The Actuarial Profession
making financial sense of the future

Open Forum: Non-Bank Lending
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Non Bank Lending

Non-bank lending – Index

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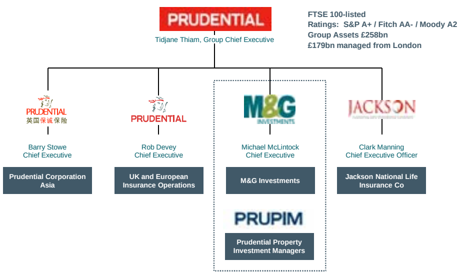
M&G investments overview

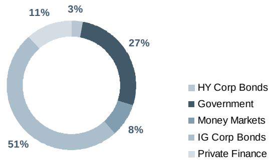


Source: M&G, 30 September 2009

M&G's fixed income capabilities

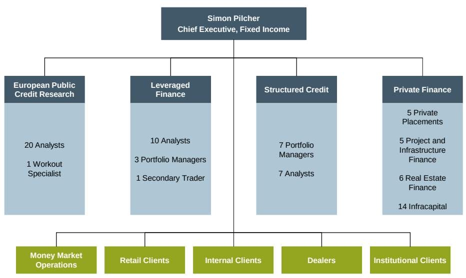
- M&G manages £72bn of UK and European investment grade corporate debt
- £12.0bn in private finance investments including private placements
- Investing in specialist markets requires dedicated, experienced resources
- 3 types of clients: internal, institutional and retail

M&G fixed income AuM* – by asset class



* Source: M&G as at 30 September 2009

M&G fixed income resources



UK debt market

- UK borrowers have had competitive advantage of many international banks operating out of City of London
- In addition, the capital markets through benchmarks provided cheap debt to banks so they were able to provide, in turn, cheap debt to many borrowers
- Basically, sun shone for borrowers (consumers, corporates, housing association, private equity sponsors, etc) for 10 years or more
- Music has stopped and now the key question being asked is what can replace some of the debt capital provided by banks, securitisation market and conduits, and at what price will new lenders come into the market

Some key funding markets

- Gilts
- Bank debt
- Company loans
- Infrastructure (with social housing)

Financing required in these markets 2010 - 2011

• Gilts	£180bn to £200bn
• Bank wholesale refinancing	£100bn +
• Company loans	£30bn
• Infrastructure (with social housing)	£50bn
• Total	£360bn +

Source: Estimates M&G

Current debates

- Effectiveness of Quantitative Easing ("QE")
  - → When QE stops, who provides the funding?
  - → Government lending targets for certain banks – how long will this last?
- January 2010: HM Treasury document:
  "Discussion paper on non-bank lending"
  - → Responses have been made from number of borrowers, investors and trade associations
- Adam Posen speech at Cass Business School (26 October 2009) on "Getting Credit Flowing" including discussion on limitations of the UK financial markets and the underdeveloped non-bank lending market
- Liquidity of different entities*:

	Banks	UK Defined Benefit Pension Schemes	Life Insurers (Unit Linked)	Life Insurers (Annuities)	Life Insurers (with Profits)
Average Asset Liquidity	Illiquid	Moderate	Liquid	Moderate	Moderate
Average Liability Liquidity	Liquid	Moderate	Liquid	Illiquid	Moderate

What are the right regulatory frameworks for each of these activities?

⇒ ***Who is going to fund Britain's future?***

* Source: Presentation: Paul Stanworth, The Actuarial Profession "How valuable is liquidity?" (June 2008)

Key for UK economy

- Will pension fund and insurance companies still want to focus on liquid assets only?
- Are benchmarks key for all investment decisions?
- Can absolute return hurdles become an acceptable measure for performance?
- Who will fill the gap of providing debt capital when banks reduce their lending?

⇒ ***There needs to be a change of behaviour in investing***

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The UK private placement market

- M&G was one of the first European private placement investors - since 1997
- We invest only if there is relative value, there is no annual allocation
- Most deals still reliant on US investors due to lack of European participation. Why?
  - Different regulatory treatment for US insurance companies
  - Need for specialist credit teams
  - Ease for issuers to go to banking and US private placement markets
- Key market observations post credit crunch:
  - Only repeat issuers in favoured industries have accessed the market
  - Large number of mid-cap UK corporates effectively reliant on a much smaller bank market for debt finance

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Why is non-bank lending important for companies?

- Previously UK capital structure was an equity and bank lending model, BUT
  - Number of active banks has reduced
  - Need for the UK banking sector to shrink in the medium term
- We think the UK needs to move to equity, longer term non-bank lending with working capital and acquisition finance from banks
  - Suits current bank market of 3-year maturities (more like 2-year facilities as facilities do not run full course)
  - Companies can choose best in class for each part of their ancillary business
  - Model successful in the US
  - Institutional investors in the UK used to lend long-term to UK corporates 20 years ago
- New relationships can be built with local investors, who may also be shareholders
- Companies need to manage debt maturity profile to avoid business critical refinancing humps

⇒ ***The credit crunch should be seen as an opportunity to change behaviour***

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Challenges for investors

- No benchmarks for non-bank lending
- Illiquid investments
- Known cashflows: coupons and principal repayments on set dates
  - Question: Are benchmarks more important than cashflows?
- Ability to source floating rate and index-linked cashflows
  - → Leveraged Finance (floating rate)
  - → Social housing (fixed, floating and index-linked cashflows)
  - → Infrastructure debt (fixed, floating and index-linked cashflows)
  - → Corporate loans (fixed and floating rate)
- Greater diversification than public bond markets

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Example of non-bank lending product Prudential/M&G UK Companies Financing Fund

- Created in Autumn 2008 post RBS & HBOS events – c. £1.7bn of capital to deploy already
- Key messages to UK pension funds
  - Alternative funding service required for UK companies with departure of a number international banks; delevering of UK banks; and new bank capital regimes
  - Solvent companies, in which UK pension funds may hold equity, could file for administration due to lack of liquidity
  - Funding for companies who do not have access to public bond markets
- Closed ended fund
- Lending up to 10 years, interest only for 5 years
- Pari passu with senior bank loans
- No public or private ratings required and no NAIC rating needed
- BUT investors need a return that is competitive with public bond markets

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Next steps

- Non-bank lending needs to move into more areas
  - Mid-market corporate
  - Infrastructure
  - Social housing
- Active dialogue required between different parts of the decision makers at investors
  - Actuaries
  - Asset allocators
  - Trustees/Board of Directors
  - Consultants

  and fund managers, who can source non-bank lending opportunities
- Flexibility of type of investing vehicles – open-ended; closed-ended; listed investment trusts, etc
- With more funds to invest
  - More investments made
  - Greater diversification
  - More resources recruited to source investments
  - Maybe secondary market develop (ie liquidity)

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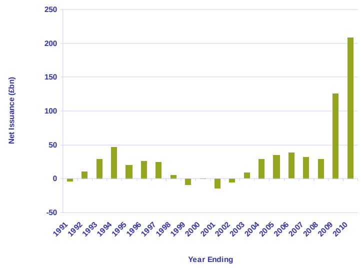
Appendix I

Net gilt issuance for the past two decade

But with the magic of Quantitative Easing there was actually a repurchase of gilts during the year…



Source: Bank of England

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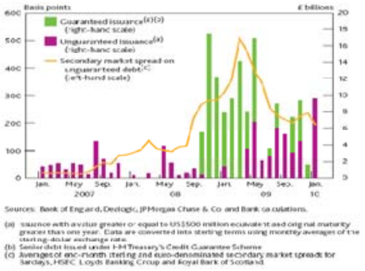
Appendix 2

UK Bank senior debt issuance



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