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Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

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For the attention of: Tax Treaties, Transfer Pricing and Financial Transaction Division, OECD/CTPA

Via Email: TransferPricing@OECD.org

Comments by[1]: Amanda Pletz, Gary Lambert, and Emmanuel Llinares

Dear Sir / Madam,

In the context of BEPS action 8 -10, the OECD has released on 3 July 2018 a Discussion Draft on financial transactions. We thank the OECD for having put together such a comprehensive paper and are grateful for the opportunity to provide comments.

This document provides comments in relation to Sections A to D of the recently released Discussion Draft. We outline below a table that summarises the main questions/comments discussed and the relevant sections.

Questions / Paragraph (OECD Discussion Draft)	Section
Box B.1: Views on the guidance included in paragraphs 8 to 10 of this Discussion Draft in the context of Article 25 of the OECD MTC, paragraphs 1 and 2 of Article 9 of the OECD MTC as well as BEPS action 4 report	Section 1 and 2
Box B.2: Views on the example contain in paragraph 17, relevance of maximum amount a borrower would be willing to lend and that a borrower would borrow	Section 3
Box B.3: Views are invited on the breadth of factors specific to financial transactions that need be considered as part of the accurate delineation of the actual transaction / Situation in which a lender would be allocated risks with respect to an advance of funds within an MNE	Section 2, 3, 4 and 5.1
Box B.4 – B.6: Risk free rate return and Risk adjusted return	Section 3 and 5.1
Box C.2: Rebuttable presumptions on credit rating	Section 4.2
Box C.3: Definition of stand-alone rating and implicit support as discussed in paragraph 68 to 74	Section 2 and 4
Box C.4: Relevance of paragraph 70 (implicit support)	Section 2 and 4
Paragraph 73 discussion	Section 4
Box C.5: Role of credit default swaps (CDS) or other economic models in pricing loans	Section 5.1
Box C.6: Financial transactions that may be considered alternatives to intercompany loans	Section 5.1
Box C.7: MNE group's average interest rate paid on its external debt can be considered as internal CUP	Section 5.1
Box C.8: Situations where a cash pool leader would be allocated risk rather than providing services and allocating cash pool benefits	Section 2, 4 and 5.2

Box D.1: Views on guarantees (accurate delineation, circumstances in which a guarantee will be required by a lender, impact of a guarantee on credit rating, examples of process or mechanism by which a price is arrived at)	Section 2, 3, 4, and 5.3

Summary of main points

We believe that financial transactions can be complex and oversimplification may be detrimental to the practical application of the arm's length principle. As in any transfer pricing analysis, facts and circumstances matter in financial transactions. For this reason, an understanding of the value creation process together with a functional assets and risks analysis is indispensable to the analysis of financial transactions. As with any transfer pricing analysis, accurate transaction delineation and options realistically available, should build on a value chain analysis.

We note that the Discussion Draft appropriately reflects the concepts developed in the Guidelines – in particular as regards to Chapter I – in relation to risk. We agree in principle that risk allocation should depend on the effective location of key decision-making ability. We would encourage the OECD to explain more precisely what this may entail in relation to financial transactions. In particular, we encourage the OECD to consider the implications of default risk.

In our comments, we provide input on a number of technical aspects. We summarize the main takeaways below:

- We believe that financial transactions are best addressed through considering perspective of both the lender and borrower (or the transacting parties)

- Where the risk-free rate is applied, we believe that it should be, in most circumstances, determined based on the local government's bond interest rate or government bond interest rate in the functional currency

- Subsidiaries' ratings may be, at arm's length, lower, equal or higher than the Group's rating and consequently the concept of capping set forward by the Discussion Draft does not seem appropriate, especially given that the relational aspects are considered in the context of implicit support.

- We are concerned that the rebuttable presumption that the stand-alone credit rating for a company would be the same as the Group's is not an appropriate simplification

- There are large amounts of potential comparable data available in the financial services industry that can be helpful to price transactions using the comparable uncontrolled price method, including in relation to pricing guarantees fees (for example, credit default swaps). The relevant data will be dependent on the facts and circumstances of each individual case

- We believe it is important to assess whether a cash pool leader is exposed to default risk, and also whether synergistic effects may have been achieved. The arm's length compensation for each participant to the pool should be a function of the value contribution of each of the respective parties and the terms associated with the individual transactions

- With regards to guarantee fees in particular, we believe that it is important to understand what the true economic benefit is that is being achieved. We also believe that it is important to acknowledge that the economic benefit may be volume based rather than just cost of funding. In addition, in an intercompany context, one should also consider default correlation between guarantor and guaranteed.

1. Introduction

The decision-making on the form of capital to be relied upon is often viewed very differently by tax authorities and financial market participants. A firm's decision on the type and level of funding and, more broadly, on how to manage funding within a group, are decisions driven by what is deemed to be an appropriate capital structure. What is deemed to be appropriate will vary depending on the industry in which the firm operates, firm and product lifecycles, business strategy and flexibility required, and transactions costs involved, to name only a few such considerations. A firm will typically assess what the trade-offs are between the costs versus the benefits derived from a given form of funding vis-à-vis alternative options realistically available.

Assessing the arm's length nature of any form of financing arrangement (including its impact on leverage ratios) is therefore very much rooted in the economic environment in which a firm finds itself and should be addressed through the effective application of Paragraph 1 of Article 9 of the MTC. This is true for all types of financing related issues including loans, cash pooling, guarantees, thin capitalisation assessments, etc. We believe that the concepts of value creation, notably the determination of what drives value and the role financing plays in this context should be further enhanced in the guidance. Similarly, the insistence on transactional focus may obscure a more comprehensive view of the relevant broader context of the case at hand.

2. Establishing the role that financing play in a group context

The most important step to address any question relating to financing, is to analyse and understand what drives value in the group, the role that financing play in this process, and how the respective entities involved in the transaction fit into this. Furthermore, it is important to understand the activities performed by the various entities, the risks assumed and their ownership of assets (including both intangible and tangible assets). The information as reflected in "paragraphs 13-15" including:

"As with any controlled transaction, the accurate delineation of financial transactions requires an analysis of the factors affecting the performance of businesses in the industry sector in which the MNE group operates..."

"As described in Chapter I, the process of accurate delineation of the actual transaction also requires an understanding of how the particular MNE group responds to those identified factors…"

In accordance with the guidance established in Chapter I, the accurate delineation of the actual transaction should begin with a thorough identification of the economically relevant characteristics of the transaction –…"

would be information gathered through this analysis. Such an analysis will provide information on the commercial relations between the entities and will provide insight on the strategic and operational importance of an entity to the group's value contribution as whole (a key component when evaluating implicit support[2]).

In addition to this, one should also consider the industry and the regulatory environment in which an entity and/or the multinational enterprise operates. Different industries have different capital needs; for example, trading businesses may rely on large volume short-term funding and may be highly leveraged;

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[2] See Section 4

whilst more basic financial service companies that are less capital-intensive may rely on significantly lower levels of financial leverage. In addition, certain regulatory guidelines may affect a borrower's preferences for certain types and level of funding, thereby influencing the potential options that a borrower may realistically consider.

The objective of the above-mentioned analyses is to obtain the necessary insights needed to understand (i) the rationale for financing, (ii) the reasons for the business financing need, (iii) the appropriate structure of the financing and realistically available options to both the borrower and the lender, (iv) the relational dynamics of the various entities and the influences of any implicit support, (v) the potential factors that may influence default risk in the context of the transaction, and the consequential covenants that would be expected in the transaction.

Only once the above analysis has been completed should one then look at the contractual terms of the intercompany financial transactions themselves including the types of loans, the repayment dates, interest payment intervals, etc., and not the other way around.

3. Analysis of the terms of the transaction

Companies have several avenues at their disposal that can potentially be used to secure financing and several types of financial instruments with varying terms and conditions linked to it. For specific companies at specific times, only certain types of instruments or terms associated with the instruments may be realistically available to them. In this section, we address issues relating to two considerations including the level of funding (Section 3.1) and provide some input in relation to the currency of the funding and the risk-free rate (Section 3.2).

3.1. Level of funding

In this sub-section, we are providing our views on the question raised under box B.2. *"the relevance of the maximum amounts that a lender would have been willing to lend and that a borrower would have been willing to borrow or whether the entire amount needs to be accurately delineated as equity in the event that either of the other amounts are less than total funding required for a particular investment"*

The level of funding that a lender is willing to extend, and the terms associated with that funding are in part (if not largely) driven by their willingness to take on risk. To determine the maximum level of funding, one should analyse the benefits and costs associated with carrying financing instruments, considering the full mix of potential financing instruments that a borrower may have at its disposal across the entire lending market, and the conditions of that market. As an example, in some situations, financing such as subordinated debt or hybrid debt may be available to the borrower in addition to senior debt and should be considered. We therefore believe that the maximum level of debt should be determined based on the facts and circumstance of each individual case, considering the alternative realistically available to both the lender and the borrower. With this caveat, we believe it is appropriate to consider that the amount of loan above the maximum amount that the lender and borrower would have agreed in arm's length conditions as equity.

3.2.   Currency of the funding and the risk-free rate considerations

As a general approach, using the functional currency of the investor is recommended, for all the reasons enumerated in paragraph 32 of the Discussion Draft. We would like nevertheless to see some refinements regarding cases where a currency is used by several countries (as in a currency union). Local government bond yields reflect specificities of the economic and political conditions that a lender operating in that country will be exposed to. It is necessary to consider such a risk-free rate rather than the risk-free rate of the country with the lowest risk of default within that currency union. However, in some cases, government bond yields may reflect a heightened risk of default, (as priced by the market). In these cases, using it as a proxy for the risk-free rate may not be appropriate and alternatives methods should ideally be considered.

4.   Credit rating assessments

4.1.   Determining default risk in an intercompany context

In addition to the risk framework outlined in the OECD guidelines Section D in Chapter I, default risk and the entity that bears this risk is an important factor to consider when dealing with most types of financing arrangements. Default risk is typically determined by means of performing a credit rating analysis.

The 'shadow' credit rating methodologies purport to estimate credit ratings of individual entities in the MNE in the absence of a publicly-available rating. In what follows, the rating that is derived through performing a shadow credit rating assessments is referred to as a "base rating". To cite just one, Moody's Investor Services, offer a relatively transparent methodology to assess the credit rating of companies in many industries that may be relied upon to perform a shadow credit rating.

We believe that in a group setting, the rating of a subsidiary can be lower, the same, or even higher than the group rating. Some of the rating agencies may choose to limit a subsidiary rating to that of the group rating.[3] Since a group rating is ultimately an overall average considering both weak entities and stronger entities that form part of the group, there is no economic reason why a subsidiary's credit standing cannot in principle be higher than the group rating. In our opinion, consideration of factors that may influence the standalone rating should be accounted for when implicit support is being assessed. We are therefore not comfortable with the statement at paragraph 73 that reads:

"If the stand-alone credit rating of an entity is higher than that of the group, it may be appropriate to consider capping the issuer rating for the entity at the group level in circumstance where the parent would likely be able to impose requirement that would undermine the existing rating"

and suggest that it is not included in the Guidelines.

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[3] When reviewing the main rating agencies methodologies in this respect, we note that only S&P ties the subsidiary rating to the parent. Both Fitch and Moody's Investor services do not. Moreover, in both Fitch and Moody's methodologies, a subsidiary rating can be higher than the group rating or parent rating. For more information, see Moody's Investor Service, Rating Non-Guarantee Subsidiaries: Credit considerations in assigning subsidiary ratings in the absence of legally binding parent support, 2003; Fitch, Parent and Subsidiary Rating Linkage, February 2018; and S&P, General Criteria, Group Rating Methodology, 2013 pg,17

Relationship between credit rating and the Group transfer pricing policy

An important consideration when doing credit rating analyses for subsidiaries, is that all related party transactions that influence the financial standing of a related party are priced at arm's length. We believe that it is therefore necessary to assess the arm's length nature of all related party transactions that form part of the financial accounts of the subsidiary prior to performing a shadow credit rating assessment, as suggested in paragraph 65 of the Discussion Draft.

Relationship between the "base" or "overall" rating and the "instrument rating"

In our opinion, if the characteristics of the transaction warrant it (for example when it is necessary to account for subordination), a specific financial instrument issued by a member of the MNE can have a different credit rating from the base rating derived for the member. The reason for this being that the probability of default on a financial instrument is linked to its features, not only the risk profile of the borrower. Therefore, we believe that it would be appropriate to use the specific instrument rating (rather than the base rating of the borrower) even in situations where it is appropriate to use similar base credit ratings for the members of the MNE.

4.2.   Implicit Support

The rebuttable presumptions in Box C.2. states "*that an independently derived credit rating at the group level may be taken as the credit rating for each group member, for the purposes of pricing the interest rate…*"; and "*tax administrations may consider to use the credit rating of the MNE group as the starting point…*"

We agree that in some circumstances, this approach may provide reasonable results. However, we are not certain that this approach is suitable as a rebuttable presumption. Namely, we believe that the reasonableness of these presumptions depends on the relationship between the different group members, and more generally how the MNE is structured. In this context, it may be important to consider factors such as the strategic significance and the operational integration of an entity within an MNE in assessing the nature of relationship between such entity and the MNE as a whole.

Should an analysis of such factors point towards a heightened integration of the member in the group, one can expect that member to be attributed a credit rating more closely linked to that of the group. Conversely, should one arrive to the opposite conclusion, a more markedly different credit rating for the member compared to that of the group can be expected and the rebuttable presumption would not reflect the nature of the relationship. In such a case, we would expect the credit rating assigned to the group member to reflect the member's specific characteristics and to be potentially different from the credit rating derived for the group.

We are concerned that there are too many circumstances where the rebuttable presumption is not valid. In this context, we believe that such a rebuttable presumption should not be included in the guidance. Instead, we believe a better practice is to perform a stand-alone shadow credit rating assessment and the necessary adjustments to this rating for implicit support to the extent relevant.

Moreover, whilst we are broadly in agreement with the text of paragraph 70 quoted below:

In assessing the extent to which it may be reasonable to assume that the group would be likely to support a particular entity, a group member with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other group members than a less integral member."

we would suggest replacing "…group's identity **or** important to its future strategy…" by "…group's identity **and** important to its future strategy…". Indeed, strategy can change over time, and sometimes quite abruptly, potentially affecting any previously identified implicit support. We believe that both strategic significance **and** being integral to the group's identity (together with operational integration) need be present to assess implicit support (and hence potentially arriving at a conclusion that a member's credit rating is more closely linked to that of the group).

5.   Pricing of the Financial Transaction

We believe that the pricing of a financial transaction is notably driven by the type of financing arrangement that one is dealing with. Thus, we divide this section into three discussion areas in line with the OECD Discussion Draft: loans (Section 5.1), cash pooling (Section 5.2) and guarantees (Section 5.3).

5.1.   Loans

Many potential characteristics related to loans have a price impact, and they should therefore be considered when evaluating the interest rate paid by the borrower. Examples include up-front fees, optionality features such as is the case of convertible debt instruments, repayment features etc.

When performing a pricing analysis, one should consider each element associated with the transaction, including form, payments, restrictions, timing, seniority, etc. identified through the analysis described in sections 2 and 3 above. All of these factors need to be considered and addressed in line with the principles detailed in Section D.1. in Chapter I of the Guidelines on Economically Relevant Characteristics.

5.1.1.   Components of an interest rate and related considerations

To effectively address the pricing of a loan, it is worthwhile considering more widely the components of an interest rate. This would help in addressing the points raised in Box B.4, B.5 and B.6.

Economic and financial theory indicates that the interest rate charged for a loan is a combination of: (a) a risk-free rate[4]; (b) expected inflation[5]; and (c) the premiums that are associated with default,[6]

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[4] Hypothetical rate typically reflecting the time value of money.

[5] The market has expectations of price rises (or declines); inflation expectations are therefore factored into interest rates.

[6] A higher probability of default increases risk and hence increases the price necessary to bear such a risk (through higher interest rates). This default risk is estimated by considering potential losses of capital (expected loss) given default of the borrower.

liquidity,[7] and maturity.[8] These components of interest rates compensate a lender for the risk it takes for providing the capital over a specified time including its cost of funds.

In the case of banks and other financial intermediaries, the interest rate also includes some element of functional compensation, typically relied upon to cover a bank's operational expenses or payment and liquidity management. In other words, on top of the components listed in the previous paragraph, there is a functional component to the interest rate charged by a bank.

Since there are several components to the interest rate, we would expect that under the guidance on risks in Chapter I, the remuneration of each of these components, when performed by different entities, is properly reflected.

In this context, we fear that the statements of reliance on the risk-free rate as highlighted in Box B.4. *"the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return"* may cause confusion with regards to the assumption of credit risk notably.

A key aspect is to assess whether a lender has the means to make the decisions to grant a loan and to undertake strategic decisions during the life of the loan. In our opinion, the current risk framework should be taken one step further in this context to specify what the decision-making and control functions may entail when dealing with loans. In this respect, we would expect key decisions to relate to default risk. In practice, the decision-making functions to control the risks associated with investing in a financial asset may involve a limited number of decisions. Such decisions making functions are different from the functions relating to the day to day administration of the loan and would potentially be compensated through what we described above to be the functional component of the interest rate.

5.1.2. Data and pricing methods to evaluate interest rates

When performing a transfer pricing study, there are many approaches and data sources that can be relied upon. We agree in general with the content and approaches outlined within the OECD Discussion Draft section C.1.7. However, in the context of the discussion, we outline below a few considerations when it comes to using different data sources.

5.1.2.1. Comparable uncontrolled price method

The availability of external comparable uncontrolled price data that can be relied upon depends on the facts and circumstances of each individual case. For example, for "plain vanilla" loans, one could potentially rely on comparable loan transactions or bond market data. For more complex loan instruments, such as certain mezzanine-type instruments with hybrid features, other sources of data or economic models may be needed.

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[7] Liquidity is defined as the ability to sell an asset on short notice, at a price that reflects the level at which the market as whole values that asset at that time (efficient market). The inability to do so (or the partial ability to do so) might force a seller to concede to a discount when offloading that asset. Holding everything else constant, the holder of a less liquid security must be compensated for that potential scenario, and hence receive a higher interest rate than would have been prevalent, had the security been fully negotiable at any time.

[8] In general, investors need to be compensated for the fact of investing money for longer periods of time. This is true for 'normal' environments where the interest rate curve is upward sloping – i.e., where long-term rates are higher than shorter-term ones. In case of an interest rate curve inversion, the opposite is true.

Furthermore, averages of internal comparable uncontrolled price transactions such as, for example, an average borrowing rate of a firm can mask a wide range of factors that influences the interest rates. These can include factors such as, currency, maturity, size, position in the capital structure, the entity borrowing and default risk, among others. Hence unless both the identified transactions, i.e., the tested transaction and the transactions relied upon to apply an "internal comparable uncontrolled price" are highly similar (same currency, same maturity, same credit risk, etc.), the average interest rate paid on external debt should not necessarily be considered as a viable comparable, unless appropriate adjustments can be performed to achieve reliable valuations.

5.1.2.2. Credit default Swaps and their use in intercompany loans

The Credit Default Swap market offers large banking groups a way to offload (or gain access to) certain credit exposures on (for) their loan books. It can therefore be a source of financial market information of default risk.

Certain caveats apply, nonetheless. The two issues described below point towards situations where CDS spreads might not be appropriate for assessing arm's length interest rates on loans, in as much as the pricing of CDS spreads can reflect other considerations not directly linked to the default risk of the reference entity (issuer).

1. Recently, the market has seen situations of 'artificial' credit events, where a lender invested in credit default swaps of a certain issuer. The lender discussed extending new favourable loans to that issuer, under the condition that that issuer took steps that constituted an Event of Default under the ISDA Swap definitions (a consequence of which was a windfall for the lender on its CDS positions) on existing debt. The recent *Hovnanian Enterprises* case illustrates that this Event of Default (and hence the level of Credit Default spreads) did not reflect the true financial state of the issuer. In such circumstances, CDS spreads should not be included in any arm's length analysis for interest rates.[9]

2. Basel III / CRD IV (in Europe) have imposed additional capital requirements on banks. These requirements include additional capital requirements linked to actual and potential credit exposure to OTC transactions contracted by the banks with their corporate clients. One way to decrease the capital requirements due to this activity is to purchase default risk protection on these corporate names. The new legislation has systematized such practice, leading large financial institutions to massively buy protection via Credit Default Swaps on certain corporate names on which they are (and potentially could be) exposed. The effect on the level of CDS spread can easily be understood: financial institutions bidding up CDS spreads on certain names (therefore increasing the level of those spreads) introduces a mark-up on the price of default risk, which is independent from the true default risk of the issuer. [10] We recommend, for this reason, to always cross-reference the information in the CDS market with other sources of information on default risk: in the bond markets, in the asset-swap market, etc.

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[9] One recent case, at the beginning of 2018, involved Hovnanian Enterprises Inc. (a home builder), expecting a loan from GSO Capital Partners LP, a unit of Blackstone Group LP, with the condition attached that it miss a small interest payment, despite being financially able to pay. Hovnanian accepted this offer and the missed repayment triggered pay-outs of USD 333 million in Blackstone's credit insurance contracts (GSO had purchased protection in the CDS market prior to extending the loan).

[10] Please see, for example, C.Kenyon and A. Green "CDS pricing under Basel III: capital relief and default protection", 22 November 2012, or Laurie Carver, "Capital relief accounts for 70% of some CDS spreads, quant say", 3 October 2013, Risk Magazine.

In conclusion, in arm's length analyses of interest rates on loans, although CDS spreads should be consulted whenever available, this process should not be done blindly. Specific situations should be assessed, to guarantee that the data obtained from the CDS market constitutes a reliable source of comparable market information.

5.2. Cash pooling

5.2.1. Assessment of risk allocation to a cash pool leader

In a cash pool analysis, we believe that it would be important to assess if a cash pool leader does in fact carry any form of risk (typically a physical cash pooling model) or whether it is a pure service provider (typically a notional cash pooling model).

For a cash pool leader to carry default risk, there needs to be a realistic probability for it to incur losses. The default risk carried by the cash pool leader is based on the default probability of the participants of the cash pool (i.e. summarized by their respective shadow credit ratings).

To effectively perform its activities, a cash pool leader needs to have the appropriate level of capital to bear the risks associated with credit risk and term transformation, including those associated with liquidity and maturity, should they materialise. The capital adequacy should therefore be estimated on an assessment of the loan portfolio that it has in relation to the participants, and liabilities that it carries towards third party lenders and participating depositors. In a banking context, regulatory guidance such as for example the Basel III framework is relied upon to establish the minimum capital adequacy requirements. This minimum is to ensure a financial institution (or in our case the cash pool leader) has sufficient liquidity to absorb the risks should they materialise.

Similar approaches as that described under Sections 4 and 5.1 above can be relied upon to establish the arm's length compensation for a cash pool structure in which the cash pool entity is exposed to default risk.

5.2.2. Allocation of benefits arrived through a cash pool

In the context of cash pools, synergistic benefits may be created. The implications of this (if any) would need to be firstly identified by means of analyses described in section 2 above, and then accounted for in an economic analysis. The remainder of this section will provide comments on the approaches highlight for "allocating the cash pooling benefit to the participating pool members".

1. Enhancing the interest rate for all participants

"This means to benefit both borrowers and lenders with a more favourable interest rate, for example by relating this to the size of the balance regardless of whether that is a credit or debit balance."

Firstly, one needs to establish that the group did in fact achieve a synergistic benefit other than a reduction in agency cost (which may not always be the case). However, once one has assessed that benefits have been achieved, applying this approach would favour all participants in the cash pool on an equal basis. It is not obvious why, under normal market circumstances, net borrowers should participate in the cash pooling benefit, in as much as the main value contributors to pool would be the depositors rather than the borrowers.

2. Applying the same interest rate for all participants

"In a situation where all cash pool members have the same or a similar credit profile, this method suggests using the same interest rate for all pool participants regardless of whether they are depositors or borrowers."

As an aside, we are concerned that the assumption that all pool participants have the same or similar credit profile may not be realistic. Notwithstanding the above, this approach would assume globally: (i) that all participants terms and conditions associated with each of the transactions are the same; and (ii) that they all operate in the same market. We are not certain that this reflects the reality of multinational enterprises, and we are therefore concerned that it may not result in an arm's length valuation. We would recommend that this approach be removed from the guidance.

3. Allocating the cash pooling benefits to the depositors

"Where genuine credit risk to the depositors, the interest rate benefit of pooling may be rateably allocated among the net depositors on the basis that the depositors have their capital at risk across all net borrowers and so should be entitled to any benefit arising from the use of that capital."

This approach assumes that the depositors are entitled to all the synergistic benefits that arise from the cash pool arrangement, potentially excluding the value contribution of the cash pool leader itself and the risk that it carries in the context of the cash pool structure. Even if the cash pool leader was only performing coordination activities and would not bear any risks, it should still receive an arm's length compensation based on its value contribution, and functions, asset and risk profile. Hence, we would suggest that the remuneration for the cash pool header is first assessed properly (also considering its share of synergistic benefit). Accordingly, since the depositors may not be the risk-bearing entities with respect to default risk per se in relation to the borrowers, they would not necessarily be entitled to the full profits achieved through synergies.

4. Alternative approaches to account for synergistic benefits

To account for synergistic benefits, it is important to identify the "marginal benefit that is achieved" i.e., the difference with and without a cash pool for each of the parties involved. Only the marginal benefit should in fact be shared amongst various participants in a cash pool arrangement in line with the relative contribution to the overall marginal benefit achieved. This can be done by means of deriving an allocation key or split factor that is based on the facts and circumstances of the case (similarly to what one would typically do to split a residual profit as part of the profit split methodology). Therefore, it is essential to clearly identify separately, and quantify the contributions to the cash pool by the entities in the various jurisdictions.

Alternative measures to allocate the arising profits amongst the contributing entities can also be applied. Bargaining theory can be a useful method to analyse how profits from joint value creation can be split. A hypothetical negotiation of related parties can be simulated based on bargaining power identified by options realistically available and the contributions made to the marginal benefit achieved.

5.3. Guarantees

The current Discussion Draft mainly considers financial guarantees. For this purpose, we will focus on this type of guarantee. Financial guarantees are instruments of credit enhancement which insure security purchasers against default (in essence, an insurance policy). Financial guarantees may typically result

in an increase access to finance (i.e., quantum effect) or the reduction of interest rate. Lenders would typically require a guarantee for the following reasons:[11]

1. Transformation of the nature of credit risk by means of achieving wider recourse;

2. Lender comfort through having access to wider pool of assets against which it can claim; and

3. The reduction of the funding costs by increasing the lender's chances of repayment, thus reducing the lender's risk and interest rate.

5.3.1. The economic benefit derived from a guarantee

The economic benefit arising to the borrower from a guarantee is either related to the borrowing terms (interest rate) or to the borrowed amount (quantum). Moreover, in some instances, although one may find an improvement in rate, a firm may seek a financial guarantee solely to have relatively immediate access to financing of a large magnitude. One sees this often in the financial services, energy, or other trading sectors, capitalizing on short notice speculative trading or dealing. Therefore, the notion that an "*entity guaranteed would not be willing to accept a guarantee equal to borrowing cost without the guarantee as described in paragraph 152*", is not systematically correct. For example, if a firm without a guarantee was not able to achieve the level of funding needed to conduct a transaction that has potential to be highly profitable, then the company may be willing to forego potentially the full extent of the benefit achieved by the reduction in lending rate or the amount of funding, since the up-side to the transaction is the future expected profits achieved through the financing that otherwise would have been lost.

Furthermore, in practice, equally rated businesses can provide financial guarantees to other third parties to allow them access to a bigger balance sheet. This has an economic value as well, and should be acknowledged as such.

In light of the above, we suggest that the guidance provided in paragraph 140, page 33, be amended to include alternative situations that arise in practice: "*Where the effect of a guarantee is to permit a borrower to borrow a greater amount of debt that it could in the absence of the guarantee, [...]. In such a situation there may be two issues – whether a portion of the loan from the lender to the borrower is accurately delineated as a loan from the lender to the guarantor (followed by an equity contribution from the guarantor to the borrower), and whether the guarantee fee paid with respect to the portion of the loan that is respected as a loan from the lender to the borrower is arm's length. (D.1 para. 140 p .33).*

5.3.2. Establishing economic benefit in an intercompany context and implications on pricing

One would expect to consider the benefits achieved through passive association (implicit support) in the context of intercompany guarantees. If the entity being guaranteed is of significant strategic and operational importance, the financing achieved through the guarantee, is ultimately to the economic benefit of the guarantor as well. In these cases, the guarantor would probably not consider to default, dissolve or divest the entity being guaranteed.

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[11] Peterson A et al., Butterworths Journal of International Banking and Finance Law, June 2002.

The second element to consider when studying a guarantee arrangement relates to the "financial ability" of a guarantor to honour its obligation if a default were to occur. In a related-party context, this element concerns not only the differential in creditworthiness amongst two entities, but also business correlations observed given the level of assets and liabilities in both entities (in other words, if a default were to occur, would the guarantor be able to honor obligation towards the financial institution, and the entity being guaranteed, especially if they are operating under similar market conditions that could have potentially adversely affected the guarantor as well?). We demonstrate this point with a much-simplified example:

Entity A in country A provides a guarantee to Entity B in country B. Entity A operates in the energy sector and so does Entity B. Globally, they are exposed to the same market risk factors. Entity A is rated AA whilst entity B is rated BBB- including consideration of the implications of passive association. Relying on a yield differential approach, the maximum guarantee fee would then be the difference in yield between AA and BBB-. Since these entities operate in the same sector, however, and are potentially subject to the same market factors, market events that cause a default of entity B may also lead to a default of entity A. In this example, the guarantee could potentially have limited value to entity B (or the financial institution), in spite of the rating differential observed between the two parties.

Similarly, if we now assume that entity A is BBB rated and entity B BBB- rated, with these entities operating in completely different markets, in which market events affecting entity B would not affect entity A, then the correlation can be said to be zero and therefore the B would potentially get the full benefit from the guarantee as measured by the yield differential.

5.3.3. Pricing methodologies

We globally agree with the methodologies outlined by OECD in the sections D.1.2 and D.1.3 Discussion Draft. In addition to this, we would add the use of CDS data. We provide some commentary on the various methods highlighted.

5.3.3.1. The Comparable uncontrolled price method

In the context of the following text: "*the difficulty with using the CUP method is that a sufficiently similar credit enhancing guarantee is unlikely to be found between unrelated parties given that unrelated party guarantees of bank loans are uncommon*". We do not agree with this statement.

There are many market participants that provide financial guarantees. Some of these include specialist monoline financial guarantee insurance companies such as MBIA, Ambac, FGIC, Assured Guarantee, ACA Financial Guarantee Corporation, and CIFG, to name a few, amongst a number of more diversified insurers providing credit insurance. Typically, although these insurance policies (transactions) exist, they tend to be private and are therefore difficult to rely upon as benchmark comparables. For this reason, it may be difficult to rely on this methodology. Furthermore, similarly to other types of insurance transactions, the CUP methodology would most likely require a number of adjustments since third-party insurers premiums would include administrative expenses and other regulatory implications that may not always be relevant in related party context.

5.3.3.2. Yield Approach

The yield approach, also referred to as a market approach, is a commonly used approach when performing guarantee fee analysis in transfer pricing. This approach is relatively simple to implement

(see example in section 5.3.2). It does however have various drawbacks such as for example (i) in cases where the benefit of the guarantee may not only be rate specific but rather quantum specific; (ii) the data is subject to its own market factors, thereby leading to diverging results when compared to other methods; (iii) terms and conditions and industries will have implications on the rates observed, thereby often requiring a comparability adjustments as outlined in the OECD guidelines section D.1 and tested transaction; etc.

5.3.3.3. Actuarial method(s)

This methodology broadly cover approaches described under paragraph 153 and 154 of the Discussion Draft. The price of the guarantee contract can be estimated by summing the expected losses (loss given default which is a factor of the default probability and recovery rates) and the opportunity cost associated with the capital used to cover any unexpected losses. The unexpected loss represents the amount of capital a financial institution should keep in its balance sheet to cover the realization of unexpected losses that can arise due to adverse market conditions. The method also includes a rate of return on the capital needed.

This method is typically used by insurance companies and banks that may issue guarantees. In a third-party context, results achieved from this methodology would be typically adjusted to account for administrative cost of the insurer or the financial institution providing the guarantee or credit insurance. This methodology can also easily be relied on in all cases where other methods may not be appropriate and can furthermore be easily be adjusted to account for varying features of a transaction.

5.3.3.4. CDS Spreads

One method not listed in the paper is the use of CDS spreads when pricing inter-group guarantees. CDS spreads are probably the most direct comparable data publicly available in the market that relate directly to the provision of credit insurance of some sort. Three parties are involved in a CDS transaction: (i) the seller of credit protection (guarantor); (ii) the buyer of credit protection (lender or entity exposed to the default event of the borrower); and (iii) the underlying security (the borrower or the entity on which the default event can materialize). Thus, CDS transactions can be used to quantify the cost of guaranteeing payment of a corporate loan. When relying on this type of data, the definition of the credit event (i.e. bankruptcy, failure to pay, restructuring *etc.*) is key in the comparability between the tested guarantee transaction and the CDS agreement. Please see discussion in Section 5.1.2.2 above for potential limitations in using the information from the CDS market.

6. Conclusion

Addressing questions associated with financing arrangements requires an approach that effectively delineates the transaction, which is based upon a detailed value chain analysis. This is more than just a two-sided functional analysis with respect to the borrower and the lender (or a guarantor and entity being guaranteed). This analysis should start with the total relevant business and how value is created and the role that financing plays in this respect. We believe that the relevant "accurate delineation" of transactions follow from that analysis, and not the other way around. This type of analysis is important to assess the economic benefit derived from the transaction and to understand the commercial and financial relations amongst the parties involved in the transaction and benefits achieved (if any) through passive association. It is therefore the foundation on which any inter-group pricing exercise should be based.

The risk framework already described in the OECD guidelines effectively identifies the items to be considered in the context of financing. This should however be taken one step further to specify what key decisions and capacities to control risk mean in the context of financing transactions. Furthermore, the evaluation and pricing of any financial transaction should be based on an analysis that is informed from the underlying financial economics.

We firmly believe that in all aspects related to financing one should consistently apply the arm's length principle. In this context, it may not be possible to produce simplified guidance. We would recommend that the guidance aims at providing additional details to facilitate application of the arm's length principle.