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Private and Confidential

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Tax Treaties, Transfer Pricing and Financial Transactions Division,
OECD/CTPA
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Dear Sir or Madam

OECD discussion draft on financial transactions

BDO International thanks the OECD for the opportunity to provide comments on its discussion draft on the transfer pricing of financial transactions ('the DD') issued on 3 July 2018.

We consider this a very important area for transfer pricing practices, not least due to the relative fungibility of financing arrangements, and it is clear that a great deal of thought has been given to this wide-ranging and often complex area.

We set out a summary of our opinions and recommendations overleaf followed by more specific comments on particular matters.

Yours faithfully

Anton Hume
Transfer Pricing Partner
For and on behalf of BDO LLP
Representing BDO International

Overview of comments

The Discussion Draft helpfully highlights difficult and controversial areas, and sets out sensible approaches for certain aspects of the transfer pricing analysis of financial arrangements.

Guidance on this area should ideally lead to increased clarity on how both borrowing and lending parties, as well as any other relevant parties such as treasury teams, should be assessed for transfer pricing purposes. However, the current DD gives us some cause for concern that a range of subjective areas could potentially remain open for conflict due to potential differences in interpretation.

We note that the DD does not represent the consensus views of the CFA, and we understand that differences of opinion remain within Working Party 6 ("WP6") in relation to certain aspects. We welcome the fact that the DD has been published in the spirit of obtaining wider input from MNEs and advisers to assist the move toward both a consensus view, and a more coherent position. BDO strongly supports the need for consensus, and we believe that, in its absence, the DD could encourage further controversy, MAP disputes and double taxation, and result in a failure to provide the tax certainty which businesses need.

The detail given to discussions on the pricing of loans is commendable, however little is covered in terms of how the quantum of loans should be assessed. For example, discussion could be included in relation to common metrics such as debt:EBITDA or interest cover, or other ratios for certain transaction types. The implications of guarantees should also be considered in relation to this area, instead of just in respect of loan pricing.

In addition, we feel that it would be appropriate to resist any temptation to turn transfer pricing interpretation into a counter for specific tax-planning scenarios where this approach has the potential to lead to a lack of clarity or potentially significant compliance burdens.

An example to highlight this is the general area of 'risk-free returns'. There is a valid concern that groups are in some cases able to make an equity contribution to a subsidiary in a low-tax jurisdiction, and then lend funds via this entity to other group members, in order to shift profits. While we would not suggest that such arrangements should be specifically spared from the appropriate application of transfer pricing principles, attempts to prevent profits arising in such companies via transfer pricing could have much wider consequences.

It should not be overlooked that in many instances groups do not have complex financial management structures within each entity, and can often be run on a group-wide basis, leading in some cases to limited discretion or control over which entity will provide funding to each other. If MNEs are assessed against a theoretical ideal of a true lending business, where credit committees would operate and detailed monitoring and analysis of ongoing arrangements would be expected, then they would often fall short.

The risk-free return approach for MNEs with limited control over their lending arrangements would appear to potentially impact most intercompany lending within MNE groups. For example, a cash pooling or similarly automated arrangement could be expected to be treated in this way. At the extreme end of the spectrum, certain treasury management roles could be transferred to low-tax jurisdictions, potentially side-stepping the type of issue the rule appears to be seeking to address.

It may still be valid to incorporate appropriate returns for MNEs managing the financing arrangements of other group members, especially where the functions performed are

complex (similar to the management of a debt fund or other set of investments), but the approach taken appears poorly targeted.

Generally, more examples upon the lines of Chapter VI would be welcome to give greater clarity to the guidelines. We also believe that this will give greater clarity to WP6's thinking in regard to the issues considered.

Our subsequent comments are selective and do not comprehensively cover every area addressed in the DD.

Specific areas

We set out below specific comments on the areas raised in the consultation.

Section B.1. - Identifying the commercial or financial relations

Assuming that it is intended that the guidance should apply to all types of business, including both regulated and unregulated Financial Services ("FS") business, then the statement that, "An MNE group has the *discretion* to decide upon the amount debt… that will be used to fund any MNE within the group" (paragraph 3), will not necessarily be correct where regulatory constraints dictate otherwise.

We believe that the intention is that the guidance should apply to FS as well as other businesses, but some explicit statement to this effect, and some commentary in relation to FS business, including examples, would also be helpful.

Delineation and characterisation

The delineation of transactions is an appropriate step in any transfer pricing analysis, however as noted in paragraphs 8-10, there are often other tax rules that may be expected to address the characterisation of balances that may appear as debt, but have certain equity-like characteristics.

In applying the arm's length principle, we consider it critical to determine the amount of debt, and other relevant terms that would have been agreed between unrelated parties. Many aspects discussed, such as the ability or willingness to make repayments, are relevant to this analysis.

The example in paragraph 17 is reasonable in this context, and we do not consider that the question of debt/equity characterisation under any transfer pricing analysis should be looked at with an 'all or nothing' approach.

We recommend that further clarity is provided to separate 'quasi-equity' type arguments that seek to determine whether in actual fact the balances appear to be in the nature of equity, from any analysis that focuses on the likely lending and borrowing capacity of parties dealing at arm's length.

While separating out capital-like balances from any financing analysis may be a benevolent aim, it creates a somewhat paradoxical state of affairs where the alternative position assumed to take place between independent parties acting at arm's length is considered to be the provision of equity.

Separate transfer pricing treatment could be considered, for instance not imputing interest income on these balances, but clarity over how this may take place would be appropriate.

On the other hand, the question as to whether a financing business acting at arm's length would advance funds, and if so, on what terms, sits much more naturally within the principles applied elsewhere in transfer pricing.

If capital structure matters cannot be sufficiently addressed by reference to the arm's length principle (clearly a conclusion of the OECD which motivated BES Action 4), then there may need to be a new mechanism available to MNEs to address the concern that current mechanisms do not efficiently prevent the problem of double taxation in relation to debt/equity matters. This might take the form of a revision to the OECD model treaty to

provide mechanisms for mutual agreement on such matters, and potential advanced mutual agreement measures and arbitration mechanisms to resolve potential disputes.

In relation to the amount of debt to be priced, BDO otherwise welcomes the DD's advocacy of the alignment of the guidance with the approach to the accurate delineation of the actual transaction in accordance with Chapter I. However, the range of factors (and the level complexity, and compliance burden, this would suggest) that are advocated should be considered. In that context. The following areas give us cause for concern:

a) The requirement to consider how a group prioritises funding needs among different projects (para 14).
b) The requirement on the part of the entity that advances funds to consider other investment opportunities (para 19).
c) The absence of any specific reference to materiality when it comes to demonstrating that outcomes demonstrate compliance with the arm's length principle.

In relation to b) above, it would seem appropriate to recognise that a lending entity in an MNE group is unlikely to consider broader market investment opportunities outside of the specific business objectives and core purpose of the wider group of which it is a part.

We would suggest that consideration should be given to the specific group factors relevant in determining what alternative investment opportunities a group company would need to consider when advancing funds to other members of the MNE group. Some specific and explicit recognition of entity versus group considerations, and the interplay between them would be helpful. So too should the 'transaction' in the context of its accurate delineation for these purposes and any 'series of transactions' of which it is a part.

These factors may also be relevant when considering the implicit support arising from passive association, and the external funding policies and practices of group management, informing the conditions under which a subsidiary would have borrowed from an independent lender etc. (see paras 35 and 67 where it is acknowledged that a consideration of the wider group dynamic is appropriate).

In relation to c) above, we have particular concerns about the potential compliance burden that such analysis may give rise to. We would advocate some guidance as to the circumstances where a lower standard of analysis (e.g. of hypothetical alternative lending/borrowing scenarios) might be justified.

BDO agrees that transactions need to be accurately delineated. However, the risk assessment guidance and functional characterisation should take into account financing transactions. General guidance cannot be applied. Example 3 (Chapter I, paragraph 1.85) in the 2017 OECD Transfer Pricing Guidelines is a good example (for cash box companies), as the contribution of the owner of the assets is limited to financing the acquisition.

It is impossible to apply the general guidance relating to risk management functions to financing transactions. Hence guidance on the delineation of financing transactions should give greater consideration to the key terms of the arrangement, and the commerciality of those in the market context, than any other factors.

Comparability Adjustments

The reference to comparability adjustments in the context of their improving the reliability of a comparable in para 20 would also benefit from more explicit and specific guidance. For

example, what are the nature of the adjustments that may be considered, and in what context?

Consideration should be given to the level of diligence to be applied in the making of comparability adjustments (which in many circumstances could be very exacting) and some specific guidance as to how the adjustments might be made.

Para 84 recognises that there is 'unlikely' to be a 'single market rate at which a borrower could obtains funds or a lender could invest funds, but instead a range of rates would likely be available. This is implicit also in the accurate transfer pricing of related party lending terms more generally, and only emphasises the complexity with which MNEs and their advisers are faced in assessing comparability factors that might be made to lending criteria in practice. Such adjustments are rarely made in practice but subjective adjustments are often made on the basis of qualitative (as opposed to quantitative) criteria.

Section B.2 – economically relevant characteristics

While it is noted at paragraph 24 (and 51) that the functions performed by a lender within an MNE group may be less comprehensive than those that would be performed by an independent lending business, this fact does not appear to have been carefully considered in respect of all other sections in the DD, in particular Box B.4.

The remaining characteristics discussed are appropriate, although it would be helpful to emphasise the importance of the borrower's financial strength and the nature of its business, as these are not fully dealt with through the functional analysis discussion, wider economic circumstances, or business strategy.

There are obvious parallels to the KERT analysis advocated by the OECD Report on the Attribution of Profits to PEs but no reference is made to that guidance. The footnote to Chapter I D.1.2.1. of the 2017 OECD Guidelines (*Analysis of risks in commercial or financial relations*), on the other hand, makes specific reference to the Report on the Attribution of Profits to PEs in the context of the approach to risk allocation for regulated entities, acknowledging that the guidance in D.1.2.1. "Is not specific to any particular industry sector." More specific guidance as to risk evaluation would be helpful in the DD – See below.

Box B.4

A lending entity should be entitled to arm's length remuneration for its assets, functions and risks. The financial capacity to bear the risk, rather than just functional capacity, should be taken into account. Hence, we cannot say that an entity that has financial capacity to bear risk is entitled to nothing but a risk free return.

Whilst there was a great deal of commentary in the DD regarding how to define a 'risk free rate' (which we believe there is a good argument to be made should be 'zero'), a more important issue for MNEs is how to define a 'risk adjusted rate'.

C. - Treasury function

The statement at para 43 that the treasury function - "Will usually be a support service to the main value creating operations" - might suggest that companies performing this role will usually act as a routine service provider. As such, these entities may potentially deserve a relatively low, cost plus reward commensurate with the above characterisation (rather than one justifying a margin on any borrowing and lending activities). This position is clearly at odds with other statements in the DD. For example, para 38 acknowledges that a centralised

treasury may have full control over the financial transactions of the group, and therefore may be engaged in potentially complex activity, employing skilled/qualified personnel. To what extent (if any) that this amounts to the controlling (and potential bearing) of complex risks (credit/FX/liquidity) is another consideration.

There is comparatively little commentary about risks related to treasury activity and the issue of evaluating where risk sits in the context of such activity, and the activity outcomes. Whilst para 44 acknowledges the importance of the identification and allocation or the economically significant risks regarding treasury activities 'in accordance with Chapter I' (and therefore draws upon the guidance provided in that chapter in regard to the accurate delineation of transactions and associated evaluation of risk, the latter, in D.1.2.1), there is little specific guidance in that Chapter, or in the DD, on its application to treasury-type functions.

An evaluation of factors relevant to a particular borrower, undertaken for the purposes of a lender making a decision whether to lend (and on what terms) (paras 49 and 50), may be very different in nature from the factors considered in a risk evaluation relating to other business activities.

As outlined above, the guidance in D.1.2.1. of the 2017 OECD Guidelines explicitly recognises that, "The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector." It acknowledges too that - "While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed."

Chapter 1.63 of the Guidelines recognises that, "risk management is not the same as assuming a risk". 1.64 recognises that, "financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises."

These considerations illustrate the necessity for very specific delineation of the factors pertinent to the analysis required of a treasury function in an MNE group. Examples illustrating this point would help draw out the factors pertinent to the analysis.

Box C.1

It is entirely possible that the MNE will not have a centralised treasury function, allowing each entity to make decisions affecting how costs of capital are optimised, and how investment returns are managed or maximised. In this context, it is highly likely that local operations would enjoy a higher degree of financial independence and control, and be able to access better deals due to familiarity with local customs and relationships, essentially providing increased flexibility.

This is particularly the case when operating in different systems, as what works in Europe may not be acceptable in Asia. This is likely to be an option for MNE groups who seek to establish more independent flow of business, and is likely to work better for MNE groups where different geographies or business units have little commonality of operations. Decentralisation of treasury functions is also more likely to occur in more entrepreneurial companies, where there is a need for agility.

In decentralised cases, treasury will usually be acting as a service provider. Where this is the case, depending on facts and circumstances, there will be services that require remuneration from other group members. That means that management of key treasury functions will be

located at local levels, and treasury function will be seen as more of a routine operation within the group.

The effect of implicit credit support in decentralised groups is also likely to be severely diminished.

C.1 - Intra-group loans

Para 52 suggests that, "The parent already has control of and ownership of the assets of the subsidiary". We note that this does not always necessarily follow. Also, where a borrower has assets that are not already pledged as security elsewhere, it would not always be appropriate in all cases to deem them as available collateral for an otherwise unsecured loan (and therefore impact its resultant pricing). Many companies borrow without security even when they have assets which might otherwise act as collateral.

We note the reservations expressed in para 63 as to the limitations of commercial credit rating tools. However, they clearly benefit from some objectivity, and provide a publically available and reasonably transparent basis for an evaluation (certainly in so far as quantitative factors, as opposed to qualitative factors, which will be more subjective, are used in the determination).

Qualitative factors may nonetheless provide a more nuanced basis for credit scoring, and should not be dismissed out of hand (nor should in-house models used for credit scoring) in evaluating whether a taxpayer has made a reasonable attempt to support the pricing policies of its treasury function.

C.1.3 Effect of group membership

Stand-alone credit rating

The use of a stand-alone credit rating is a common tool used by lenders in assessing the credit risk of a single borrower, when making investment or financing decisions from a risk tolerance perspective. In other words, the stand-alone credit rating refers to the borrower's creditworthiness, in the absence of extraordinary support or intervention from its parent or affiliated company. Extraordinary or implicit support is typically idiosyncratic in nature and is extended to prevent an issuer from becoming nonviable.

Each credit rating agency applies its own methodology in measuring creditworthiness and uses a specific rating scale to publish its ratings opinions. This corroborates the fact that the assignment of credit ratings is not an exact science.

Credit ratings constitute just one of many factors that the marketplace should consider when evaluating debt securities. Accordingly, a credit rating might be used as an indication of credit quality, but investors should consider a variety of factors that affect the credit quality of a borrower. Within the framework of assessing the creditworthiness of a single borrower, the borrower's willingness and ability to repay its obligations in accordance with the terms of those obligations should primarily be evaluated.

More specifically, within the framework of a stand-alone credit rating analysis, among other quantitative factors (such as profitability, leverage, liquidity, etc.) and qualitative factors (such as industry characteristics, country risk, legal and regulatory environment, etc.), available current and historical financial information should be evaluated, and the potential impact of foreseeable future events should be assessed. In addition, the existence of external

support or credit enhancements (such as letters of credit, guarantees, insurance and collateral) and the existence of implicit support should be also evaluated.

The proposal that there should be a rebuttable presumption (C.1.3.) that each group member has the same rating as the group of which it is part is patently contrary to the proper application of the arm's length principle. In the absence of explicit parental guarantees it cannot be contended (even where adjustments made for implicit support given the varying degrees of importance of different subsidiaries to the wider group) that any reasonable application of the arm's length principle would result in the same credit rating for all group companies.

Furthermore, it is not clear as to whom could rebut any such presumption. Does this mean the taxpayer as well as the tax authority concerned? Does the ability to rebut a presumption help provide any more clarity as to the proper application of the analysis than without it?

Implicit support

The synergy effects of group membership have recently been getting more and more attention from tax authorities (and Courts on litigation) globally. More specifically, when analysing an intra-group debt from a transfer pricing perspective, the effects of the implicit support that arises from a subsidiary's passive association with its MNE group should be also considered (among other quantitative and qualitative factors).

Despite the fact that, for the time being, no exact definition exists for "implicit support", the most commonly used meaning is that it reflects the expectation that a parent company will step in to support its subsidiary in the event of financial difficulty and meet its debt obligations.

In addition to formal guarantees (i.e. explicit support), any transfer pricing analysis considering the arm's length financing terms available to a borrower within an MNE group should also consider the potential impact of implicit support from affiliated companies. For this purpose, it is important to consider both the degree of strategic importance of the respective MNE within the group, and the parent company's willingness and capacity to provide such implicit support.

In this respect, it is important to note that there is still a substantial difference between a formal guarantee (i.e. explicit support) and implicit support. Implicit support might be limited to the hope that the parent company will step in to provide support even though there is no contractual obligation to do so.

An assessment should be made, based on a number of factors, whether the parent company would provide implicit support to the MNE in case of financial difficulty. If so, the extent of such support should be also taken into consideration in a credit rating analysis.

While the practices followed by each of the major credit rating agencies may not be entirely consistent, each of their methodologies applies a "notching" approach whereby they may take into account the strategic relationship between a MNE and its parent company.

Once the overall quantitative and qualitative factors has been assessed, an MNE's stand-alone credit rating might be adjusted upwards to the parent company's rating to reflect the implicit credit support. Any analysis must also take into consideration the effects of the respective MNE's strategic importance to the group's ultimate parent company.

We do not favour automatic capping of the borrower's rating to that of the group level as this approach does to reflect the arm's length principle. There are many examples of subsidiaries with a higher credit rating than that of the MNE group of which they are a part.

BDO broadly, however, agree with the approach set out as reflecting the impact of the 'halo' effect. More implicit and prescriptive guidance would be helpful, with some examples illustrating its impact.

C.2. Cash Pooling

The DD insists that cash pooling is a short-term liquidity arrangement (albeit in practice balances often remain in place for significant periods of time), and that a functional analysis should be carried out in order to determine the functional profile of the cash pool leader (e.g. service provider, in house bank, or hybrid).

Regarding the benefits generated from a cash pool structure, an analysis should be conducted to determine whether those benefits result from group synergies caused by the concerted effort of the participants. If so, the benefit should be split between the cash pool participants after remunerating the cash pool leader with an arm's length reward based on its functional profile.

The DD mentions that a cash pool leader will, in most cases, perform basic functions (e.g. coordination functions), and bear limited risks, resulting in a relatively low expected arm's length return on these activities. However, the question of how the cash pool leader should be remunerated if the role of the cash pool leader is more complex (with functions beyond a simple coordination role e.g. bearing credit risks, performing treasury functions, investment manager, etc.) and is not addressed in the current draft.

Equity at risk

In cases where the cash pool leader performs functions and bear risks beyond those of a plain service provider, the cash pool leader should have the people, and the financial capacity to control and assume those risk. In addition the entity should have enough equity to assume the financial risk in case that risk materializes (equity at risk).

The DD is not clear on how to estimate the equity at risk, and what parameters should be considered. A common approach used in some countries is based on an estimation of the potential loss. In that case, using the borrower's credit profile and historical and expected financial performance, it can be possible to estimate the probability of default. Using such a probability based approach could be a good way to estimate any expected loss, and consequently the expected equity at risk.

Allocation of group synergy benefits

Another important issue regarding cash pooling arrangements is the allocation of the resulting benefits. The DD emphasizes that the benefits should only be allocated to the participants if those entities have deliberately performed actions to earn the benefit, provided that the benefit is not a direct consequence of group synergies.

Before an MNE decides to participate in a cash pooling structure, a careful analysis should be performed to determine the particular benefits for that entity. An MNE acting at arm's length would only be a member of the cash pool if it expected to obtain a tangible benefit from the arrangement, and that benefit must be better than the best possible available alternatives. In

any case, an MNE shouldn't be obligated to be a member of the cash pool just because of group policy.

Another issue that should be clarified is whether an entry fee should be paid by new cash pool members that want to participate in an existing pooling arrangement that is already generating benefits for its participants. If so, further consideration must be given to how this entry fee could potentially be calculated?

C.3. Hedging

Delineation of transactions

In a situation where there are off-setting positions within an MNE group, the appropriate delineation of the actual transaction under Chapter I of the 2017 OECD Guidelines will be dependent upon a number of factors.

For example, what influence, input and risk management direction is provided by the MNE group entity booking the transaction, to the MNE group entity booking the risk? The entity booking centralised hedging transactions may have limited autonomy over risk management activities, and may simply act as a hub for booking hedging transactions so that risk can be better monitored, and hedging costs can be reduced through group synergies.

Also the terms of the actual transaction need to be clearly identified in order to determine the discretionary risk management activity undertaken by the hedging entity. For example:

a) The terms of the actual transaction
b) The quantum
c) Other market risk exposures such as FX, interest rate and counterparty credit risk

Where transactions are simply hedged on a back to back basis the terms of the actual transaction will directly affect the profits and losses arising on the instrument hedging the underlying risk.

Offsetting group positions

Where a member of an MNE group has a risk exposure which it wishes to hedge, but there is an off-setting position elsewhere in the group and group policy prevents the MNE from hedging its exposure, the appropriate treatment will be largely dependent on the hedging policy adopted by the MNE, and the degree of risk management discretion exercised by the hedging entity.

A ‘split’ hedge will arise where the MNE assets/transactions being hedged are booked in a different group entity to the hedging activity. Group transfer pricing policy should address split hedge situations and seek to align the group’s arrangement with those that might be expected to be adopted between independent third parties. The most appropriate transfer pricing approach will be driven by the operating facts; including the actual booking of the transaction and the associated hedging activity.

Where ‘split’ hedging arises it is normally appropriate to allocate profits or losses arising from the hedge to the entity booking the actual primary transaction. This is on the assumption that the sole driver for the hedging transaction is the underlying transaction entered into by the unhedged group entity.

In arriving at the appropriate transfer pricing outcome for a split hedge, the connection between the underlying asset being hedged and the hedging transactions should be examined. Given that the hedging transaction is being entirely driven by the underlying asset, it would be reasonable to conclude that the significant people or KERT function originating the actual transaction should drive the attribution of the associated hedge. In the absence of the origination of the underlying asset no hedging transaction would be required.

Failure to attribute split hedging transactions to the location of the underlying asset would also result in losses/expenses in the hedging location with no expectation of achieving a profit. The hedging location would suffer the hedging costs without receiving any of the income from the associated underlying asset which is being hedged. This position is not commercial and clearly does not reflect arrangements that would be adopted between two independent third parties.

Unless the unhedged MNE exercises some direction over the underlying hedging activity, it is only reasonable to allocate hedging results associated with a notional value equivalent to the underlying transaction. Where proprietary positions are taken on hedges (i.e. the hedge does not match the terms and risk exposures of the underlying transactions) the profits and losses associated with these positions should reside with the hedging entity.

Where significant risk management discretion is exercised by the hedging entity then it may not be possible to easily delineate the profits and loses that should be allocated to the unhedged entity. In these circumstances an allocation will need to be made, applying appropriate allocation keys, which is commensurate with actual transactions booked by group entities. This is on the assumption that the main purpose of the Group hedging policy is to eliminate or reduce the exposures arising from actual transactions booked by group entities.

D. Guarantees

Delineation of financial guarantees

In order to delineate a financial guarantee, first it should be determined whether or not the borrower within the MNE group has obtained a benefit from being part of the group. For instance, has a lower interest rate been paid, or a higher loan amount obtained. In some cases a lender may not be willing to lend at all without the assurance of a guarantee. If a benefit has been identified, then there might be either an implicit guarantee for which no guarantee fee has to be paid, or an explicit guarantee for which a guarantee fee might have to be paid.

If the borrower has obtained a benefit via an explicit guarantee, the next step is to determine the nature of the benefit, specifically whether it is a benefit for which an independent party would be willing to pay. For instance not all third party lenders request that related party guarantees are put in place, as they may assume that financial support will already be received in case of a default by the borrower.

On the other hand sometimes an independent party requests an explicit related party guarantee only to increase the likelihood that a debt can be repaid. In that case there is no additional benefit derived for the borrower in respect of this explicit guarantee. If the benefit for the borrower is indeed a benefit for which an independent party would be willing to pay, a guarantee fee for the explicit could be considered appropriate.

It is also possible that a related party will provide a guarantee in the form of pledge on an asset. In that case the relevant asset will be sold in the event of default. This will be the case when the guarantor has insufficient liquid assets available itself to repay the outstanding

loan. This form of guarantee could affect any applicable guarantee fee, as there might be additional expenses incurred (e.g. transaction costs) in order to liquidate the asset.

However, overall the value of the guarantee mainly depends on the benefit it brings the borrower, as well as the strategic influence of the borrower within the MNE group.

Insisted guarantees

An independent party can request an explicit guarantee be put in place to increase the likelihood that a debt can be repaid. This may be the case where a borrower has a relatively low standalone credit rating due to a lack of sufficient assets. There are also independent lenders which, based on policy, will request an explicit guarantee when the loan provided exceeds a certain threshold.

Impact of insisted guarantees on credit rating and loan pricing

The overall credit rating of the MNE group will not be affected by the insisted guarantee as the rating of the borrower is indirectly included in the credit rating of the MNE group. However, an insisted guarantee provided by a related party to the borrower could affect the standalone credit rating of this guarantor. The effect of the guarantee on the standalone credit rating of the guarantor depends, among other things, on the risk that the guarantee will be invoked. If this risk is expected to be high, then this fact could influence the standalone credit rating of the guarantor. A guarantee provided to a borrower with a high risk of default will potentially influence the quantitative factors (such as profitability, leverage, liquidity etc.) considered by a credit rating analysis.

Other remarks

Paragraph 140 mentions two issues in the case where the effect of a guarantee will be to permit the borrower to borrow a greater amount of debt than that it could have otherwise borrowed in absence of the guarantee.

a) Whether a portion of the loan from the lender to the borrower is accurately delineated as the loan from the lender to the guarantor (followed by an equity contribution for the guarantor to the borrower); and
b) 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.

First of all we doubt whether it will be practically feasible to determine the part of the loan which could had been lent by the borrower on a standalone basis. A third party lender will always take into consideration the fact that the borrower is part of a MNE. Substantiation of an amount based on third party comparable data seems impossible. Secondly, there is the issue of how this should be processed in the borrower's and guarantor's accounts - There may be complex differences between tax and statutory accounts that may be of a temporary or permanent nature.

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