

EUROWEEK

Adapting to the New Financial Landscape

June 2012



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The Lloyds Bank Roundtable: Adapting to the New Financial Landscape



Issuers, investors and intermediaries all agree that the structure and character of the debt capital markets has undergone extensive change over the last four years. This will remain the new normal until further notice.

As they learn to compete and prosper within this new environment, all three groups of market participants will need to adapt to the very different challenges it will bring.

To discuss these challenges and opportunities, corporate borrowers, investors and bankers gathered at the Lloyds Bank roundtable.

Participants in the roundtable were:

Simon Allocca, managing director, head of loan markets, **Lloyds Bank**

Martin Bates, managing director, head of flow credit sales, **Lloyds Bank**

Philippe Berthelot, head of credit management, **Natixis Asset Management**

Rainer Haerle, director and head of global corporate credit, **Deutsche Asset Management**

Katherine Horrell, group treasurer, **Centrica**

Ben Lord, fund manager, **M&G**

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David Wilson, treasury projects manager, **DS Smith**

Catherine Zamparini, vp finance, **Vivendi**

Phil Moore, moderator, **EuroWeek**

EUROWEEK: Are there any indications that we may be emerging from the crisis?

Farouk Ramzan, Lloyds Bank: I would like to say that the glass is half full, but I'm afraid it may be half empty, as regards emerging from the crisis.

The paradigm is one of a rolling crisis, be it economic, political or social. It's the way these crises ebb and flow that affects what we do in the capital markets. That backdrop is not straightforward.

It could be argued that we're in a double dip recession in the UK. Within the eurozone there is a potential 0.4% GDP contraction this year and within that theatre there are

highly diverse economic indicators. Spanish unemployment is over 25%, compared with German unemployment which is at its lowest level since reunification in 1990.

On the political side, the outcome of the presidential election in France has cast doubt over the sustainability of the Europe-wide austerity package. Local elections are coming up in Germany that could mean the administration there becomes another government that falls as a result of the financial crisis.

So there are a lot of competing dynamics, all of which would suggest that we are not coming out of the crisis. The question is — how do we deal with it and come out with funding strategies that cope with localised market volatility,

at a time when the backdrop is so unclear?

Philippe Berthelot, Natixis Asset Management: There is a new paradigm coming in which is what I call the Japanisation of Western economies. There is no growth in the engine in the UK or continental Europe. The exception is Germany, but the rest are suffering.

This is why there is a growing recognition that putting in place austerity packages throughout Europe at the same time would be counterproductive in the long run. This will be at the heart of the discussions between Hollande and Merkel.

Our economists at Natixis Asset Management are forecasting a light recession with eurozone growth of minus 0.5% this year. With that level of growth you can't address your debt to GDP ratio; you can't solve the unemployment problem. In Spain half of the young population is unemployed. This is what makes for revolution. So it looks as though we will have more social problems in western Europe.



Philippe Berthelot,
Natixis

Rainer Haerle, Deutsche Asset Management: Germany is doing well and is the exception in Europe. The question is, why? Clearly it is benefiting from the single European currency, which is why it is so interested in supporting the European Union.

There has been a lot of concern worldwide about the French election. But in an election campaign it's normal to make ambitious promises. Now there will be a reality check and France will behave like a good European.

In terms of the economic outlook, we think we will see a recession in the eurozone, but it will very different from one region to the next. In southern Europe it will be a disaster, and the problems there will go on for a long time. The sovereign debt crisis is here to stay and will induce further volatility in the market.

EUROWEEK: Japanisation, disaster in southern Europe, and a crisis that's here to stay. What does all this mean for the UK?

Robin Stoole, Lloyds Bank: My focus is on the corporate side and perversely it seems that the asset class of choice has become corporate bonds. We have a supply/demand imbalance as the usual drivers of bond issuance simply aren't there.

Obviously there are redemptions. But there is no major M&A activity and capex has been scaled back. As a consequence the investor base is desperate to put its cash to work in corporate bonds as a perceived safe haven. But we don't have enough corporate bonds to service that demand.

The supply problem in Europe is exacerbated because the US market is so competitive and the swap mechanics are such that if you need dollars you go to the dollar market. Even if you don't need dollars you still go to the dollar market because execution risk is much lower, the depth is greater and the swap works in your favour. So even borrowers that don't particularly need cash — Vodafone, for example — will issue at Treasuries plus 85bp and swap back into Euribor minus 15bp.

So we have lots of factors that are reducing supply in both the sterling and euro bond markets at a time when demand for those assets has never been higher.

Martin Bates, Lloyds Bank: The interesting development over the next few years will be how the buy and sell sides engage with the rates and credit markets. Traditionally the rates part of the market was the risk-free part, where people were able to deploy low-volatility resources. The credit market was where riskier trades were put on.

The collapse in liquidity in the credit markets is driving people to reassess how they engage with risk-free and risk assets. Increasingly, assets that were credit-like in nature, such as covered bonds and term repo, now appear more risk-free, and are attracting more participation from investors in the rates side of the market; whereas what were traditionally risk-free assets, such as government bonds, are increasingly being used by credit funds.

Liquidity has also dried up in some of the rates markets, but there is still sufficient liquidity in many to make them useful to credit funds. Correlation levels across asset classes are increasing. Whether it's equities, rates or credit, they're all being driven by the same macro factors and people are moving to where the liquidity is. So how we structure portfolios, and trade and manage risk across these markets will be interesting.



Martin Bates,
Lloyds Bank

EUROWEEK: How do investors deal with this?

Ben Lord, M&G: Risk-free just doesn't exist anymore. It's about perceived safe havens, and in a flight to quality, you need to do your very best as an investor to identify those

safe havens and make sure you have a long, heavy position in them.

As an investor you're also constantly asking yourself how long that perception of safe haven will last. I see a huge continuation of the drive towards US Treasuries and the dollar, although the long-term outlook for the US is still pretty bleak because it is accruing liabilities at a greater rate than almost anywhere else in the world.

As the euro stands today, we don't think the single currency works. For that reason we have not been exposed to it. I agree with Philippe that the Japanification of eurozone rates is going to continue because the eurozone does not have an institution that can take the decisions needed to resolve this.

All Merkel and Hollande can do is come out with a verbal commitment to something which is probably years away from being put into place. So I agree that the medium term is looking very grim.



Ben Lord
M&G

As an investor you have to try to be optimistic, and Germany's approach of forcing austerity on all and sundry at the cost of 52% youth unemployment in Spain is going to come into huge question over the next couple of years.

But you have to look to the endgame. If we reach the point of social unrest, and we're heading towards it very fast in Greece and Spain, the path will have been laid for peripheral countries to leave. If that's the case, Portugal and even Italy will be just around the corner. If we see a break-up of the euro, which is still a very real possibility, the question is how will this impact Germany?

Arguably, Germany has been in the sweet spot of the global economy, exporting high-end, high value-added goods. But if Germany goes back to the Deutschmark, who in Europe or anywhere else will be able to afford those products? So this endgame of going back to drachmas and pesetas would be incredibly painful for Germany. There is a possibility that this realisation broadens and we see the monetisation of the European debt problem, with the core of Europe writing an enormous cheque, in the form of QE, to the peripheral nations.

In the near term it's foreseeable that Greece exits. At that stage a big firewall will have to be put in place. Not like the one two years ago that hasn't yet been funded. Not one that means every time a country like France gets downgraded it's going to need more money. We need a real, funded firewall that specifically looks after Spain, Portugal and Italy.

Berthelot, Natixis Asset Management: At the risk of sounding politically incorrect, there are a lot of misunderstandings in the Anglo-Saxon world about Europe. The European Union was created because millions of people were killed in two world wars. It has been driven by political rather than economic reasons.

Every time I look at Bloomberg or CNBC there are a lot of people saying the euro is unsustainable from an economic perspective.

We need a credible plan to put austerity measures to work, and at least to ensure people understand the efforts to reduce the fiscal imbalances that exist today.

It'll be tough and it'll take time. Look at what happened in Japan where deleveraging led to 20 years of flat growth. Deleveraging clearly has a cost in terms of growth and social welfare. We may have social unrest and rioting.

Can the euro survive without Greece? Yes, it probably can. The real question mark is over Italy, which is of systemic importance to the eurozone. Portugal and Spain are probably do-able, but Italy is definitely too big to bail out.

But again let's be pragmatic. If the Fed buys \$300bn of Treasuries that's monetisation. If the Bank of England buys Gilts, that's monetisation. Why would the ECB not be allowed to do the same?

If the euro is to survive, the questions we need to ask are: will any eurozone countries be prepared to accept loss of sovereignty? And will Germany eventually accept that it will have to finance some of the southern European countries? This will only become clear over the coming months. In the meantime, sovereign risk is something that we'll all have to get used to.

Lord, M&G: I agree. To bring the discussion back to the UK, while in the short term there will continue to be concerns about the potential break-up of the euro, our independent currency will ensure that we remain one of those safe havens. It almost feels as though because it is independent, sterling is becoming a reserve currency again, which is extraordinary.

There are so many reasons to fundamentally despise an investment in Gilts, and to despise exposure to the UK. But the independence of the currency is making many people, and I'm one of them, bullish on sterling and on Gilts.

EUROWEEK: Would the UK's safe haven status be jeopardised by any deceleration in the pace of spending cuts and therefore by a threat to the triple-A rating?

Bates, Lloyds Bank: I'm not sure that the flows coming into the Gilts and sterling markets are being driven by a safe haven flow, but by a diversity flow. At times when there is turmoil in the eurozone, the sterling market is a way of achieving diversification. I don't think it represents a fundamental vote of confidence in the prospects for the UK economy.

We're buying growth by increasing debt, and all that does is push the problem further down the road. Ultimately we have to deal with the debt itself.

Ramzan, Lloyds Bank: Isn't that what LTRO did — push the problem further down the road for the eurozone?

Haerle, Deutsche Asset Management: But the UK has fiscal union and an experienced Bank of England. This is

what the eurozone needs. The path needs to be towards fiscal union, but that is not easily achieved. It won't be decided by Merkel and Hollande. Before such an agreement is reached, the constitutions in 17 democracies will have to be changed.

Fred Maroudas, BAA: Is there really any prospect of that happening, based on election results over the last 12 months?

Haerle, Deutsche Asset Management: Looking at sentiment in Germany at the moment, no.

Maroudas, BAA: What Europe has been crying out for is strong and unequivocal leadership — but that has not been forthcoming and it is now too late. France showed at its recent election that nobody wants to go down the path of austerity and fiscal union that central bankers and politicians want.

Philippe rightly talks about the threat of revolution, and people forget in this country how recent the experience of revolution is in many parts of Europe. There is at least an even bet that before you get fiscal union, you get revolution.

There can be no credible firewall between Spain and Italy. You can't talk about bailing out Portugal and Spain but not Italy. It's clear that the markets won't let that happen. Either you bail out everything, which is not feasible, or you bail out nothing. What is the point of bailing out Spain when you then have Italy on the brink?

Berthelot, Natixis Asset Management: Because Italy has a primary surplus, which is not the case in Spain. The inventory of debt in Italy, at over 100% of GDP, is far bigger than in Spain. Nevertheless, Italy has made huge structural efforts to reduce its debt. And Italy is of systemic importance because it is too big to bail out, no matter how much the size of the EFSF is increased.

You're right about public opinion. Every incumbent politician has failed over the last two years because voters don't want to have their welfare systems compromised.

Lord, M&G: I'd question whether any of the recent elections have suggested that public opinion is against the single European currency. I'd suggest the electorates were voting against austerity. I know that points to problems in the future because it means we will continue to borrow to grow. But even Tsipras in Greece has said he wants to see an end to austerity but to remain in the euro. So I wonder if the revolution we're seeing is more about a change in course than a complete break-up of the euro.

Maroudas, BAA: You're probably right. People still, though I don't think this will last for long, like the idea of the euro, but without any of its drawbacks. But that's something they simply can't have. You won't get Germany and the rest of northern Europe allowing the sort of Keynesian policies demanded by southern Europe. So, and I say this as frustrated believer in the European dream, it seems to me that the only endgame is a break-up.

Berthelot, Natixis Asset Management: I agree that people aren't rational. Look at the Greek polls — 80% of people want to stay in the euro but 75% don't like austerity.

Charles Stewart, BG Group: What we're talking about in the context of the euro is the difficulty in transitioning from where we are now to where we want to be in the future. But if you set aside the transition difficulties, is the euro fundamentally a good thing, or is it better for independent countries to have independent currencies? I know there would be difficulties getting there. But is the whole construct a good thing?

Berthelot, Natixis Asset Management: It depends on the country you're in. If I were a German I'd be very happy with it. In the rest of Europe and especially in the weaker European countries it's a bad thing. This is why some countries can't afford to stay in the euro without some adjustments being made. Spain and Portugal won't be able to compete with the rest of Europe without these adjustments, which we used to call competitive devaluations. This is exactly what Greece needs.

Maroudas, BAA: What Martin said about the global investor view of sterling is partly right. It's not all about the strength of the UK economy because plainly we're in a recession. But it is about comparative strengths versus the eurozone and above all it's about simplicity. You know what you're getting with sterling. You don't have to worry about sterling falling apart because even if Scotland goes, sterling stays. So it's that simplicity allied to what is still a major global economy that safeguards the sterling story — plus of course a lot of QE which makes it difficult not to buy Gilts.



Farouk Ramzan,
Lloyds Bank

Ramzan, Lloyds Bank: Haven't we all, as market participants constituting 'the market', also been learning new tricks? For 11 out of 26 weeks in the second half of 2011 there was no issuance in the European corporate investment grade market. Yet although the information flow, apparently, hasn't fundamentally changed, so far this year there has been no week in which there has been no issuance. So aren't we just becoming more comfortable with the new paradigm and getting more adept at adjusting our relative value frameworks to allow for the supply/demand imbalance in the capital markets? Because we all pay our insurance premiums and that money has to be put to work by institutional investors within the context of LTRO and QE.

In addition, although there have been wholly disappointing M&A levels that need capital markets solutions

compared to anticipation at the beginning of the year, there are still issuers who need to fund themselves as part of the normal course of business. So while the first quarter of 2012 saw only 43% of the European M&A volume seen in the first quarter of 2007, the reality is that the refinancing world keeps turning and we are learning to adapt to the lack of clarity.

Lord, M&G: You could argue that the LTRO brought about a change in the landscape. It was a sea change in investors' minds because there was hundreds of billions of bank and sovereign funding to be done every month at the start of this year. If that funding had not been done, we would have seen banks falling like dominos throughout Europe and a complete funding freeze in Spain and Italy.

LTRO doesn't just kick the can down the road. It may create even worse things in three years' time, if we don't get anything else. If it hadn't been for LTRO there would have been a ramping up of sovereign and bank defaults in the first three months of the year.

LTRO provided pre-funding. The level of structural subordination it has created has been dramatic, which presents new challenges across bank funding.



Simon Allocca,
Lloyds Bank

Simon Allocca, Lloyds Bank: CDS levels are now 100bp higher than in February, so if it was a game changer, it was a very short game. It hasn't changed anything fundamentally. My concern, from the lending side, is that with all the uncertainty, how do we generate supply? Whether the glass is half empty or half full, nobody wants to pour anything into it, because they're worried about macro and sovereign issues. The lenders want to lend and the companies around the table want to generate more corporate activity.

EUROWEEK: Surely conditions are right for opportunistic funding, given the supply/demand imbalance that Robin was describing?

Catherine Zamparini, Vivendi: We did an acquisition worth roughly €8bn last year, buying the 44% of SFR we didn't already own, and had to refinance this big acquisition in the bond market.

We've been a frequent issuer in the euro market and in order for the new issue premium not to increase too much, we have diversified our investor sources by tapping not only the euro market but also the dollar market.

It has been part of our policy to go more and more to the bond market instead of the bank market, because banks have seen the price of their liquidity increase as a result of new capital rules and the financial difficulties they face. A little more than 60% of our debt is in bonds, and our policy is to increase this share to at least 70%. Bank facilities have been used as bridge financing for acquisitions pending a refinancing in the bond market, and will only be considered as a liquidity resource.

We've been issuing when windows of opportunity have been open to us in the Euromarket. Those windows shut each time there's turmoil in the market, mainly because of the sovereign debt crisis. But this year we've already been able to do more than €1.5bn in bonds, and we've issued \$2bn in the dollar market. So we have been able to find the funds we needed in the bond market.

We have a cautious financial policy, meaning we are aiming to refinance one year in advance. We believe that this crisis is not over, so we have to ensure that there is no risk of us facing a liquidity crisis.

Katherine Horrell, Centrica: What Catherine has just described is a sensible sort of model — using banks for back-up lines and the bond market for cash funding, and in current markets where we're going through periods of intense volatility you wait for the LTRO or some other external factor to calm things down. Then you go in and fund.

For those of us who have a decent corporate credit presence in the bond market, this is a great market because you can get in and out quickly. You just have to keep an eye out for windows of opportunity and take advantage of them.

EUROWEEK: Is that equally applicable to sterling and euro?

Horrell, Centrica: Yes. There is sometimes a relative advantage where one market looks better than the other. But the key driver is market volatility. So to answer Farouk's question, the reason people weren't issuing at the end of last year was that there was a lot of volatility around.

What made the difference was the LTRO. Yes, it may have kicked the can down the road. But it calmed the markets down for long enough for those of us who wanted to issue to go in and take some funding out. You have to keep searching for that moment of calm in which to issue but you also have to make sure you have a good lead-in period. If you leave it to the last minute, markets can shut very quickly.

Maroudas, BAA: The last quarter of last year was a very undistinguished time for our market.

M&G was one of the few investors prepared to put money to work at the end of last year because its thesis was that there was nothing broke in the UK corporate sector. It was still a market in which borrowers were providing attractive spreads on a historical basis. It was very difficult to get other investors to take that view because institutional investors who are, in theory, mandated to take a long term perspective in their investment decisions are forced, largely by the increasing focus on quarterly benchmark performance, to invest defensively and second-guess what the price of a new issue is going to be at close that day and the day after, rather than whether it represents long term value.

That is frankly not the way I want my pension fund to be managed, but it is the way pension funds and insurance companies are increasingly operating in volatile markets.

It's fair to say that the banks found it very difficult accurately to assess appetite for new issues in Q4. In fairness to them they weren't helped by increasingly stringent regulation, which is making it almost insanely difficult for banks to talk to investors. In fact, it is much easier for me to talk to my investors than it is for Farouk to talk to them. That's a daft situation and makes life enormously difficult for issuers. As a result, a number of deals, including two of our own, either didn't get off the ground or stalled on take-off. Yet the very same trades were hugely successful in Q1 this year. But what changed for BAA between September and October of last year and January this year? Precisely zero. Our results are enormously predictable and incredibly stable — we predict our Ebitda to within £1m each year.



Charles Stewart,
BG Group

Stewart, BG Group: It's almost crazier than that. It can be a day-to-day phenomenon. You can be planning a 10 or 30 year bond issue, and on a Tuesday you may be told that there have been a couple of successful deals that day and things are looking good for tomorrow. You wake up the following morning, and you have your go, no-go, call and you find that because there has been one comment in a newspaper reporting something that some politician is alleged to have said, everything's off — for a 30 year bond.

Maroudas, BAA: It's even worse than that. I've never known a market like it. In one instance we were out at 8.30am and the trade was looking fine, and by 9.15am it was dead. That was all due to some arcane rules about collateral on Italian government bonds which nobody really understood. That is not a market that is functioning.

Lord, M&G: Remind me why the deal was pulled. Was it because investors said they weren't investing in anything that day?

Maroudas, BAA: Yes. Exactly.

Lord, M&G: We saw a lot of issues where we were involved in some very gentle pre-sounding, and where we indicated that for an issuer in that industry we would be interested in, say, a 4.5%-4.75% coupon. And if that day the market gets the jitters, and price talk is inside our level, we clearly won't be interested. We've been sounded out, we've been

clear about what we'll buy and at what price, and we're not interested if it comes through our range.

But to me, if the market has the jitters and that borrower is still issuing paper at 4.75%, investors should step up because it's in their range. In the US they'd get that deal done.

Maroudas, BAA: You at M&G were an honourable exception. But other UK institutions were not as robust.

Bates, Lloyds Bank: The real change is a collapse in secondary market liquidity. On days where there is news volatility, secondary market liquidity vanishes. We used to have a lot of arbitrage and contrarian investors who came from prop desks, hedge funds and correlation desks. These have now all gone, largely because of deleveraging in the system.

Market dealers can only provide as much liquidity, in anything other than the very short term, as exists in the market. The idea that dealers can just step in and fill the liquidity vacuum is just not practical. So in a world where we've lost the vast majority of contrarian or arbitrage accounts, what we find now is that everyone rushes from one end of the playground to the other at the same time. Insurance companies and asset management investors are driven by very similar factors, and they're either risk-on or risk-off. So when we do have higher news flow, there simply isn't the depth or diversity of participation in the credit market to give investors comfort that there is sufficient liquidity.

Lord, M&G: I'd agree that there is no liquidity and I don't think it's coming back. Inventory in the major UK banks has probably gone from between £200m-£500m on any given day in public bonds to below £50m. That isn't going to change. So for a fund manager to assume he can create some space for a new issue by selling £20m to the Street is illusory. This will be the new normal until we see enough deleveraging in other parts of banks' balance sheets, which will take years, allowing them to free up some capital.

Ramzan, Lloyds Bank: Aren't we also seeing increased home bias of the investor community? Is there more of a preference among French investors for French companies and among German investors for German companies than before the crisis?

Berthelot, Natixis Asset Management: That used to be the case, definitely. Investors are looking for relative value, which is increasingly difficult to find. There used to be a natural propensity for local investors to prefer local issuers for regulatory and tax reasons. That is much less the case today, because we are living in a global market.

Ben made a very interesting point about liquidity. The only objective, independent measure of liquidity we have is dealers' inventories in the US. It is amazing that we are back to the sort of liquidity levels we were seeing 10-15 years ago, given that the corporate market has doubled or tripled in size. As an active portfolio manager that means I can't be sure that I'll be able to sell €5m- €10m of an issue at any given time because suddenly liquidity can vanish. This is the big difference between the US and European markets, because last August was the first time in 10 years in Euroland where there was no primary issuance in the high yield market.

In the US during the crisis of 2007-08, people were able to trade and have price references, whereas in Europe that became impossible because of the sovereign risk and the disappearance of what we call the risk-free reference.

When I began my career 20 or so years ago we priced everything against the OAT curve, then we moved to the Bund curve. But when everything skyrockets, how can you price?

Maroudas, BAA: How do you price against secondaries when there are no secondaries to price?

Berthelot, Natixis Asset Management: Exactly. This has been the case in the ABS market since 2008. This is the tricky issue.

One of my colleagues says that the new safe haven will be corporates. Not sovereigns, but the best-in-class corporates. There are almost none left in the triple-A bracket so these will be rated double-A, single-A and double-B.

But we have to admit that the Bund remains the benchmark, which is why 10 year Bunds yields were recently 1.45%.

The LTRO definitely helped to prevent further systemic damage and restore confidence. But does it solve any structural issues? Not at all. It buys time because it allows European banks to address their over-leverage by selling \$1.5tr of assets.

In terms of the capital market, we are being Americanised. Two-thirds of European CFOs used to rely on their banks for funding. In the US it's the opposite. We will see two-thirds of corporate funding going through the bond market. This is good for us because it will allow more liquidity to come into the market.



David Wilson,
DS Smith

David Wilson, DS Smith: We're an exception to the corporate rule because we've just completed a major acquisition which has doubled the size of the company. It's gone very well.

I'd challenge the use of the word 'crisis'. The so-called crisis in the eurozone will be with us for many years and we need to learn to live with it. The banking industry has been in trouble since 2008, so that is no longer a crisis. It is what it is, and it's not going to get better. Economic growth in the eurozone is flat. But that's not a crisis either. It just means we're going sideways.

In that context, we viewed our transaction as utterly

compelling. It wasn't something we did on a whim. We didn't gear up simply because we could and because nobody was asking the right questions. This was a strategic and compelling transaction between a willing seller and a willing buyer. It gives us access to Germany, Sweden and the Netherlands, not significantly to Greece, Spain or Portugal.

So when people asked us what about the eurozone and what happens if the euro collapses we said that it wouldn't help, but it wouldn't stop us doing this compelling deal. We had to convince the banks of that and we had to convince the shareholders, which we did. To build on the challenge to bond investors, companies aren't going to get finance from banks unless they can see how you're going to refinance in the capital market.

We were too small to access the investment grade bond market and we did not have a credit rating. But we are a big issuer in the US private placement market, which has been open all the way through this crisis, with US investors in Ohio happily investing in European credit. It is also currently cheaper than the bond market.

That is a challenge to European investors, and one of my first questions to the banks when we began this acquisition was, why isn't there a European private placement market?

Ramzan, Lloyds Bank: You're absolutely right to ask that question. The US private placement market has been defying gravity for a while, with something like \$15.8bn of issuance this year.

In terms of the bigger question as to how the UK and Europe have responded to the success of the US private placement market, there is a big political push to give SMEs access to funds. Given that investors have money to put to work, surely a private placement market should be looked at. Old European concerns about the lack of secondary market liquidity in the private placement market are redundant because we are not seeing any liquidity in the public markets anyway.

There are plenty of government bodies looking at capital market solutions for SMEs. M&G has been doing work on developing this market in sterling for years, having set up a fund specifically for private placements. The take-up has been low. This must be for perceptual and emotional, rather than economic, reasons because I don't see any arguments against it. I agree that it defies logic that we haven't gone down that route.

Lord, M&G: You're absolutely right. A lot of demand for paper has come from the retail side. Retail fund managers have to be able to trade in and out of the bond. For that reason, the immediate reaction when they are offered a private placement is to worry about liquidity. But we don't have liquidity anyway. So why don't we do more of this?

Ramzan, Lloyds Bank: Let's be clear: it's not just small companies that can make use of private placements. Companies across the spectrum can use this market to tap into discrete pockets of demand.

Allocca, Lloyds Bank: Picking up on Philippe's point about the European capital market becoming more like the US market: we all know that in Europe the number of companies that have investment grade credit ratings is very low. You're not going to have the 70%/30% funding model when there is such a low number of rated companies.

Bates, Lloyds Bank: I know of at least six European institutional investors who invest in the US private placements market. There is growing demand from European investors, and the buyers of some of the European and UK names that go to the US PP market are often European and UK names.

Stoole, Lloyds Bank: This reflects the differences between the public bond markets in the US and Europe. The US public bond market is always open, execution risk is low, and the depth of the market is enormous. That's because it's



Robin Stoole
Lloyds Bank

a big homogenous group of investors who are effectively all doing the same thing.

Europe by contrast is a big, fragmented market where investors are not all demonstrating a common strategic intent. So, yes, there are a few investors in the UK looking at an equivalent private placement market as something to be developed. But it isn't established in the way it is in the US. If you want to raise three tranches of \$50m each with five, six and seven year maturities, documentation is straightforward, you know exactly which insurance companies in the mid-west you need to approach. It's tried, tested and a straightforward and reliable source of liquidity. The swap back into sterling or euros is also extremely favourable.

Maroudas, BAA: Aren't there two issues here? One is rating and the other is size. They are going to be dealt with in different ways. We're seeing a welcome growth in the high yield market in the UK and Europe. To be fair, it is growing largely because yields are so shockingly poor in every other asset class that people have to look down the credit curve — but it is a good sign of increasing market depth. Certainly from the perspective of a sterling issuer, this is a very flexible market — I can do anything from two to 50 years in sterling if I want, and I can do so in small sizes if necessary. So I don't really need a private placement market in the UK.

Part of the reason we don't have a private placement market in the UK is that investors, be they retail or even some larger pension funds, have such a poor understanding of how the bond market functions. So we're a long way from the US culture where everyone understands how companies finance themselves.

Lord, M&G: BAA could issue in the flexible way you're describing because everybody knows the BAA name. But if you're a small company that nobody has ever heard of, who

is going to dedicate the necessary resources to do the credit work and buy that \$75m clip of paper?

Maroudas, BAA: That would be where the high yield funds would come in.

Ramzan, Lloyds Bank: Rather than have individual, disparate companies all trying to access the bond market in small clips, it is so much more efficient if you can group them together. Take the example of housing associations, which have started to explore the capital markets. Many of them are coming out with £100m clips, and they're getting done successfully because credit analysts increasingly understand the framework and can more efficiently focus in on the credit metrics that separate them rather than taking a simplistic view of separating them into the two camps of 'big' and 'small'.

If we as a bank continue to take seriously our responsibility of educating investors in a new developing market of issuers, then the pricing mechanism becomes more efficient and debut issuers are more likely to access the market within the sector. That has to make sense and has to make it easier to nurture a private placement market for companies within the sector.

All of this can happen without even beginning to talk about aggregated issuance vehicles that group together small issuers who do not have access to the markets individually.

Lord, M&G: There is a way to get investors to commit money to new names, new sectors and smaller entities, and it comes down to pricing. If you put a big enough coupon on a bond in today's market you'll find enough people to take it.

In the dollar market, we see new issues come with credit spreads that are phenomenally generous to investors. That guarantees that the deal is heavily oversubscribed and that it performs very well in the secondary market. But the all-in yield, for the issuer, is very low. The issuer gets 10 year money at 4.5% and is happy. Investors are also happy because they're being given a 280bp credit spread.

One thing I find a little frustrating in Europe is that on a number of occasions we've seen new issues from companies and in sectors that we like, but where issuers have either tried to avoid a new issue premium, or bring it with a 10bp premium. That's unlikely to be enough to persuade investors to make a commitment in this highly nervous environment, irrespective of the fact that we're talking about a difference of less than an eighth of one percentage point of coupon. The obsession is with the credit spread, rather than the all-in yield.

If we were shown a company we didn't know, where we had to get an analyst to spend a week looking at it, but if it was investment grade and was happy to issue at 6%-6.5%, we would probably have a strong appetite for that.

Ramzan, Lloyds Bank: Isn't it true that there are very few fixed rate borrowers in the market who really focus on the all-in yield? There are a couple of utilities who might look at the market that way. But in the case of Centrica, how would you persuade the Centrica board to go for an issue on an all-in yield basis? It doesn't matter about the spread or how that spread looks relative to other comparably rated utilities with similar business models. Could you sell that to the Centrica board?

Horrell, Centrica: I think we could. Boards are less concerned with the absolute credit spread or coupon than with making certain that the funding is there. But nobody wants to go into the market and give away 20bp to their investors. Nor do investors want to give 20bp away to the issuer.

Lord, M&G: But we have seen this happen in the US. At the end of last year when the market was pretty much shut in Europe, a very well known bank brought a senior unsecured issue at probably double the spread that it was trading at in the secondary market in Europe. It brought it at a 4.5% coupon for 10 years. Even after taking into account the cross-currency basis swap, that struck us as phenomenally generous. They got away benchmark size in a couple of hours.

Stewart, BG Group: I wonder if there's a philosophical difference between Europeans who tend to be floating rate thinkers and the US. If you look at our peers in the oil and gas business, our US peers are fixed rate whereas our European peers tend to be floating rate-focused.

Having said that, our long term policy is floating rate. But right now quite a bit of our portfolio is in fixed rate.



Fred Maroudas,
BAA

Maroudas, BAA: There is a great danger that we allow ourselves to be penny wise and pound foolish. The idea that you get kicked out of the treasurers' club if you leave something on the table is nonsense. It's all to do with market dynamics. In a good market we can price aggressively knowing that investors will still come in. In this market we would have to think very carefully before playing the same game.

I agree about certainty of funding. I won't get fired for leaving 10bp on the table. I will get fired for failing to fund myself adequately.

Horrell, Centrica: There's a bit of a convention here, isn't there? When you open a book for a sterling bond, you give a price guidance as a spread to Gilts, and price off the Gilt that afternoon on the basis of the orders that have come in. I have no objection to having a discussion the day before about pricing with a 4% coupon. Then if investors participated in the order book saying they'd come in at 4% but not at 3.75%, you could execute the deal that way. But that's just not the way deals are done.

Lord, M&G: We probably need to rip up quite a few con-

ventions about how we price bonds.

Stoole, Lloyds Bank: One thing that should be looked at from the investor side is our inability to soft-sound now. Syndicate members are no longer allowed to speak to investors ahead of a transaction. After Lehman when the market was all over the place you'd soft-sound a transaction to determine what was do-able.

In an ideal world, I'd announce the transaction and the spread range and undertake to price within that range. That would be what most investors would like to see. But in the current system we end up with a huge order book and the issuer then puts pressure on its banks to tighten the spread in. We no longer have the ability to work out what the initial spread guidance should be because we can't soft sound.

Stewart, BG Group: What about an opposite construct, where a similar system is used to a Gilt auction? Everybody puts in their bids and you draw a line at a certain level.

Bates, Lloyds Bank: In liquid markets that works relatively well.

Stewart, BG Group: But it's never done, is it? You never put in a binding bid, draw a line and that's it.

We place cash every day, quite a lot of which is placed with funds that only invest in US Treasuries. But some is placed with banks, and if you line them up in order of how much they're prepared to pay, you suddenly find the banks that are desperate posting a bit more. Your natural response is not to place with a bank that's posting a completely different rate.

Lord, M&G: That's true in the commercial paper market. But if a bank comes with a 10 year senior bond at 300bp over when I've been expecting 250bp I don't think the bank is desperate for the funding. I'm thinking this is a tough market, it's still paying a low coupon, and ultimately I'll buy more of the issue. If you call the sales guy and say, 'I'm out because the spread is too high', you're shooting yourself in the foot.

Horrell, Centrica: The soft-sounding issue is as big a problem for issuers as it is for investors. It's in everybody's interest to understand where the market is and deliver a deal at the right price for everyone.

Maroudas, BAA: The banks are too conservative, but it's not entirely their fault because they're not getting the feedback they need from investors in my experience. M&G is an honourable exception which is quite good at saying, 'I'll buy at this price but not at that price'.

But it would be nice to have a market where I have something I want to sell and you have something you want to buy and we can agree a price at which we can both do business. In this market we don't seem to be able to do that.

Lord, M&G: The restriction on soft-sounding is designed to prevent me selling a bond in secondary because I know a bond is coming at a 10bp new issue premium. But the onus should be on compliance departments and investors to ensure that's not the business they're in. If I've been pre-sounded on an issue and I go and sell a secondary because I think I can get a pick-up then I've got a short career in the

business. If my compliance team is doing its job and I'm doing mine that should not happen.

But to have a situation where banks, issuers and investors can't talk any more just to prevent a couple of SIVs from selling FRN 3bp tighter than where a new issue is coming is nonsense. That horse has bolted.

Ramzan, Lloyds Bank: Is there more gamesmanship by the banks in the way they market to issuers, because they have to be very careful about the feedback they're getting from sales and trading? Do you feel that there is more of a range in terms of the pricing advice you're getting from the banks?

That would theoretically be the consequence of the soft-sounding regulation. It's supposed to help and protect, but the practical application seems to be making things dramatically worse.

Horrell, Centrica: There's quite a range of price indications but that is partly because of the secondary market being so illiquid.

Haerle, Deutsche AM: There's one sure way to communicate with investors, which is via arranging a roadshow for every bond. We used to see a roadshow with every new issue. But in bull markets like in the first quarter of this year we immediately saw a lot of non-roadshowed deals in the market. We were more or less forced to participate in order not to miss out on anything. But we felt very uncomfortable with that.



Rainer Haerle,
Deutsche Asset Management

In a roadshow we can talk to issuers about the covenants we expect, and have an open dialogue about price ranges, which is very helpful for all parties involved. As soon as the market rallies, you stop seeing roadshows.

Maroudas, BAA: Look at the communication chain we have. I talk to DCM. DCM talks to syndicate. Syndicate talks to sales. Sales talks to a fund manager or sometimes an analyst. How on earth can you sell anything with that absurd communication chain?

We need to solve this problem because it's a market that is not functioning very well.

Bates, Lloyds Bank: Credit was probably trading as far too liquid an asset class for too long, and we may be moving into a period where credit simply isn't as liquid an asset

class as we assumed it to be. When I talk to investors I'm increasingly told that holding periods are longer and that active management is extremely difficult.

The relative volumes of primary versus secondary markets are unrecognisable compared with five years ago. The shift has been extraordinary and we have to live with a new level of liquidity in the credit markets and we need to adjust our models to reflect that.

EUROWEEK: What is the outlook for retail-targeted bonds in the sterling market?

Bates, Lloyds Bank: Credit managers are increasingly embracing Ucits and ETF markets. I don't think the amounts raised have been that significant but people are definitely deploying resources to raise cash there.

The other interesting angle is that we're increasingly seeing activity among genuine retail end-investors through stockbrokers, over e-platforms. Average trading sizes are diminishing but there is a broader market, particularly in higher yielding assets as government bond yields have collapsed.

Stoole, Lloyds Bank: There are more issuers aware of retail-targeted bonds as a concept. Have volumes increased dramatically? No. But it's a slow-burn thing that we could continue to see more of.

Lord, M&G: What concerns me is the motivation for issuing retail bonds because the size isn't there and the liquidity isn't there. We've seen a few deals where we as retail fund managers would not have participated at the levels that borrowers got away. The examples in the UK have been reasonable enough, but if you look at some of the issues in southern Europe this is a front-page news story waiting to happen.

Every bank in Italy and Spain has issued deposits in the form of tier one capital notes to their depositors. They sell them as deposits and the small print says quite clearly that they aren't.

In the UK there haven't been any examples of those. But the examples we've seen have always contained something that wouldn't get us as investors fully committed.

Bates, Lloyds Bank: There is clearly a move towards name recognition rather than credit quality.

Ramzan, Lloyds Bank: Retail targeted bonds throughout Europe have always been angled towards name recognition, however, as borrowers, would you value the diversification opportunity that retail bond issuance offers?

Maroudas, BAA: We've looked at it very carefully, and if we did so we would probably follow the path of National Grid and issue on the linker side where there is almost no liquidity in the institutional market and there is a product that makes a huge amount of retail sense.

We've diversified hugely in the last 18 months across currencies and across product, be it inflation-linked or nominal, and retail is another very obvious alternative. What has become very clear over the last three years is that different markets are open at different times. It used to be the case that if one market was closed, they all were. That's not true anymore.

We're lucky because we're BAA and everybody knows our credit, so it would be foolish not to look at this market.

Zamparini, Vivendi: We had the possibility of doing retail-targeted issuance in our EMTN programme but we haven't used it. So far we've been able to raise all the financing we needed from institutional investors.

In terms of regulation and disclosure requirements it is much simpler when you're dealing purely with institutional investors than when you deal with retail.



Catherine Zamparini,
Vivendi

Wilson, D S Smith: I was involved in the early stages of the John Lewis Partnership retail bond. We issued direct to the customers of John Lewis and Waitrose, who have money. John Lewis Partnership credit cardholders are the UK equivalent of the Belgian dentist. You don't question the motivation of John Lewis as an issuer. It's a long term player which has tremendous name recognition allowing it to issue unrated bonds.

So it was a successful way for John Lewis to raise quite a lot of money. People are going to chase yield and John Lewis was offering 4.5% (and 2% in gift vouchers) when bank deposits paid virtually nothing.

Disintermediation is always a threat to banks. For a security like the John Lewis Partnership bond, where you have people who want to invest in companies directly, do you need banks at all? It's a slow burn but you can build up a lot of funding this way.

Ramzan, Lloyds Bank: Sure, but are you comfortable with the execution risk involved with having long offer periods?

Wilson, D S Smith: The concept for a company like John Lewis is that you can set up a programme, rather like an MTN programme, and roll it over.

Bates, Lloyds Bank: What are the minimum subscription sizes?

Wilson, D S Smith: £1,000. The minimum has to be a level where you're comfortable that people can afford to invest in the product.

Regulation may also help this market grow. You have people wanting to lend and people wanting to borrow, and if you can cut out the regulated part in the middle, so much the better.

Maroudas, BAA: It seems strange to me that when we talked about private placements we all nodded our heads and agreed that they should be encouraged. But we don't seem terribly keen on selling direct to retail. There would be a very different reaction in the US and in certain parts of Europe.

Horrell, Centrica: But we're all managing to get a reasonable amount of money out of the market.

Stewart, BG Group: In Q4 last year we did \$3bn in the US market, and two weeks later we did £750m and two weeks after that, we did €1bn. So that was \$5.6bn equivalent raised very quickly and easily. National Grid put a huge amount of work into its retail bond, which raised £282m. That wouldn't move the dial on our funding needs because we have a very large capex programme.

Stoole, Lloyds Bank: That's exactly the point. Retail bonds involve a lot of work for minimal diversification. At the end of the day you may raise £50m, £75m or £100m.

It may be more appealing in the inflation-linked market. But it's very labour intensive.

Lord, M&G: The institutional linker market is extremely long term because of the nature of investors' liabilities. Retail is much shorter. We have a couple of funds that target the short end of the linker curve, so I don't think you should just focus on demand from retail.

Bates, Lloyds Bank: In an OTC market, the participation costs for retail are quite high. Perhaps we need to shift towards exchange-based trading, as we have for equities.

Berthelot, Natixis Asset Management: Equities are much easier to understand. Retail investors buying bonds need to understand about capital gains, capital losses, taxation on the coupon and so on. This is why so few corporates in France use banks' networks to distribute bonds. EDF did, three years ago.

Maroudas, BAA: What's hard about understanding a bond? You lend me money. I pay you back in five years' time and pay interest on it.

Ramzan, Lloyds Bank: The fact is, we're still a home-owning society, not a bond-owning society.

Wilson, D S Smith: But there's a message here. Borrowers aren't just sitting there saying, 'oh dear, the bond market's closed'. They're looking at alternatives, such as private placements, retail bonds and factoring.

EUROWEEK: Simon, where does the loan market fit into the diversification picture.

Allocca, Lloyds Bank: It's frustrating to see people's reluctance to break with convention as to how we look at these things. Everybody seems to be fixated on going down a predetermined route, when we should be exploring new opportunities and avenues, and if that takes a bit of time, so be it.

I would like investors to be more open-minded about opportunities. We hear fund managers and insurance com-

panies telling us they want to buy project and infrastructure bonds, private placements, SME financing. But when you go and talk to them, the reality is that is not the case. The fundamental problem is that there is no real investment in diversity.

That's a problem for issuers. They don't want to be caught out in the bank market. They don't want to be caught out in the bond market as it stands because in half an hour the market may be closed. They want diversity, but there's not enough action being taken as yet.

Horrell, Centrica: We all want diversity, but nobody wants to be the first borrower into a new territory. I'd love it if someone else created a new private placement market, but I don't want to be the one who blazes that trail, especially when there's an established market I can access funding from.



Katherine Horrell
Centrica

Allocca, Lloyds Bank: I look at it the other way round. M&G for example has a mid-market loan fund. They ask us to show them opportunities, which we do. But the execution is not there from the investor side. It's not just M&G. Some insurance companies have set up mid-market funds. But when you show them assets they don't want them.

Ramzan, Lloyds Bank: In addition, why would a bank show M&G a loan asset, when if it were that interesting surely the bank would do it itself?

Allocca, Lloyds Bank: If I take 25 year project finance loans as an example, we all know there is a requirement for infrastructure investment, but the banks are not the right source for 25 year money. Who are the natural takers of 25 year assets? Pension funds and insurance companies. So you go and speak to those investors and they say, yes. But when it comes to execution they say no.

Bates, Lloyds Bank: We've all been thinking that the next big move, as banks continue to deleverage, is the movement of these types of assets from banks' balance sheets to insurance companies' balance sheets. But when we open that dialogue, institutions want to buy these assets but they're driven by yield opportunity. For as long as central authorities provide funding to banks which continues to enable them to lend at levels that aren't attractive to institutional buyers, we will remain the best bid in town for these assets.

Allocca, Lloyds Bank: I agree that's one element of it, but when you speak to a potential investor about the nuances, it's clear that because of the barriers and hurdles they don't want to invest.

Lord, M&G: In 300bp time we'll see those hurdles coming down.

Berthelot, Natixis Asset Management: There are a lot of risks in commercial real estate which many of the banks would like to shift to investors. We're about to launch a senior European commercial real estate loan fund in a partnership, but it's something we've been working on for more than 12 months. We used to lobby the French regulator to allow us to invest in loans within traditional Ucits 3 funds, but it refused. The only way to put loans in a fund is in a Luxembourg SIF, an Irish QIF or a French FCT. So regulation is evolving slowly but it's still less convenient to deal with loans. It's the same for PPP, infrastructure, trade and project finance.

The other thing we lack in Europe, leaving aside Dutch pension funds, is institutional investors with long term liabilities.

Maroudas, BAA: A real issue in the infrastructure market is the shortage of banks prepared to lend long term. The number of institutional buyers of the debt as opposed to the equity is small. That probably affects you, Charles, because BG Group is the only project-based borrower among us.

Stewart, BG Group: This comes back to our discussion about diversification. Our strategy isn't about looking specifically at project finance in the traditional sense where the lender or investor takes the risk on a specific project. It is about borrowing from export credit agencies and development banks on a corporate guaranteed basis. For example we've just signed a \$500m facility with Export Development Canada but it's not linked to any specific project.

We can use it in connection with Canadian procurement anywhere in our worldwide capital expenditure programme.

EUROWEEK: Farouk, you started this discussion by saying we'd have to learn new tricks in this market. Have we learned any in this roundtable?

Ramzan, Lloyds Bank: The point that has come across quite clearly is that this is the new way we do business: dealing with regulation, being more able to interpret market volatility as a fitted fixture and trying to find new ways to reduce the supply/demand imbalance in both the public and private markets.

There are some very healthy elements to what we're doing in navigating the markets. In addition, judging by the commonality of opinion shown today, there is enough agreement that we should find a more rational, consistent way of ensuring that the markets continue to function as the new European model develops — and the impact it has on the UK market becomes clear.

So although I started this discussion by saying I was a glass-half-empty man, maybe the glass is half full — or we should use smaller glasses. D



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