Reform of taxation of securitisation companies

Consultation response from Allia C&C, the Impact Investing Institute, Big Society Capital and Social Enterprise UK

Background

The Retail Charity Bonds platform (RCB) was created to address a point of market failure.

Over the last twenty years there has been an increasing desire amongst both retail and institutional investors to go beyond traditional ESG investing. They are looking to use their funds to support positive social and/or environmental impact, but also still need to invest in appropriately regulated, listed securities.

There are also many charities that operate as successful businesses, generating revenues and developing assets to fulfil their charitable purpose. While the very largest universities and housing associations have been able to grow by raising debt in the capital markets, the costs of issuing listed securities made this source of funding inaccessible to any borrower looking to raise much less than £50 million.

Upon its launch in 2014, RCB significantly lowered this hurdle. By issuing the bonds through a special purpose vehicle with standard form documentation, the platform has made it affordable to raise far smaller amounts. In each case, the proceeds of the issue are advanced to a single charity under the terms of a loan agreement. This pass-through arrangement means that investors take credit risk on the charity, as if the charity itself were the issuer of the bonds. In order for this arrangement to work, RCB is reliant on meeting the conditions of being a note-issuing company.

Today, the minimum issue size is determined not by the costs of issue but by the securitisation regulations that prohibit RCB from issuing amounts below £10 million. We consider that this unnecessary barrier should be lowered so that charities are able to connect with investors through regulated channels for amounts as low as £5 million.

Minimum Note Issuance Threshold

Should the threshold limit per capital market arrangement be changed and if so, to what sum and why?

Retail Charity Bonds PLC raises funding for charities by issuing bonds and lending the proceeds, in each case, to a single charity borrower. As an SPV it has no other business and relies on qualifying as a securitisation company to ensure that it is taxed only on its retained profits. If it ceased to satisfy the conditions to be taxed in accordance with the securitisation regulations, it could be subject to additional tax liabilities which would leave it unable to make payments to investors under the bonds.

RCB therefore cannot currently raise amounts of less than £10 million. This makes the platform of no benefit to any charity wanting to borrow any smaller sum. It also creates execution risk for charities wanting to borrow £10 million as the bonds cannot be issued if the sum raised is any fraction below the threshold.

During the financial year 2017/18 there were 751 registered charities with annual income of £10m or more.[1] There were however a further 5,464 charities with income between £1m and £10m. While there is no simple correlation between revenue and borrowing ability, the data suggest that there are significantly more charities that might want to borrow between £5m to £10m than could borrow more than £10m.

While RCB has considerably reduced the costs of issuing listed securities, there is still a minimum cost and we consider that this puts the smallest viable issue size at £5m. We therefore propose that the threshold limit be changed to £5m so that borrower behaviour can be determined by the market and not by regulation.

We believe that such a change would benefit more charities with access to medium-term unsecured funding through the capital markets that is not available to them elsewhere, resulting in the growth of charitable activities and greater social benefit, particularly in areas such as affordable housing, supported living and care for the elderly. We also consider that an increase in the number of RCB issues will further stimulate investor demand for impact investing opportunities. Indeed the government's own taskforce recommended this review of the minimum issuance threshold as a means of expanding the social investment market in the UK.[2]

In addition, it is worth noting that the alternative for charities wanting to reach multiple investors for amounts below £10m is to make an offer of mini-bonds. This presents greater execution risk to the charity and is likely to result in greater risk to retail investors. The unfortunate consequence of the current threshold is that this regulatory barrier is driving investment behaviour into unregulated markets.

Should the threshold be subject to any other amendment: for instance, should it be possible to take into account an issue made earlier in an accounting period in assessing whether the threshold is met for a second issue later in the period? If so, how and why?

If the minimum threshold is reduced to £5m then we do not consider there to be a need for any further amendments. However if HMRC opts to retain the £10m threshold for a first issue by a securitisation company, we believe the regulation should not require subsequent issues to meet the same condition.

A test that looks at total issuance within the bounds of a single accounting period is problematic. This limited view would mean that the note-issuing company could not issue £9m on the first day of its financial year even if it had separately issued £100m the day before. Instead, we consider it instructive that a company need only make one qualifying capital market arrangement to come within the scope of the securitisation regulations. If one such arrangement is sufficient, our view is that once the conditions have been met the size of investments made under future arrangements should not be relevant as long as the company does not engage in any other activity in breach of Condition D of the conditions of being a "note-issuing company".

In other words, if the company is party to a single capital market arrangement whereby the total value of the capital market investments made under such arrangement is at least £10 million, then the company should be considered to meet Condition C regardless of the total value of capital market investments made under any subsequent capital market arrangement.

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[1] UK Civil Society Almanac 2020, NCVO. Note that this is only charities registered with the Charity Commission; it does not include exempt charities such as housing associations and other community benefit societies.

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/664321/Full_Report_Growing_a_Culture_of_Social_Impact_Investing_in_the_UK.pdf

If any such changes are proposed, what would be the best way of minimising the risk that arrangements are inadvertently caught by the amended rules?

We are not aware of any companies that both: (a) meet all the existing conditions of being a note-issuing company, apart from the size of their capital market investments; and (b) would want to avoid inadvertently falling under the definition of a securitisation company. In particular, we note that Condition D draws the boundaries very tightly to exclude any companies that are not genuinely established as a special purpose note-issuing company.

Equally, we are not aware of any circumstances in which a company meets all the conditions apart from the size of their capital market investments and in which harm might arise from treating the company as a securitisation company.

We consider therefore that the simplest solution is to lower the threshold. However, if HMRC considers there to be a material risk of arrangements being inadvertently caught then we would alternatively propose that companies be permitted to opt in to treatment as a securitisation company if they meet all the conditions apart from the threshold size. The regulations are intended to be supportive of genuine securitisations and not to prohibit tax avoidance. It is appropriate that companies above the given threshold should not need to take any action to come within scope of the regulations; but we do not believe that an opt in provision for those below would give any potential for avoidance behaviours, given the tightness of the other conditions.

Retained Securitisations

In corporate bond issues, retained bonds offer a valuable means of allowing issuers to raise additional funding as required during the term of the bonds. This avoids both the costs of carrying surplus debt from the outset and the expense of a new issue.

RCB has used this technology since 2016 as a means of further reducing the cost of funding for charity borrowers. In each bond issue a certain proportion of bonds are sold to the manager and immediately repurchased by the issuer, and held on its behalf by a custodian. When the charity wants to increase its borrowing the issuer may sell some or all of the retained bonds at the prevailing market price to professional investors – even in small tranches under £1m – and the proceeds are transferred to the charity as a further loan advance.

This is essentially the same as the 'treasury notes' described in the Corporate Finance Manual at CFM72390, except that the bonds are held by the issuer and not by a trustee acting as nominee.

There is however a lack of clarity in the regulation as to whether the holding of retained bonds by the issuer can be considered an 'incidental activity' under Condition D of the conditions for a note-issuing company. If a judgment were to be made that the holding of retained bonds for any one issue was not incidental the issuer might cease to meet the conditions, resulting in defaults and losses for investors across all issues.

For this reason the proportion of bonds retained has always been less than 50% of the total amount issued and the issuer has, in advance of every offer of bonds, requested affirmation from HMRC that the holding of the proposed amount of retained bonds would be considered an incidental activity and would not affect the issuer's treatment as a securitisation company.

We would therefore request that HMRC provides clarification in the Corporate Finance Manual that the holding of any amount of retained bonds in relation to a capital market arrangement is an incidental activity.