

An Agency for Business Lending – “ABLE”

Improving access to finance for small and medium-sized enterprises

October 2012

About AFME

The Association for Financial Markets in Europe is the voice of Europe's wholesale financial markets. We represent the leading global and European banks and other significant capital market players.

Our purpose is to provide a practical, constructive market view to policymakers on the significant reforms taking place in the European financial system.

We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

Focus - on market, wholesale and prudential issues

Expertise - deep policy and technical skills

Strong relationships - with European and global policymakers

Breadth - broad global and European membership

Pan-European - organisation and perspective

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1. Executive Summary

Background

- 1.1 In March 2012 Tim Breedon issued a government-sponsored report (the “Breedon Report”) on the state of lending to small and medium-sized enterprises (“SMEs” or “businesses”) in the UK.
- 1.2 The report’s broad conclusion was that as the economy recovers there is a potential gap that will arise between the supply and demand of credit in the UK SME space. The UK currently has no infrastructure capable of addressing this long-term structural weakness.
- 1.3 Temporary interventions, such as the Funding for Lending Scheme (“FLS”), will help to bridge this gap - but only temporarily. The FLS launched formally on 1 August 2012 and is scheduled to make funds available for drawdown until 31 January 2014. Also, it is an intervention that only caters for a selective range of finance providers and its cost and other parameters are not suitable for all its potential participants.
- 1.4 The Breedon Report made a number of recommendations about how the gap might be bridged, including proposing the establishment of “a feasibility study, led by the Association for Financial Markets in Europe (“AFME”), to explore the creation of an aggregation agency to lend directly to SMEs and/or to pool SME loans to facilitate SME access to the public corporate bond markets”.
- 1.5 In this paper we refer to such an aggregation agency as the “Agency for Business Lending” or the “ABLE”.
- 1.6 AFME is grateful for, and this report draws on, the expertise of a broad range of participants who have contributed to our work and who are listed in Appendix 1. They represent the views of business, investors, the capital markets, lenders, academics and foundations, legal and accounting firms as well as the Government, policy makers, regulators and the Bank of England.
- 1.7 This report and the accompanying appendices set out the conclusions of the Feasibility Study recommended by the Breedon Report. It should be read alongside the accompanying detailed Technical Paper, and is submitted further to AFME’s letter to the Secretary of State for Business, Innovation and Skills dated 6th September 2012.

Summary conclusions

- 1.8 We believe that, through the aggregation of SME loans, the ABLe could facilitate SME access to the public corporate bond markets.
- 1.9 There is a particular need to find a solution that ensures that high growth SMEs and mid-cap businesses have more choice in access to longer-term investment capital than is currently available. While these businesses can satisfy their working capital requirements through overdrafts, credit cards, trade or asset finance, their longer term ‘patient’ finance options (5 years plus) are scarcer and, due to bank regulatory capital requirements, increasingly restricted to equity. An equity investment effectively means sale of all, or part of, the company, which many owners are not inclined to pursue and which is not always desirable. A longer-term solution is therefore needed.
- 1.10 It is difficult to predict with accuracy the amount of funding that could be achieved, as this

will depend on a number of factors which cannot be quantified with certainty. Having said that, we are cautiously optimistic that if our recommended structure is implemented, capital markets funding in the range of tens of billions of pounds could be accessed.

- 1.11 A key component of our structure will be the role of the Government, whose role will be critical if significant volumes of funding are to be achieved. Having reviewed the international markets and discussed the matter with investors, we have concluded that such funding would not be stimulated without support from Government. Based on this feedback, and also in line with international precedents, we recommend that the liabilities of the ABLe carry a full guarantee from the UK government.
- 1.12 We have achieved a broad consensus across the finance and business communities to reach our conclusions. We believe that the ABLe:
- would provide additional long term “patient” finance that businesses cannot currently access easily;
 - would be attractive to international investors, who have confirmed that, in principle, they would be interested in investing in the securities issued by the ABLe; and
 - would be sufficiently flexible that it could complement and enhance the effectiveness of the “Business Bank” that the Chancellor announced recently.

The business perspective

- 1.13 AFME was tasked with assessing whether, through the aggregation of loans made to SMEs, an institution could provide SMEs with sustainable access to the capital markets and thereby access to longer term investment capital. We were guided by the findings of the Breedon Report, which suggested that between now and the end of 2016 there is a risk that creditworthy UK businesses are likely to need more finance than banks will be able to provide given the capital constraints imposed on them as a result of the Basel III Accord, and that this funding gap could be of the order of tens of billions of pounds.
- 1.14 Direct access to long term investment capital from institutional investors has not traditionally been available to individual businesses for a number of reasons. One is that these businesses lack the resources and expertise to undertake the more thorough due diligence process that this form of fundraising requires. Certain necessary up-front costs of securities issuance (for example, listing, legal and rating agency requirements) also have a discouraging impact. Capital markets investors have much larger minimum investment thresholds than small and medium-sized enterprises can support. Lastly, there is lack of detailed, historical and consistent information on the performance of loans (aggregated or not) taken out by UK businesses and SMEs in particular which means that investors struggle to compare SME risk with other investments.
- 1.15 Our proposal is that the ABLe should focus on the needs of businesses with a range of turnovers from £2m up to £250m.
- 1.16 The expected key businesses which will benefit from the ABLe are those which will be of

more medium to mid cap size which total some 21,500 in the UK today and contribute 31.8% of private sector GDP. These businesses are typically fast growing and require long term “patient” capital to grow and develop.

- 1.17 Companies with a turnover below £2m, which include the self-employed, sole traders and small trading companies, while numerous, have different needs and pose different challenges, and we do not believe the ABL platform will be suitable for them.

The investor perspective

- 1.18 We believe that investors with long dated liabilities may be prepared to invest in long-dated SME risk with the right risk/return as long as the risks are transparent, within their risk appetite and there is sufficient liquidity in the market for them to adjust their portfolios.
- 1.19 To achieve this, investors will need to be confident of certain factors.
- 1.20 Firstly, credit underwriting at origination will need to be of a sufficiently high quality. The ABL should be used to provide funding to viable growing SMEs.
- 1.21 Secondly, ongoing performance information will be needed to enable liquidity to be maintained. Over time, collection of ongoing performance data on aggregated pools will be key to developing the market further.
- 1.22 It is also critical to recognise that, unlike the US, today the UK does not have a pool of investors ready to take direct investment or exposure in businesses, or an active UK investor-led private placement¹ market. This is a historic position driven by a range of factors including, inter alia, lack of appetite to build in-house expertise in SME risk assessment, scarcity of resource against strategic objectives, lack of historical trends in SME success factors and a perceived lack of a secondary market for SME risk.

The impact on participating originators

- 1.23 Whilst the Bank of England’s Funding for Lending scheme goes some way to alleviating the funding shortage, it does not address the capital shortage. The design of the ABL therefore addresses both of these issues.
- 1.24 The need to act urgently for any intervention to have a significant impact has influenced the way we have approached this issue, and that is why we have suggested using existing infrastructure as much as possible. However, we have not excluded the possibility that the ABL could develop its own infrastructure in the future.
- 1.25 We have also worked hard to find a solution that provides additional finance and does not

¹ Private placements are fixed coupon debt instruments issued directly to institutional investors. Due to the flexibility provided by the direct relationship between lender and borrower, they provide an effective route for mid-sized businesses to access the debt capital markets. See further the Breedon Report, Section 5.2.

merely support banks' current business models / lending strategies. A key message that all participants in this study have agreed on is that whilst temporary interventions, such as the Funding for Lending Scheme, will help bridge the funding gap faced by businesses to some extent, they do not address the long-term financing needs of businesses, particularly SMEs.

- 1.26 Originators should retain "skin in the game" by retaining a portion of the risk in the loans they originate and pass to the ABLe. A balance will need to be struck here, however, particularly given the fact that the ABLe also needs to help generate incremental lending capacity in the financial system which means that some risk transfer from bank originators will be necessary to free up regulatory capital.
- 1.27 Whilst ABLe will specify the type of finance provider that can become a Participating Originator, it will ultimately be the choice of a finance provider as to whether it wishes to participate in the ABLe programme or not.

The ABLe itself

- 1.28 We believe that the ABLe will facilitate the provision of long term investment capital to those businesses which cannot currently access the capital markets and which therefore are almost entirely reliant on banks for their financing. The ABLe should operate in a variety of ways to allow it to tap as many different sources of funds as possible. It could operate by buying, funding, guaranteeing or providing hedging of or to, either individual loans or aggregate portfolios of loans, from existing and future lenders, i.e. the originators of the loans.
- 1.29 We do not propose that the ABLe be a fully regulated bank. However, its place within and/or relationship with the recently announced Business Bank will be key. We are familiar with existing precedents where non-bank entities are utilised to support finance providers such as regulated banks in both funding and risk transfer, but further details of the Government's proposals for the Business Bank will be required to progress this analysis further.
- 1.30 The ABLe's key function would be to act as a bridge between SMEs and the capital markets using present and future loan originators. It would be agnostic about the ways in which it would both assume and divest assets and risk, and arrange its funding.
- 1.31 In order to achieve a significant impact quickly, loan origination, initial credit assessment, servicing and monitoring would be undertaken by existing and future loan originators. These would include, but not be limited to, established banks.
- 1.32 However, the ABLe would initially support the origination of new, long-term (5 years plus) finance. It could be targeted at other parts of the UK's market infrastructure that fall short, as they are identified in the future. Careful structuring and appropriate advice will be needed to ensure this is achieved, and to avoid in particular issues arising from State Aid rules.

The role of Government

- 1.33 We were set the task of designing a solution that could operate without Government support. This remains our medium- to long-term ambition for the ABLe.
- 1.34 However, having reviewed the international markets and discussed with investors, we have concluded that such a market would not be stimulated without support from Government. In particular, we recommend that, in line with international precedents, the liabilities of the ABLe carry a full guarantee from the UK government. By this we mean that where ABLe funds itself directly, or provides a guarantee, the providers of such funding or beneficiaries of guarantees assume the same credit risk as the UK government. Examples of types of funding and guarantees which ABLe might undertake are set out in the Technical Paper.
- 1.35 It is worth noting that the experience of other countries, particularly the US and Germany, is that the provision of access to wholesale funding has been supported by Government guarantees for a considerable time and no international equivalents have withdrawn government support. Of course, simply because empirically this has been the case does not mean that this is impossible to achieve, and it is certainly the case that the greater availability of performance data that we envisage being collected by the ABLe can only serve to increase liquidity and make it easier for private sector investors to participate more fully in the market.

The result

- 1.36 While of course much more work remains to be done on the details of (inter alia) costs and implementation, we hope that with Government support as outlined, the ABLe will represent a step change in the provision of funding to businesses, thereby facilitating capital markets participants to invest in businesses by creating the mechanism and incentives for investors to channel funding to SMEs and mid-caps who the Breedon Review predicted will experience a significant funding gap over the next 3-5 years.
- 1.37 The ABLe would also support competition and diversity in the banking markets by ensuring all lenders, regardless of size, could access capital markets funding support for their lending operations. The ABLe would provide a long-term solution, working with the grain of existing markets and leveraging existing origination and distribution channels.

2. The perspective of businesses

The landscape

- 2.1 Businesses in the UK range in size and diversity significantly: from self employed 'micro businesses' to sole traders and small trading companies to established businesses with high-scale growth opportunities; often many are family and private firms. The small business landscape in the UK is typically estimated at some 4.1 million enterprises with turnover typically below GBP1-2 million, with the remainder defined as 'medium-sized' enterprises (MSEs) with turnover from GBP2 million to GBP250 million. These businesses are again very diverse in structure, ownership and sectors.
- 2.2 The majority of micro companies have relatively simple working capital requirements, which can usually be met through overdrafts, credit cards, trade or asset finance which are offered by a wide range of finance providers including specialised lenders. These businesses are unlikely to require longer term capital unless they are on a clear and steep growth trajectory. The MSEs however often have the need for longer term finance of five plus years, which is capital-intensive for regulated banks to provide.
- 2.3 Direct access by businesses seeking long term capital from institutional investors to drive expansion and growth has traditionally been prohibitive to individual businesses as a consequence of due diligence processes, resource constraints, lack of appropriate expertise and high costs.
- 2.4 Equally MSEs individually do not generally have a large enough individual funding requirements to justify the cost and time required for a bond issuance, nor the resource or skills to manage the credit-related dialogue that is required with investors or rating agencies, or balance sheet dynamics.
- 2.5 Businesses want access to long term capital via a simple, quick and non-bureaucratic process with a relatively predictable outcome, and would welcome the ability to access greater pools of long term investors which are not banks.
- 2.6 This perspective is endorsed in the recent CBI report "Financing for Growth"² where it recognised the UK was entering a "new normal" for financing where a structural change in banking driven by capital and liquidity reforms changes the finance outlook for businesses and the need for the UK to implement measures that allow businesses better access to equity finance and non-bank capital markets investors. The CBI equally acknowledged that demand by businesses for finance is subdued with uncertainty over the economic outlook the biggest reason for a firm being cautious to invest; as a result there is a collective need to encourage confidence and demand in order to drive up usage of any new forms of finance solutions. Businesses will need support and education on alternative finance options.
- 2.7 When considering therefore the structure and nature of the ABLe, coupled with the business backdrop in terms of diversity, needs, resource capacity, expertise and day to day

² Section 1 of the CBI report cites the following as sources that indicate a subdued demand for finance: the Bank of England Credit Conditions Survey q1 2012; June Deloitte Survey of UK Chief Financial Officers; and the SME Finance Monitor Q1 2012 where the proportion of SMEs not applying for finance in the previous 12 months as being content not to do has risen from 68 percent in q1 2011 to 74 % by q1 2012.

demands we recommend that the following overarching principles should apply in the ABLe's design.

Principles for the ABLe

- 2.8 The ABLe intervention must be one that focuses on growth businesses that can directly impact the UK economy through expansion, employment, international aspirations and regional growth.
- 2.9 From a business perspective, for any solution created it will be crucial to easily understand:
- whether this type of finance/ capital is applicable to it;
 - where to apply and attain the investment finance;
 - who the party it is dealing with as the finance provider;
 - what are the terms;
 - where to get help/guidance and support in accessing it; and
 - where help can be found for the business if it gets into difficulty.
- 2.10 To encourage the confidence and demand in businesses to access finance through this route it will be important that ABLe demonstrates a sustainable and long term commitment .
- 2.11 The ABLe needs to be quickly scaleable to meet demand as economic recovery kicks in and needs to be flexible enough to take account of the diversity of businesses, their needs and regions and sectors they operate within, as well as the terms upon which businesses wish to access finance.
- 2.12 To cater for simplicity of approach for businesses the ABLe should seek to build on existing infrastructures.
- 2.13 The ABLe should be flexible enough to attract wholesale as well as retail investors (but avoid the need for investors to credit check individual business names).
- 2.14 The ABLe needs to be cost effective so as to ensure a business is not deterred by high costs or onerous application due diligence procedures.
- 2.15 Recognising that many businesses have an aversion to equity finance due to the concerns over 'ceding' ownership and/or diminishing control, it is recommended that the ABLe first concentrates on long term debt provision. This could be positioned or labelled as a long term capital instrument flexible in supporting term lending, or asset-based finance, or mezzanine finance.
- 2.16 The ABLe needs to cater for genuine viable growth propositions and needs to deliver an incremental source of funding.
- 2.17 The ABLe should seek to address the broader issue of branding of government support and the long held business desire to have one 'go to' agency and source of government-backed

schemes and support programmes in similar vein to the US Small Business Administration and the German KfW.

The business experience when applying for long term finance supported by the ABLe, and proposed business criteria

- 2.18 It is important for a business for it to be clear and simple to understand whether it is eligible for support from the ABLe and how to gain access to the support the ABLe provides.
- 2.19 For ease of access and simplicity we believe that it will be important for the business to be able to access the support from either its existing finance provider (where relevant) or from a known published approved participant to the ABLe programme. In addition, so that businesses expectations are managed it will be important for the ABLe to define minimum business criteria at the outset. We recommend these criteria be established along the following lines.

Business eligibility and the business experience

- 2.20 We believe the following types of businesses should be eligible for the ABLe:
- established UK businesses, or foreign businesses with UK presence, with track record and strong growth potential;
 - all sectors with the exception of financial services;
 - target turnover range expected to be GBP2 million – GBP250 million;
 - finance requirement is for term finance of five years plus (expected maximum 25 years); and
 - as a condition of finance provision additional UK jobs will be created.
- 2.21 In terms of the business experience when seeking to apply for finance supported by the ABLe it should occur in the same manner as it does today when seeking any finance offer, i.e. the business should approach the finance provider with a request for long term capital/finance in the usual manner. The business, just as it does today, would then discuss with its finance provider the form of finance most appropriate to meet the business needs including providing business plans, cash flow projections, strategy, etc., and completing the usual finance application process and documentation.
- 2.22 The business will then be assessed for that finance in the same manner that the assessment takes place today. Assuming the business is considered viable for the finance the money is provided by the finance provider to the business in the most appropriate form - for example a term loan, an asset-backed facility, a mezzanine finance product - and in the normal 'contractual' way, laying out relevant terms and conditions. Behind the scenes – and opaque to the business customer – the Participating Originator will earmark the finance provision for future ABLe support through its chosen aggregation methodology (see Section 4 below).

3. The perspective of investors

The landscape

- 3.1 There is a limited base of capital market investors here in the UK today who invest directly into SME businesses given the majority do not have the origination, credit assessment or resource to effect the end to end process for such investment.
- 3.2 Capital markets investors usually require a liquid market for portfolio valuation & disposals. Most require one or more external credit ratings and more detailed investor roundtable work will assist in determining exact requirements and the attractiveness of different options to their alternative investments.
- 3.3 The target businesses for the ABLe are more likely to attract investor interest where part of a secured and ring-fenced structure. Default rates amongst this business group are material at certain points in the cycle and as a consequence for investors it is likely that an additional credit enhancement is likely to be required in some form. This could be achieved by the lenders retaining first loss at a level sufficient to create an equivalent of an investment grade asset. Alternatively a government guaranteed element could enhance the credit rating even if only put in place as a short term measure to 'kick start the market'.
- 3.4 Investors with long dated liabilities may be prepared to invest in an asset class with the right risk/return as long as the risks are transparent, within their risk appetite and there is sufficient liquidity in the market for them to adjust their portfolios.
- 3.5 Investors will need to be confident that due diligence at issuance and ongoing information is available to enable liquidity to be maintained. This would potentially be complicated in a portfolio with multiple originators.

4. The perspective of the finance provider: the “Participating Originator”

Benefits for the Participating Originator

- 4.1 The ABLe will provide a reliable source of finance for originators who provide long-term finance to businesses according to pre-agreed terms. Because, initially at least, these loans will be for long term finance and incremental to those the finance providers make as part of their existing businesses, this will mean a deepening of their relationships with their existing clients and, potentially, winning new clients. In due course consideration should be given to any additional incentives that may be required for Participating Originators (such as perhaps fees payable for the origination, as well as an on-going fee for monitoring and servicing, of the loans originated and passed to ABLe).
- 4.2 The Participating Originator would be required to retain skin-in-the-game, not only to meet the requirements of recent EU legislation but also to assist the ABLe in ensuring appropriate risk management during both origination and the process of monitoring, servicing and if necessary restructuring loans during their life-time.
- 4.3 It is possible that after some years of successful operation the presence of the ABLe may act as an incentive for new entrants into the UK banking sector.

Becoming a participating originator for the ABLe – the process

- 4.4 All finance providers in the UK should be eligible to participate in the ABLe providing the provider is servicing businesses as customers and is able to offer loans, asset-backed finance and / or mezzanine type facilities to businesses. The “Participating Originator” can be a wholly- owned UK institution or a foreign-owned institution but with a UK presence. It can be a regulated or an unregulated entity. It will be the choice of a finance provider as to whether it wishes to participate in the ABLe programme. ABLe will be the decision maker regarding the suitability of a finance provider to do so.
- 4.5 In order for a finance provider to become a Participating Originator within the ABLe the following steps should occur:
 - the finance provider enters into a bilateral agreement with the ABLe (the “Participation Agreement”) to become a Participating Originator under the generic parameters laid down by the ABLe;
 - as part of the Participation Agreement the Participating Originator agrees to which businesses the Participating Originator will seek to provide finance, that is the eligible business which will be a part of the ABLe programme;
 - the Participation Agreement will require the Participating Originator to advise the ABLe of the product type or asset class it proposes to offer to businesses. This could be an existing product (for example, a term loan or asset-backed finance facility), or a newly named product (for example, a long-term capital bond);
 - the Participation Agreement defines the capital retention requirements for the Participating Originator. This will be sufficient to ensure the Participating Originator retains sufficient risk to maintain ‘skin in the game’ but not so much as to undermine

capital benefits to it. This principle is fundamental to ensuring that the ABLe creates funding capacity that otherwise would not exist.

- 4.6 Having provided finance to businesses as defined in the Participation Agreement the Participating Originator has the following options:
- to bundle the agreed assets itself into a portfolio ready to promote to investors pre-agreed with the ABLe. The ABLe assesses the portfolio to ensure it does in fact meet its required parameters as defined in the Participation Agreement and provides the guarantee to the Participating Originator for the agreed portion of the transaction. The Participating Originator undertakes the management and sale process to the investor base. The ABLe records its level of commitment within its balance sheet.
 - alternatively, the Participating Originator notifies the ABLe it has a sufficient pool of assets ready to be sold to the ABLe and bundled by the ABLe to the agreed investor pool. In this instance the ABLe again reviews the assets to ensure they meet its required parameters as defined in the Participation Agreement and will then itself, as ABLe, manage the end to end investor process.

How the relationship engagement with businesses operates

- 4.7 As in its normal course of business the Participating Originator promotes its services and products to businesses that fulfil the eligible business criteria. As referenced above, this may be an existing product brand or a newly created product that has been pre-agreed in the Participation Agreement.
- 4.8 The Participating Originator assesses the business finance proposal against normal credit criteria and underwriting standards. As long as the business meets the required viability tests the Participating Originator will provide the business with the finance requested. This is provided in the normal manner and under usual contract and pricing terms and the Participating Originator services the relationship with the business customer in the normal way.
- 4.9 Behind the scenes - and opaque to the business customer - the Participating Originator will earmark the finance provision for future the ABLe support through its chosen aggregation methodology.
- 4.10 The ABLe should support genuine viable growth propositions and needs to deliver an incremental source of funding.

What is the minimum role the ABLe has to play to attract participators?

- 4.11 In structuring the ABLe it must have sufficient flexibility to provide both a long term funding intervention and long term capital relief intervention. To achieve this, close liaison by bank originators with the FSA will be essential. If capital relief is not a feature then the number of likely participating originators will be reduced.
- 4.12 Equally a long term funding solution will be important to ensure that at times of market dislocation sustainable intervention available remains available.

5. ABLE – its establishment and role

Aggregation – why intervention is needed

- 5.1 The best guide to the economics of the aggregation analysis can perhaps be found in the small number of securitisations of SME loans that have been issued and placed with genuine third party investors (as opposed to central banks under repo arrangements) since the onset of the financial crisis. It should be noted that margins and market conditions can change quickly, so we would urge caution in placing excessive reliance on particular figures quoted at any one point in time.
- 5.2 In today's market, investors would require a margin of around 200 basis points per annum for a AAA/Aaa rated SME securitisation from a well-regarded originator/lender with a tenor of 7 years. A poorer quality portfolio backed with commercial mortgages could price much wider than this – say over 500 basis points. Both these re-offered margins are of course for the senior tranche only; the weighted average margin for the financing as a whole will be much higher. If regulatory capital is not released, then the capital-adjusted cost of funding is higher still.
- 5.3 In today's market, a business will expect to be charged a margin which will vary depending on whether the loan is secured or unsecured, fixed or variable rate, amount, term and the assessment by the finance provider of the credit risk of the business.
- 5.4 Assume now the ABLe intervenes by guaranteeing, in return for a fee, a mezzanine tranche of the credit risk of the loan, or of an aggregated pool of the loans. Because the ABLe carries the full faith and credit of the Government (we assume) then the (high and increasing) regulatory capital required to be held by the bank originator/lender would (subject to conditions including regulatory approval) no longer be required. The cost of such regulatory capital would be reduced and therefore the capital-adjusted cost of funding for the originator/lender would also be reduced. The fee payable to the ABLe for the guarantee would still be payable, of course, but it is assumed that this will be less than the weighted average cost of regulatory capital released.
- 5.5 This would facilitate the ability of the originator/lender to maintain the loan at a margin acceptable to the business while still meeting its internal return targets. Effectively this would be a pricing subsidy from the Government to the originator/lender. The Government is in a unique position to do this because of the favourable treatment sovereign credit risk is given under applicable bank regulatory capital legislation.
- 5.6 The regulatory capital released as a result of the Government guarantee will be redeployed to support additional lending. Appropriate mechanisms and terms within the Participation Agreement will be required to ensure this.

Establishment

- 5.7 The ABLe is established as a new PLC incorporated under the law of England and Wales. It needs to be a PLC to issue securities to investors.

- 5.8 The ABLe is potentially owned by a group of private sector shareholders, with independent directors to ensure the entity is off the UK Government balance sheet. Careful structuring and appropriate advice will be needed to ensure this is achieved, and to avoid in particular issues arising from the State Aid rules.
- 5.9 The UK Government provides support to the ABLe. This can be in the form of equity; general guarantees of the ABLe, and would include specific guarantees of SME loan portfolios/bonds acquired by the ABLe. Management and resources from government could also be deployed.
- 5.10 The ABLe is the interface between Participating Originators and investors.
- 5.11 The ABLe will not be a bank as a banking licence is not required for it to fulfil its functions; such a licence would add significant capital and operational costs which would materially and adversely affect its viability. Other legal issues as to required licences, regulatory approvals, etc. will need to be considered further.

Example operations undertaken by the ABLe

- 5.12 The ABLe should be agnostic about the types of funding or risk it supports. The Government guarantee is critical in creating the flexibility for the ABLe to operate in a variety of ways to allow it to tap as many sources of funds as possible.
- 5.13 For example, the ABLe could purchase portfolios from Participating Originators, or it could lend directly to them; or it could provide synthetic credit protection to a Participating Originator through a credit default swap. Funding could come from a single issuance of bonds backed by business loans; these could be secured or unsecured, and aimed at institutional investors, sovereign wealth funds or (subject to suitability, legal and other requirements) retail investors.
- 5.14 The ABLe could also guarantee elements of more complex financings structured by loan originators and supported by the same types of assets; this could provide the mechanism for the provision of regulatory capital relief for those loan originators who were banks, as the risk of lower rated tranches could be assumed by the ABLe giving those tranches a lower/zero risk weighting and enabling those banks to recycle the capital thereby released into new lending.
- 5.15 Some examples of possible funding / guarantee scenarios are listed below and in more detail with accompanying diagrams in Appendix 2.
- 5.16 Scenario 1: ABLe purchases portfolios of long-term loans from originators and issues a bond backed by that portfolio of loans.
- 5.17 Scenario 2: ABLe purchases portfolios of long-term loans from originators. ABLe creates a tranching structure, and sells each tranche to investors. ABLe guarantees the mezzanine tranche, which is subscribed by the participating originator. Because of the ABLe guarantee, the capital treatment of the mezzanine tranche in the books of the participating originator is less than before, creating capital relief (subject to the applicable regulation and the approval of appropriate regulatory authorities). This creates capacity for

additional business lending by the participating originator.

- 5.18 Scenario 3: the Participating Originator creates a tranching structure and sells the senior and junior tranches but retains the mezzanine tranche which is guaranteed by the ABL, again creating capital relief (subject to the applicable regulation and the approval of appropriate regulatory authorities).
- 5.19 Scenario 4: ABL purchases portfolios of long-term loans from multiple originators, combines them into a single portfolio and then raises funds by issuing a secured bond backed by the aggregate portfolio.

Common principles

- 5.20 Portfolios of eligible loans will be transferred to the ABL from Participating Originators in a 'true sale' transaction.
- 5.21 Participating Originators will need to retain risk in the portfolios to mitigate moral hazard but they will also need to transfer sufficient risk that the transactions deliver capital benefits to the originators – this is essential in creating the incremental capacity that the Breedon Report identified as being necessary.
- 5.22 In addition or as an alternative to funding or credit support, the ABL could provide structured support to improve the efficiency of the issuance, for example by providing guarantees of currency or interest rate swaps required to tap specific pools of investor demand such as European or US investors.
- 5.23 The ABL will charge a guarantee or funding fee to the Participating Originator.
- 5.24 The ABL should act as a point of data collection on the characteristics and performance of SME loans. Building up this track record of data will be an important role of the ABL.
- 5.25 The ABL would of course be responsible for managing its own risk appetite and monitoring and would control (directly or indirectly) which types of risk it would accept, in its sole discretion. The ABL could accept a range of degrees and types of risk depending on the characteristics of the financing proposal and assets in question.
- 5.26 The ABL would define eligibility criteria for the types of loans it will be willing to acquire. Compliance with these criteria would be monitored and recourse to the Participating Originators will be retained for loans which are found not to comply.

6. The role of Government

Considerations

- 6.1 In countries such as the US and Germany, governments support agencies that provide finance for SMEs. This is typically in the form of government guarantees for both wholesale lending and securitisation, and in the form of specific funding streams for SMEs delivered either directly or through private sector intermediaries.
- 6.2 We analyse two potential structures for the ABLe, a so called 'government heavy' structure and a 'government lite' structure.
- In the 'government heavy' structure the UK Government provides full guarantees for debt instruments issued by the ABLe to investors.
 - In the 'government lite' structure the UK government does not provide full guarantees but does potentially provide more limited guarantees and some liquidity support.
- 6.3 We do not extensively discuss the precise form of instruments to be issued by the ABLe as we believe that once the guarantee structure is decided upon, the ABLe will be able to issue multiple types of debt instruments (e.g. asset based bonds to capital markets, retail bonds, forms of covered bonds etc.)

Recommendation

- 6.4 We recommend that the 'government heavy' structure be adopted. Adoption of this structure should deliver:
- Capital benefits to originators, creating incremental 'capacity' in the system.
 - Capital markets instruments that investors are familiar with, can understand quickly and can price utilising existing methodologies and benchmarks.
 - Instruments which investors will be more comfortable to invest in for longer maturities (> 5 years) – the ABLe can pass longer term funds raised in the capital markets to SMEs to provide the longer term funding and capital they will need as the economy grows.
 - Easier and cheaper hedging opportunities – for example, currency swaps – which could facilitate access to EU or US investors.
 - Pricing benefits over the government lite structures which can be passed on to SME borrowers.

7. Scale: assessing possible volumes

- 7.1 It is difficult to predict with certainty the volumes of incremental funding that could be created as a result of the establishment of ABLe. Critical variables will include:
- the overall level of demand in the economy, economic growth, and consequently the demand from SMEs;
 - the varying risk appetite from investors: much depends on the details of structures, asset quality and performance, origination and underwriting systems; and
 - the different pools of investors that may be available to invest: European Union or US-based investors will be currency-driven and sensitive additionally to how cross-currency risks are managed through swaps
- 7.2 Having said that, a number of factors which exist today can be taken as the basis for some reasonable estimates of potential scale, including
- the current size of the SME securitisation market: we appreciate that the ambition of ABLe goes beyond just securitisation, but today's securitisation market provides useful pointers; and
 - the volumes achieved by government-supported agency funding programmes elsewhere; it should be noted in particular that in Germany KfW has issued over EUR 70 billion of debt during 2010 and 2011, and EUR 45 billion so far in 2012

This demonstrates, and anecdotal evidence we have gathered during this study confirms, that investors do have appetite for suitably structured and supported agency debt including debt backed by SME loan collateral.

- 7.3 The more detailed analysis in our Technical Paper therefore seeks to set out:
- the incremental funding that can be achieved by designing bonds for capital markets investors whose risk and other features attuned to specific pools of investor interest; and
 - the more efficient use of regulatory capital through the “recycling” effect of capital relief (where it can be achieved) by regulated bank originators, coupled with redeployment of such capital in the same sector thus supporting additional lending
- 7.4 In the former case, the “funding” trade, the ABLe effectively intermediates between originators who would not otherwise have access to the capital markets and the capital markets themselves.
- 7.5 In the latter case, the “capital” trade will allow originators who potentially have access to sources of funding but are constrained by their regulatory capital base to create capital ‘headroom’ to allow them to extend incremental facilities to the SME sector:
- the ‘impact’ of such a trade is difficult to quantify but given that the guarantee amount will be smaller than that required under a funding trade, the ‘bang for buck’ is likely to be higher;
 - it should be noted that in a “capital” trade the ABLe risk participates and in so doing releases incremental capital into the system. This addresses a fundamental gap identified in the Breedon report.

8. Legal and regulatory considerations

- 8.1 Representatives of several legal firms have participated in the working group discussions and in preparing this Report. The proposals in this Report allow for a range of legal structures and transaction types involving different kinds of counterparties and investors. As such it is not possible at this point to address legal and regulatory considerations in detail. Subject to the resolution of EU state aid issues and to political and economic considerations, while legal and regulatory considerations would obviously shape and limit the ABLe's structure and activities in some ways, we have not identified any specific legal or regulatory issues that would likely prevent implementation of a programme having the main characteristics proposed in this Report.
- 8.2 Regulatory status of the ABLe: Based on the proposals set out in this Report, it should be possible to structure the ABLe such that it is not regarded for UK regulatory purposes as a bank or as an entity undertaking regulated activities in general (except for consumer and data protection laws referred to below). We do not expect any licensing requirements to present wider issues, but further consideration will be required in the course of developing and implementing any specific programme. In particular, the ABLe's funding arrangements will require further consideration, as will its investment activities to the extent that the ABLe may hold itself out as conducting market making or dealing activities.
- 8.3 Consumer and data protection: the ABLe may be subject to certain provisions of consumer credit legislation and data protection laws if it acquires or finances credits to smaller SMEs. We expect these requirements, if any, can be managed in an acceptable manner as in other structured financings of SME credits.
- 8.4 Ownership structure: the ABLe's ownership structure, capitalisation and governance structure will need to be considered. In particular, accounting or regulatory considerations will potentially impact persons having equity or equity-like investments in the ABLe. These considerations are likely to be easier to resolve in a "government heavy" model where the need for substantial internal capital is likely to be reduced. However, ownership, capitalisation and governance of the ABLe in a "government heavy" model will impact the extent to which the ABLe will need to be regarded as a public sector entity.
- 8.5 Risk retention etc: Structures that involve tranching of credit risk of pools of exposures where payments to investors depend on performance of those exposures will be treated as securitisations for purposes of bank risk-based capital rules, will be subject to risk retention and due diligence requirements applicable to European bank investors and, probably, subject to similar requirements that will apply to insurance and reinsurance undertakings and certain investment funds and fund managers. It is likely that the originating lenders will need to retain 5% first-loss or pro-rata economic risk of the SME credits.
- 8.6 Bank capital relief: The "government heavy" model should enable bank originators to transfer significant credit risk to the ABLe so that, if other operational requirements are met, the originators may reduce their risk-weighted capital requirements with respect to the transferred assets. Whether an originator can achieve significant capital savings in a particular case will depend on the specific terms, the risk profile of the transferred assets, regulatory approval and other factors.

- 8.7 Investor criteria: Certain investment products may be designed to meet eligibility requirements for central bank funding where appropriate. Treatment for purposes of bank liquidity standards and other regulatory classifications to be considered. These matters will depend in part on the content of central bank funding criteria, which are altered from time to time, and on the CRD IV liquidity standards, which are not yet in final form.
- 8.8 Other issues: A range of other legal and tax-related issues would need to be considered in relation to specific ABLe structures and products, as in relation to any securitisation or structured debt issuance backed by SME credits or similar assets. These issues include:
- method of transfer of underlying SME credits, or interests in or risks and benefits of those credits, to the ABLe or investors, including any restrictions on transfer;
 - borrower set-off rights, arising under the terms of underlying contracts or by operation of law, that in some circumstances could limit the ABLe's or investors' rights to payment on transferred loans;
 - legal eligibility criteria for subject credits, including criteria designed to limit or exclude, for example, risks arising from transfer restrictions or set-off rights referred to above;
 - limitation of the ABLe's exposure to originating lender credit risk, including measures designed to achieve legal isolation of transferred assets, putting them out of reach of the transferor and its creditors even in an insolvency proceeding involving the transferor;
 - tax treatment of the ABLe and payments to and by the ABLe; and
 - securities law requirements, including disclosure requirements and selling restrictions.

The specific treatment of these issues may vary depending on the nature and characteristics of the transferors and the assets the ABLe would acquire (or as to which it would provide credit enhancement), the ownership structure, capitalisation and other aspects of ABLe, the types of securities or other investments offered to investors, and other factors. Though these issues would need further work in the context of any actual programme, they have been solved in previous transactions and we have not identified any that are likely to be especially problematic.

9. Implementation and timing

- 9.1 A formal project management team should be drawn up from private sector and government to establish the entity, which could either be housed in an existing government structure or alternatively within a new structure such as the Business Bank.
- 9.2 This team will need to have a dedicated lead manager, a dedicated project implementation office and a steering committee. In this regard the Government may consider leveraging existing resources familiar with such interventions such as Capital for Enterprise; the Shareholder Executive (who have recent experience with inter alia the UK Green Investment Bank) and other resources.
- 9.3 The implementation team will need to draw on varying disciplines and have as work streams working on, inter alia:
- corporate structure;
 - regulatory approvals;
 - human resources;
 - operational logistics; and
 - criteria and parameters of operation including business plan, funding arrangements, investor base and participating originator base, etc.
- 9.4 With the recent announcement of the new Business Bank, one scenario is that ABLe may be part of broader entity that could also be undertaking other activities such as bringing together the various different existing Government funding schemes.
- 9.5 In all cases, the staffing of ABLe needs careful consideration to ensure that the personnel have the appropriate skills and the structure is capable of undertaking the tasks required and have the full confidence of all counterparties. As the capital markets are perpetually changing, especially with respect to investor demands and pricing expectations, ABLe will need to have staff with the necessary background in the capital markets. In addition, it will need to have personnel able to understand the mechanics and issues involved in lending to small and medium-sized enterprises, so that the dialogue with Participating Originators is strong.
- 9.6 We suggest consideration be given to the process used by the Asset Protection Agency ("APA") some years ago. The APA was established in December 2009 by H.M. Treasury to operate the Asset Protection Scheme ("APS"). Under this, the APA had a role to protect financial institutions participating in the APS against exceptional credit losses on certain portfolios of assets. The APA was built up quickly and rather than always use in-house resources, it used a Request for Proposals ("RFP") process to produce a list of specialist firms that would be employed on specific portfolios.
- 9.7 Applying a similar process to the ABLe, a similar RFP could be produced and after the necessary due diligence on the responses a list of qualified external parties would be produced. Each of these parties could assist the ABLe in assessing one or more portfolios of SME loans; more permanent service level agreements could also be established. Under this model, the staffing of the ABLe can be established more quickly; staffing can also be more streamlined as certain tasks can be outsourced. Another benefit is that having run a similar process for the APA, H.M. Treasury has practical experience in such an approach.

- 9.8 The other advantage of using external parties to check a potential portfolio is that it widens the number of parties who bring an objective assessment to the loans in question beyond the Participating Originator. Having a third party independently check the suitability of proposals brought to ABLe by Participating Originators could add further confidence to investors over and above ABLe's direct support through its guarantee.
- 9.9 Some participants in our study have experience not just of the APA but also of, for example, the Business Growth Fund where a dedicated core team of individuals from across disciplines (legal, regulatory, banking, finance, consultancy) performed as the core project team under the supervision of a steering committee responsible for driving the various components forward depending on workstream.
- 9.10 In the case of the Business Growth Fund an aggressive timeline was set for achieving operational status within 6 months.
- 9.11 Outline steps are attached in Appendix 3.

Appendix 1: participants in the Feasibility Study

Richard Hopkin (AFME)

Richard Watson (AFME)

Phillip Monks (Aldermore)

David Krischer (Allen & Overy)

Alex Batchvarov (Bank of America Merrill Lynch)

Charles Gundy (Bank of England)

Allen Appen (Barclays Capital)

Irene Graham (BBA)

Adam Marshall (British Chamber of Commerce)

Mario Levis (Cass Business School)

Lucy Armstrong (CBI SME Council)

Kevin Ingram (Clifford Chance)

Tom Fogarty (Deloitte)

Priyen Patel (Federation of Small Businesses)

Ashley Kibblewhite (FSA)

Mike Conroy (HSBC)

David Petrie (ICAEW)

Georg Grodzki (L&G Investment Management)

Reinald de Monchy (Lloyds TSB)

Gillian Walmsley (LSE)

Mark Hutchinson (M&G Investments)

Kevin Hawken (Mayer Brown)

Charles Roxburgh (McKinsey Global Institute)

Eric Wragge (J.P. Morgan)

Michael Slevin (RBS)

Craig Rydqvist (RBS)

Nicholas Bamber (RBS)

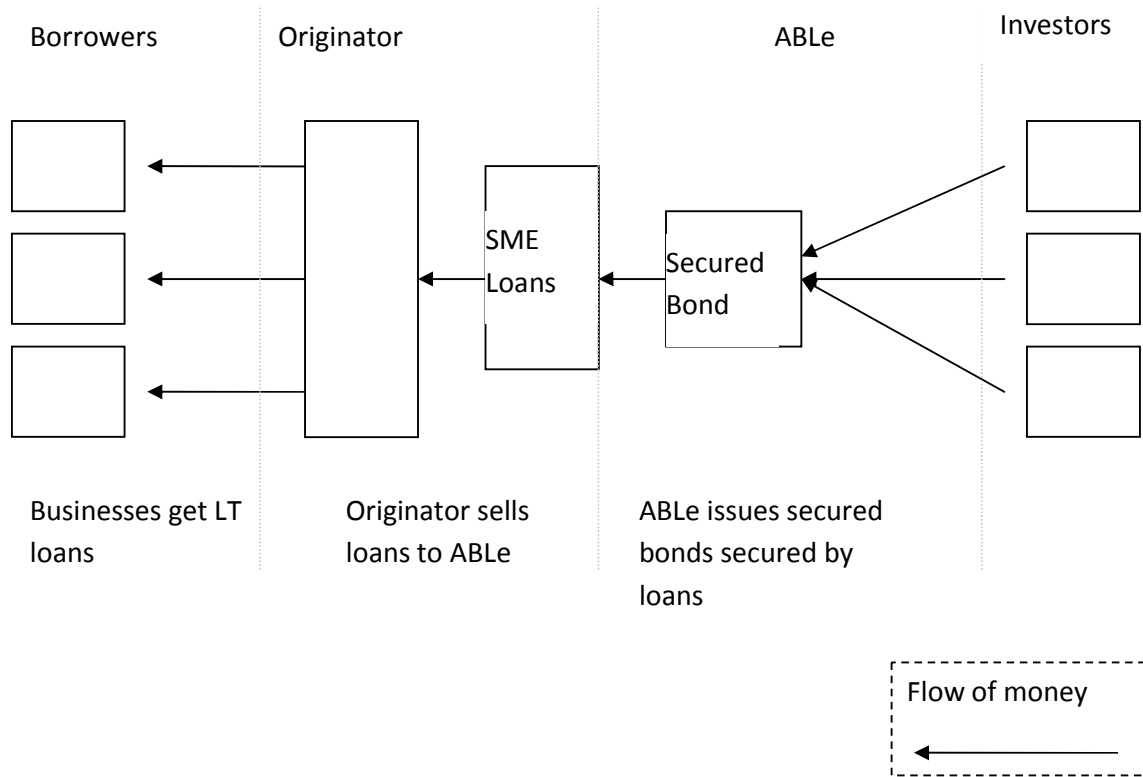
Liz Williams (Santander)

Appendix 2

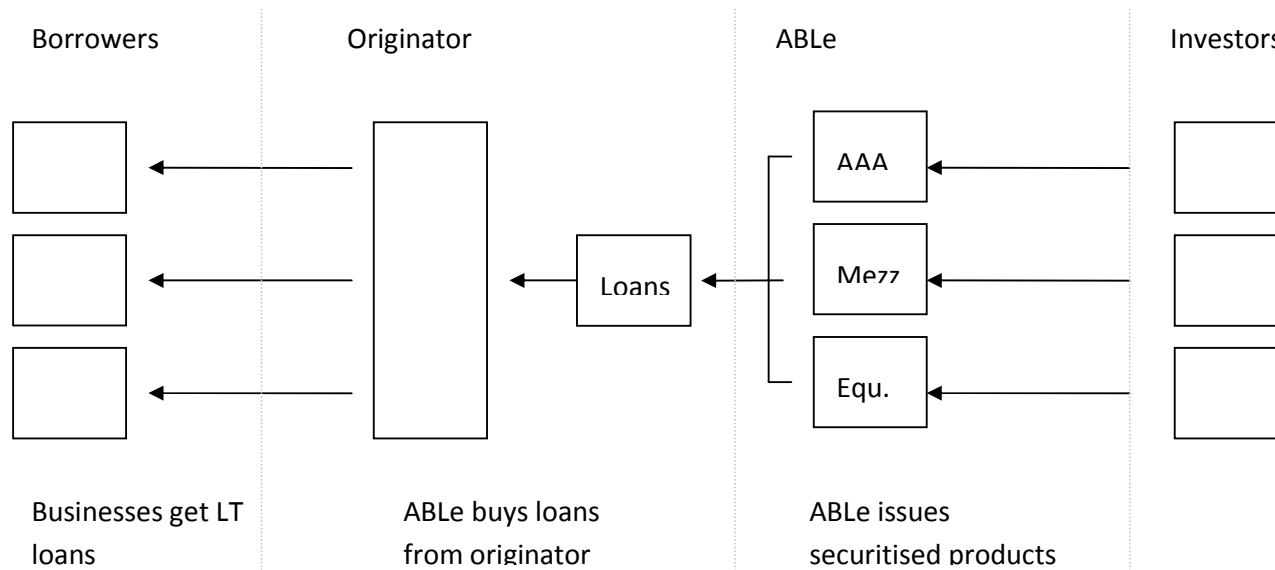
ABLE should be able to operate in a variety of ways to allow it to tap as many sources of funds as possible. Four possible approaches are illustrated below.

Approach 1

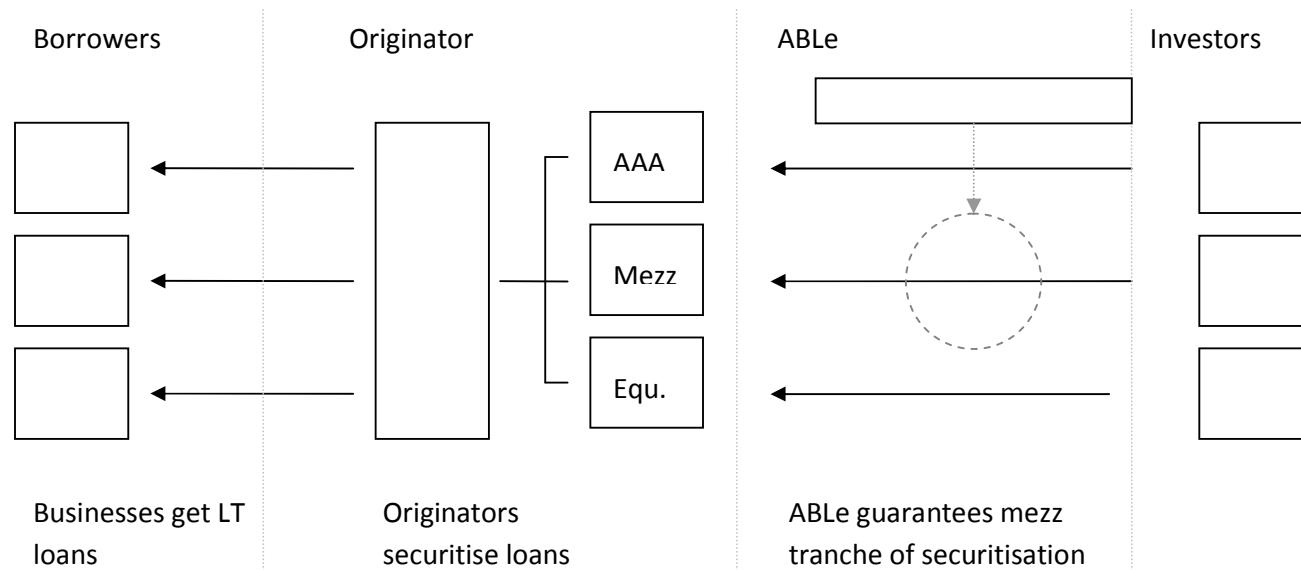
ABLE purchases portfolios of long-term loans from originators and issues a bond backed by that portfolio of loans.



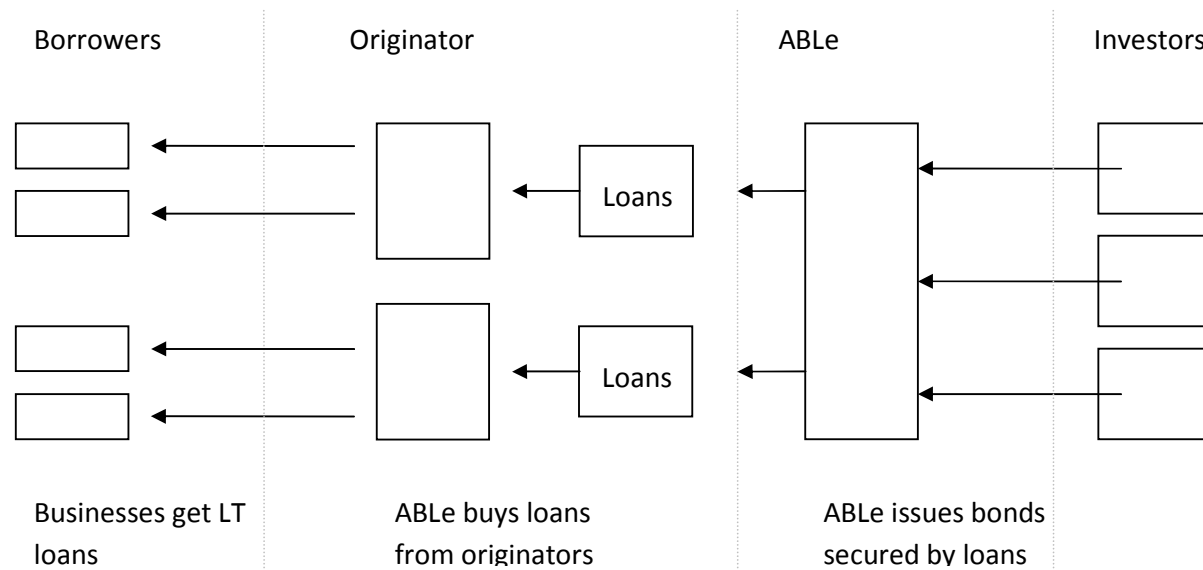
ABLE purchases portfolios of long-term loans from originators, creates a tranching structure, and sells each tranche to investors. ABLe guarantees mezzanine tranche, which is retained by the originator which then receives capital relief.



Originator creates tranching structure and sells senior and junior piece. Originator retains the mezzanine tranche, which is guaranteed by ABLe, providing capital relief.



ABLE purchases portfolios of SME loans from multiple originators, combines them into a single portfolio and then raises funds by issuing a secured bond backed by this portfolio.



Appendix 3 - outline implementation activity required to establish ABLe

Aiming for a 6-9 month set up to become active within 9-12 months

Shareholders' Agreement

- Identify shareholders
- Agree shareholding parameters and entity capital parameters
- Legal Request for Proposals
- Appointment of lawyers
- Confirm capital parameters and confirm Tax Status
- Establishment of Initial Company
- Shareholders Agreement
- Signing of Shareholders Agreement

Regulation and State Aid

- Regulation of the Entity
- Agreement upon regulatory treatment of the aims of the entity with FSA etc
- Review of State Aid issues

Business Strategy and Planni

- Accountants Request for Proposals
- Appointment of Accountants
- Organisation Structure
- Operational Requirements
- IT Costs
- Market Survey
- Draft Business Plan
- Review by Shareholders
- Sign-Off by Shareholders

Operations

Premises

- Interim Offices
- Possible Locations
- Possible Medium Term HQ
- Regional Offices

Information Technology

- Communications (Telephone, E-Mail)
- Short Term IT Suppliers
- Possible IT Suppliers and Proposals
- Medium Term IT Suppliers

Policies and Procedures

- Expenses

Finance Structure

- Payments to Suppliers
- Payments to Companies
- Payroll to Employees
- Appointment of Bankers
- Insurance

Communications

Suppliers' Brief
Agreed Generic Information
Internet Site
Standard Responses to Contacts
Marketing and Communications Strategy
Branding
Marketing (Advertising)
Communications (Speeches, Op Ed)

Investment and operational Framework

Standardised Criteria
Standardised Process
Standardised Investment Analysis
Proforma Heads of Terms
Proforma Contracts

Arrangements with Third Parties

Due Diligence Providers
Legal Panel

Human Resources

Recruitment

Executive Search Request for Proposals
Chairman
CEO
Board Representatives
Government Board Representative
Non-Executive Directors
Investment Management
Key Support Functions
- Finance
- Operations
- Marketing and Communications
- Head of Legal/Coy Secretary

Employment Contracts

Senior Management
Staff
Remuneration Policy