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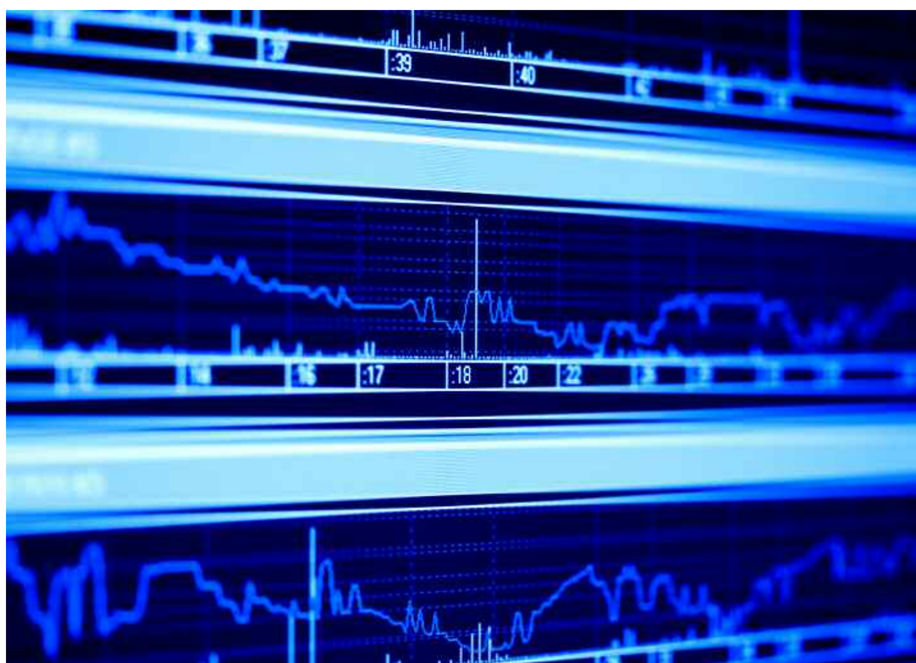
Can new forms of finance provide support for the real economy?

While economic growth depends on the ability of companies to access finance, banks face new regulations that threaten to constrain lending. How to square this circle is a conundrum facing the UK Government. The challenge of raising capital for the real economy also extends beyond banks to other lenders including government efforts to fund infrastructure projects. Journalist Brian Thompson hears Clifford Chance specialists assess the problem, examine the latest proposals and consider the other approaches that could be used.

Access to finance is a crucial issue for both business and the UK's policymakers. While lending has been constrained ever since the credit crisis, the growth needed to help the UK emerge from austerity requires it to be expanded. A further complicating factor is that banks, which were already deleveraging to repair their balance sheets, are now required by impending regulation – such as Basel III and CRD IV – to be even more careful about how they allocate their capital.

The Government has responded to this situation by introducing several initiatives that are designed to get money, whether from banks or other lending sources, flowing to where it is most needed – the real economy.



Despite the seriousness of the problem at a macro level, perhaps a practical question financial institutions should consider when looking at these initiatives is why they should be interested in any of them. Kevin Ingram, a partner in Clifford Chance's Capital Markets practice, believes that there are two very good reasons for financial institutions to be up to speed on the latest developments. The first is defensive. "With the topic so prominent in the public and political eye, it is inevitable that there will be changes resulting from these initiatives, and market participants need to be aware of how these changes might impact their markets," he explains. The second reason is positive. "There will undoubtedly be opportunities in the financial sector on the back of these new initiatives," he adds.

Project Merlin

The failure of Project Merlin to deliver the intended outcome for small businesses was undoubtedly fresh in the mind of the current Government as it designed its new proposals. While the agreement between the Government and various high street banks to lend UK businesses a total of £190bn has met its target in terms of gross lending, it has failed to do so on both the targets for net lending and small business finance.

Businesses have complained that they have missed growth opportunities because they could not access funding at the right time. They have also complained that there have not been enough alternative sources of funding to banks. Meanwhile, banks have argued that, in difficult economic conditions, and with the cost of wholesale lending still relatively high, they could not lend more. Faced with this impasse, the Government, which is trying to cut public spending, has not been willing or able to make up the shortfall.

"The result of this mismatch between supply and demand is a funding gap that is estimated to reach between £84bn and £190bn over the next five years," says Maggie Zhao, a senior associate in Clifford Chance's Capital Markets group. There are no easy solutions to this problem. The European Union's promise to look again at the capital charges associated with loans to small businesses to find out if it can help to free up lending is unlikely to provide an answer in the short term. However, Chancellor George Osborne,

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> **Kevin Ingram**, Partner, Clifford Chance

who has publically stated that he wants the UK to be the best place in Europe to start up and grow businesses, is keen to act quickly. This goal has resulted in the creation of two principal credit easing initiatives.

The National Loan Guarantee Scheme

The National Loan Guarantee Scheme (NLGS), which was set-up to help SMEs access cheaper finance, is open to companies with an annual turnover of up to £50m. The Government's intention is that, by providing a guarantee to the banks on their senior unsecured bond funding, banks will be able to access the wholesale funding market at a cheaper rate and pass this benefit on to their borrowers. The scheme should enable a business taking out an NLGS loan to receive an estimated discount of up to one percentage point compared to the interest rate that they would otherwise have to pay. The total value of the government guarantee is £20bn, with £5bn made available in the first tranche. Banks that have so far signed up to the scheme are Aldermore, Barclays, Santander, Lloyds and RBS. It is important to note that, because the Government is not guaranteeing individual loans to businesses, it is not taking on the credit risk of loans made under the scheme – that risk is retained by the bank and therefore its usual lending and credit parameters apply.

Unlike Project Merlin, the NLGS looks to have more prospect of success as it addresses both business and the banks obstacles to the provision of lending. However, there are a few caveats. First, it has been left up to the banks to decide the minimum level of loan. This choice allows them the freedom to rule out exactly the type of small, higher risk loans needed by start-ups. By leaving credit risk with banks, there is the risk that only the safest bets will benefit from the scheme, which could defeat its purpose. The scheme's usefulness could be further limited by restricting it to term lending and not extending it to services such as revolving credit facilities, overdrafts, invoice financing and business credit cards. "The end result could be a scheme that makes lending cheaper only to those businesses who currently access it anyway," says Kevin Ingram.

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The Business Finance Partnership

The Government has addressed the issue of non-bank financing through the proposed Business Finance Partnership (BFP) in which the state will co-invest with the private sector in managed funds that will lend directly to mid-sized businesses that have annual turnovers of up to £500m. The first £100m of a package that could total £1.2bn has already been allocated and the Government is set to commit as much as 50% of initial investments and up to £250m in any single fund. Following a request for proposals from private sector partners, the Government has named seven shortlisted fund management groups (including M&G Investments and Cairn Capital) who have agreed to co-invest with the Government.

Infrastructure and beyond

Financing growth in the real economy extends beyond lending to small and mid-market businesses: it also covers various other areas including larger corporate lending, funding for infrastructure and high-value retail items such as car loans and mortgages.

The issue of funding infrastructure projects presents the Government with another dilemma: while building new infrastructure can both stimulate short-term growth and support medium-term economic success, it can also add to the public sector expenditure which the Government is seeking to reduce. "With current planned investment in UK infrastructure estimated by HM Treasury to be worth over £250bn, and the private sector currently funding two-thirds of UK infrastructure, attracting significant private sector investment is vital" says Clare Burgess, a senior associate in the Capital Markets practice in London and part of the global Energy and Infrastructure group. However, attracting it depends on the Government's ability to address current obstacles such as the lack of bank lending capacity and the post-credit crisis absence of monoline insurers from the infrastructure market which has reduced bond market finance to a dribble.

The Government is taking action on three fronts. First, it has proposed a package of measures to encourage investment in infrastructure, including identifying a pipeline of 500 projects to help those involved to plan appropriately and creating a Cabinet committee to help progress priority projects. The focus has clearly shifted to economic infrastructure such as transport, energy, communications, water and waste, and away from social infrastructure, such as schools and hospitals. The Government has announced reforms to the planning process to speed up projects.

Secondly, the Government is looking at alternative models for financing infrastructure, and has announced its intention to reform the Private Finance Initiative (PFI) procurement model. PFI has been used to deliver around 700 projects in the UK over the past 15 years and, by placing the financial risk of delivery with the private sector, creates strong incentives for projects to be delivered on time and on budget. However, PFI appears to have fallen out of public favour, being seen as expensive and inflexible. The Government issued a call for evidence in December 2011, seeking proposals for new delivery models which deal with these issues whilst retaining the benefits of PFI. The Government specifically indicated that new models should enable access to a wider range of financing sources, including pension funds investment.

New financing models for UK roads have received specific attention, with the Government indicating that tolling for new roads may be their preferred way to fund investment without making demands on the public purse. With regard to the wider road network, the Government may be looking to apply the Regulatory Asset Base (RAB) model of financing more broadly. This model is already applied to water companies and BAA, which have continued to raise finance through the credit crisis, including in the capital markets. In a recent speech, Prime Minister David Cameron queried why roads are funded with public finance when other infrastructure such as water is funded by private sector capital through privately owned, independently regulated utilities. The RAB model is most easily applied in relation to regulated activities where there is an ability to levy charges to users. An initial value, or RAB, is assigned to the assets used for the regulated activities (usually on privatisation), and further efficient capital expenditure can increase that value. An acceptable rate of return on capital is then agreed with the regulator, and applied to that RAB. This level of return is a key element used to determine the charges to customers. Those charges are typically reviewed by the regulator every five years, so there is level of certainty and confidence around the charges and expected returns which is attractive from a financing perspective. The regulator setting the permitted level of profits may also be politically advantageous (particularly when compared with returns made by the private sector on some early PFI

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deals). A feasibility study by the Department for Transport and the Treasury into new ownership and financing models for the UK's roads system will report in the autumn.

The Government has also recognised that the market may not be able to bear every risk in major new projects, and has announced it will make available up to £1bn by way of government guarantees to support specific projects. The Thames Tideway tunnel has been identified as a project which could receive a guarantee in respect of certain unusual construction risks. It is clear though that these guarantees will only be available in limited circumstances, and the Government will need to be convinced that best value for money for taxpayers and users is achieved by it taking on risks rather than the private sector pricing them in to the cost of finance.

New structures to enable local authorities to raise finance to invest in infrastructure have also been introduced, including the Community Infrastructure Levy, which allows authorities to charge developers undertaking new building projects in order to fund local infrastructure needed as a result of development, and Tax Increment Financing, which allows authorities to borrow against predicted growth in their locally raised business rates and use that borrowing to fund infrastructure to support local economic growth. Tax Increment Financing may be trialled on the extension to the Northern Line – part of the London underground metro train system.

Finally, the Government is looking for new investors in infrastructure. Commercial banks have historically provided around 80-90% of infrastructure private debt, but capacity for infrastructure loans, which typically have longer maturities and are relatively illiquid, is now severely constrained by the banks' constrained balance sheets and the coming implementation of Basel III so margins on any such loans (which have in the past been relatively low) can be expected to increase. Recognising this, the Government is looking to attract investment from sovereign wealth funds, pension funds and insurers. The Government is helping to set up a Pension Infrastructure Platform to be run by professional fund managers, into which pension funds can invest. This has a "first wave" target to raise £2bn of investment by 2013. The Government is also working with the Association of British Insurers (ABI) to set up the Insurers' Infrastructure Investment Forum. Overall, the Government is looking to raise investments worth up to £20bn from pension funds and insurers.

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Challenges and solutions

"Although both pension funds and insurers have a natural fit with the long-term, often inflation-linked investments that infrastructure can offer, investment by such institutions in greenfield infrastructure debt has historically been limited" explains Clare Burgess. Where debt investments have been made, often by larger institutions, these have often been in monoline wrapped project bonds, which achieved a AAA credit rating on issue and benefitted from the ongoing monitoring function performed by the monolines. Given the previous investment model, the pension funds and insurers may currently lack the dedicated teams with specialist knowledge of infrastructure finance to enable them to evaluate and manage specific investments. The Government's various initiatives may help with building up this knowledge and momentum.

However, regulatory requirements are likely to pose a more daunting challenge. Under the standard approach in the current draft of Solvency II, the EU's new regulatory regime for insurers, infrastructure debt is treated in the same way as corporate bonds, even though studies have shown project bonds have tended to have a lower default rate and loss-given-default than corporate bonds with the same ratings. Insurers will have scope to apply their own internal risk models to reflect this reduced risk and thus determine a lower capital charge, but this model requires approval by the regulators and therefore this route may not be attractive to all institutions. Clearly if Solvency II could recognise infrastructure credit risks as a separate asset class within the standard model, this could make a significant difference to investor appetite.

The capital charges also increase with debt maturity, so will not be favourable

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for long-dated infrastructure debt, although there may be some scope for insurers to reduce capital charges through the "matching premium" provisions where the duration of their assets and liabilities can be matched. Solvency II also includes relatively higher capital charges for investments rated below single A, and there are currently limits on the percentage of BBB rated credits which can be included in portfolios benefitting from the matching premium. The ABI has said that a minimum single A rating is required to invest, meaning that credit enhancement may be needed for many infrastructure projects. It is hoped that the EU 2020 Project Bond Initiative could provide the necessary ratings uplift. This initiative, which is currently in pilot phase, will offer credit enhancement for senior bonds by way of either a contingent credit facility or a mezzanine loan provided, in each case, by the European Investment Bank (EIB). In addition to the credit enhancement, it is hoped that the involvement of the EIB will be seen as a form of "kitemark" and encourage wider investment.

Despite their pariah status of late, Collateralised Debt Obligation (CDO) issuance of notes backed by portfolios of project loans made by banks could also provide a solution. This would utilise the banks' vast experience in putting together infrastructure deals, which are then refinanced through the CDO structure so that funds can be released for other projects. If this refinancing is done after the construction phase, there is the added benefit of permitting phased drawdown of debt, avoiding negative carry. Infrastructure debt funds, which take project loans from banks either after construction or from first close, are also gaining momentum.

Finally, retail investors may provide a previously untapped source of funding for infrastructure. Utilities companies have already raised finance from retail investors by the issue of bonds listed on the Order book for Retail Bonds of the London Stock Exchange, often at competitive pricing levels. With the UK retail investment pool being around £1,000bn, there is scope for companies who are known to and understood by retail investors to access these funds. In addition, the idea of retail investors buying bonds to finance the development of local infrastructure is attractive and a good fit with the Government's localism agenda.

Investor of last resort

While the Government, constrained by austerity measures, is reluctant to add infrastructure risk to its balance sheet, there are limited exceptions. These include the government guarantees discussed earlier and, notably, the Green Investment Bank (GIB). The initiative provides an opportunity to see this Government's approach to funding. Sir Adrian Montague, chair of the GIB advisory committee, said in a recent interview that the bank would base its lending on commercial principles, rather than make risky investments in early stage technology or offer preferential rates. While this comment may strike the right note with free market politicians and concerned tax payers, it

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raises the question of how effective the GIB will be at unlocking the many funding constraints in the sector. The GIB will invest £750m from April 2012 and will provide a total £3bn of initial capital over three years.

Non-bank lending stepping up to the plate?

According to Karen Hodson, a partner in Clifford Chance's Banking practice, non-bank lending is nothing new. "Although investment grade lending to corporates is very much the banks' domain, non-banks have long played a major role in areas such as leveraged finance," she says. An interesting recent development is, however, the emergence of corporate financing funds, such as the one established in 2008 by fund managers M&G Investments in response to the decline in corporate lending by the banks post credit-crunch. The purpose of the fund is to lend longer term loans to medium-sized UK companies. Factoring, securitisation and supply chain financing are also well-established routes by which funding can reach the real economy through non-banking sources. Indeed, cash-rich corporates are increasingly using their own funds to support their customers and suppliers, for example through supply chain financing.

However, it would be unwise to write the banks out of the picture altogether as their expertise and resources are likely to remain essential. In leveraged finance, for example, banks commonly provide all the funding before syndicating the loan to non-bank investors. The ability to assess complex projects, analyse risk, optimise tax position, leverage long-term client relationships and manage the documentation process means that banks will almost certainly remain essential to deals even if they are not the major end-investors.

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As for traditional capital market investors, they are likely to have little appetite for deals to support small business lending unless some sort of bundling is undertaken. In a report commissioned by the Business Secretary to look at ways of diversity by business finance (Breedon Report), which was published in March, the issue was highlighted. The Breedon Report recommended some form of an aggregation agency to lend directly to SMEs or pool SME loans to facilitate their access to the public corporate bond markets, but details about exactly how such a scheme might work, and who would undertake the credit analysis, are as yet unclear.

A feasibility study is also being undertaken by the Association of Financial Markets in Europe to explore issues such as the form the aggregation agency should take, the actions it should perform, the impact on the wider economy of the creation of such organisation and the role that can be played by the government.

There are a couple of initiatives for securitisation and covered bonds that aim to offer a "kitemark" type quality labelling to allay investor concerns and stimulate the market. There is a proposed self-certification scheme for covered bonds which would provide assurance on meeting appropriate regulatory and disclosure standards. As for securitisation, the industry-based Prime Collateralised Securities initiative is due to be launched later this year. It will provide independent verification on areas such as quality, transparency, simplicity and liquidity.

Various innovative initiatives to boost the retail housing sector have also been launched. The recently announced New Buy Guarantee Scheme offers an innovative way of stimulating the first-time buyer market at a time of caution by mortgage lenders. In essence, the scheme works by enabling housebuilders and the Government to guarantee part of a homebuyer's mortgage, allowing borrowers to take out larger loans than they might otherwise have been eligible for. Although the scheme is unlikely to make a significant impact, it is a good example of the Government's creative approach to social funding.

Finally, it is worth noting the role of Export Credit Agencies (ECAs), which now have more flexibility in the support they offer companies. The UK's Export Credits Guarantee Department (ECGD) can, for example, issue bonds to support performance obligations, assist in covering off FX exposure and make working capital available. These are valuable tools that will help companies that are short of capital.

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What else can be done?

While many of the initiatives that have been described in this article have real value, the most effective long-term means of incentivising small business lending is likely to lie in reducing its capital cost to banks. The EU is looking at this issue in detail in the context of CRD IV. Hopes are high that the EU will find a way to reduce capital allocation for SMEs. Similarly, any preferential capital treatment for infrastructure investments which may be included in CRD IV or Solvency II would provide a significant push forward, and regulatory certainty around the infrastructure itself is vital – the turmoil caused by changes to the feed-in tariff for solar-powered electricity, for example, demonstrates the consequences when regulatory changes occur.

There is, however, the danger that, by applying piecemeal incentives here and relaxing regulations there, sight is lost of the bigger picture and how all the elements interrelate – not just in terms of distorting the market but also in opening the door to areas of 'shadow banking' that are perhaps less suited to this activity. Is there is a risk that, having tightly regulated the banks, the authorities are now rapidly removing obstacles to allow less regulated and more opaque non-banks to play a bigger role? It seems that perhaps, and not for the first time, government and regulators want to have it both ways.

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