals.

As an additional and final observation, we would also urge the Commission to recognise that a range of different financing solutions are needed to bring about a long-lasting recovery in Europe, not all of which are necessarily "long-term" in nature. For example, the Commission is clearly keen to ensure that SMEs receive appropriate degrees of investment (and it is true that SME investment will contribute to long-term recovery). However, SMEs, in particular, require access to all types of finance – for example, regular and predictable sources of working capital finance are equally important. This is also true in a trade finance context – many export finance instruments such as letters of credit are either short-term in nature, or "rolled over" on a yearly basis (e.g. standby letter of credit facilities). Arguably, these types of instrument are equally important to the growth and development of small businesses as long-term capital investment and should therefore not be disregarded simply because they fulfil a slightly different function. In summary, we would stress that the Commission's aim is to achieve a long-lasting economic recovery. This does not automatically translate into a need for financing solutions which are long-term in nature – rather, regular, reliable, flexible and above all, ongoing investment is arguably far more important, especially to the SME community.

We would be pleased 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](mailto: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](mailto:nicholas.voisey@lma.eu.com) or by telephone on 020 7006 5364.

Yours faithfully



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