3.1. Case Study 1: Intra-group Loan Pricing

3.1.1. Facts of the Case

A group operating in the business and consumer services sector is headquartered in the United Kingdom (hereafter "UKHeadCo") and has affiliates dispersed across Europe. The treasury company managing group liquidity is also based in the United Kingdom and is a direct subsidiary of UKHeadCo. The group treasury is centralised thereby managing the group liquidity and funding requirements. Some localised unrelated party lending is allowed depending on lending conditions and based on business needs. For the purpose of this case study, the two UK entities will jointly be referred to as "UKCo" as the treasury entity, in substance, operates as an extension of UKHeadCo.

3.1.2. Functional, asset, and risk profile of the treasury entity

UKCo manages and optimises liquidity for the entire group, procures capital on the financial markets, and ensures that all operating entities have adequate resources to meet their goals. The extent to which local entities require capital is determined locally, and an "application or business plan" is forwarded to the treasury team for assessment. As a result, the treasury entity, together with UKHeadCo, is charged with the management and mitigation of most of the group's financial risks (e.g., credit risk, foreign exchange risk) and bears the majority of financial risks regarding unrelated party funding and credit risk in relation to the borrowing entity. UKCo can be described as an "in-house bank" containing all of the necessary functions, reserves,[39] and substance to manage risk and issue financing. Given the functional, asset, and risk profile, a routine remuneration is not sufficient for compensating the treasury function for the services that are provided.[40]

3.1.2.1. Functional, asset, and risk profile of the borrowing entity and how it fits into the group value chain

The group operates across five different business lines that are all subdivisions within the same business and consumer services sector. UKCo has affiliates located in France. The French business is structured as a French holding company

39 As stated in the OECD guidance, the lender must have the financial capacity to assume the risk. See, for more information, OECD, Transfer Pricing Guidance on Financing Transactions, Inclusive Framework Actions 4, 8 to 10, section B.3.2, para 10.25, p 10.

40 As stated in the OECD guidance, understanding the lender's functional, asset, and risk profile and the extent to which it has the necessary functions and processes in place to decide whether and under which terms to advance funds. This would *"typically include an analysis and evaluation of the risks inherent in the loan, the capability to commit capital of the business to the investment, determining the terms of the loan and organising and documenting the loan"* amongst other considerations. See, for more information, OECD, Transfer Pricing Guidance on Financing Transactions, Inclusive Framework Actions 4, 8 to 10, section B.3.2, para 10.24, p 10.

("FrenchCo") with two subsidiaries operating mainly within one of the group's broader business lines; both are domiciled in France ("French OpCo 1" and "French OpCo 2").

FrenchCo and its subsidiaries represent a sizeable proportion of the group's European operations, accounting for approximately 20% of its European revenue. However, it does not bear the group's name as it joined the group through an acquisition.

The group is active in Europe, North America, and Asia Pacific, but over 50% of its revenues are concentrated in the European market. Of the five separate business lines, two are exclusively offered in Europe.

Although the French entities may perform some level of activities in all five business lines, over 80% of FrenchCo's revenues are attributable to one of them that derives less than 15% of the group's global revenues. UKCo provides the following services to the local entities:

- It designs the product offerings made available globally with moderate influence from local entities and supports the provision of collateral for marketing purposes;
- It offers centralized procurement services to decrease group-wide operating costs. Some exceptions exist in which FrenchCo would source products directly from the market (this, however, is minor); and
- It provides all the treasury, IT, and other support services.

FrenchCo is active exclusively in the French market. However, the way FrenchCo operates therein is similar to how other group subsidiaries perform in other EU markets in terms of managing clientele.[41]

3.1.2.2. Group Summary Value Chain

The main value-drivers of the group are depicted in the value chain diagram below:

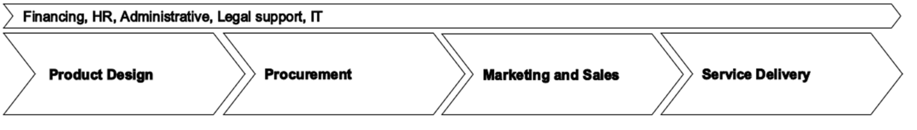

Figure 3 – Case Study 1: Industry Value Chain

41 Understanding the functional profile of the borrowing entity provides an outline of the options available to the borrower, the commerciality of the transaction, and also insight into the borrower's risk profile. Furthermore, it provides insight into the economic circumstance and business strategy and how funding would be used. See, for more information, OECD, Transfer Pricing Guidance on Financing Transactions, Inclusive Framework Actions 4, 8 to 10, February 2020, section B.3.2, para 10.26, p 10, B.3.4 and section B.3.5, p 11.

UKCo is responsible for the first two value drivers (Product Design and Procurement) and most support services while FrenchCo and its subsidiaries are accountable for the latter two (Marketing and Sales and Service Delivery). FrenchCo may receive some marketing support from UKCo. Due to FrenchCo's business of focusing on a product line that is relatively minor for the group's global business, FrenchCo contributes to Product Design and, in some instances, may even perform some activities independently of UKCo. To a great extent, the strategy for the local market is managed locally. It is important to understand the borrower's contribution to value creation as it provides insight into the business strategy of the group, the effects of the implicit support, and potentially realistically available options regarding the borrower's funding.[42]

3.1.2.3. Terms of the transaction

In the context of refinancing some existing debt and funding for on demand working capital, UKCo has issued a loan to FrenchCo. The terms and conditions of the loan are:[43]

- Notional amount CU 200,000,000
- Issue date: 10 April 2019
- Repayment features: Interest quarterly but capital on maturity
- Maturity date: 9 April 2024
- Interest rate: 3% fixed rate

No other optionality or specific feature was attached to the loan. Given the capital structure of FrenchCo and specifically the presence of senior unsecured debt on its French consolidated balance sheet, it was determined that the loan should be subordinated.

3.1.3. Questions Raised

The issue under scrutiny was whether the loan interest rate that was applied was at arm's length. More specifically, the fundamental questions raised are:

1. What is the default risk associated with the transaction and the implication of implicit support?
2. Is the pricing at arm's length?

42 OECD, Transfer Pricing Guidance on Financing Transactions, Inclusive Framework Actions 4, 8 to 10, February 2020 section B.3.5, p 11.

43 The contractual terms and characteristics of the financial instrument are often stated in the loan agreement and, in the context of the transaction, is aligned with the conduct of the parties and adhere to similar conditions that would have been agreed between unrelated parties. See, for more information, OECD Transfer Pricing Guidance on Financing Transactions, Inclusive Framework Actions 4, 8 to 10, February 2020, section B.3.1, para 10.22, p 10 and B.3.3, p 11.

3.1.4. Suggested Solution(s)

It is necessary to fully and accurately delineate and recognize the transaction as outlined in Chapter D.1. of the OECD TPG to effectively address the above questions.[44] Thus, understanding the value chain and the functional, asset, and risk profiles of the transacting parties provides the following important insights:

The business line in which FrenchCo and its subsidiaries are involved is the most significant division of the group's operations within the French market but is minor in comparison to the group's global business *(Business strategy)*.[45]

- The French management personnel have a level of autonomy with respect to local decision making and would ultimately provide input to UKCo which it would take on board when considering product offerings *(Functional Analysis)*.[46]
- The funding provided to the local entity is purely used for local refinancing and local working capital, all of which are managed by local staff. The decision to refinance and the applied terms and conditions are the responsibility of the group's central treasury department *(Functional Analysis, Contractual Terms, Economic circumstances, Business Strategy)*.[47]
- There are no other guarantee transactions/cross-subsidization or any other credit-enhancing support transactions in place *(Economic circumstances, Characteristics of the Instrument)*.[48]
- A service fee has been established between the United Kingdom and France for services rendered by UKCo. This fee has been determined to be at arm's length. No other non-arm's length conditions require consideration *(Business strategy and Functional analysis)*.[49]

Having established the key facts from a detailed factual review, the level of default risk inherent in the transaction must be analyzed.

3.1.4.1. Determining Default Risk

The default risk of a transaction is a key comparability factor that needs to be considered when evaluating loan transactions. Not only would it determine the price of the transaction but also the amount and type of transaction that would be feasible considering the facts and circumstances.[50]

44 OECD, Transfer Pricing Guidance on Financial Transactions, Inclusive Framework on BEPS: Actions 4, 8–10, February 2020.
45 OECD, Transfer Pricing Guidance on Financial Transactions, Inclusive Framework on BEPS: Actions 4, 8–10, February 2020, Economically relevant characteristics of the actual financial transaction, Section B3, p 10–12.
46 Ibid.
47 Ibid.
48 Ibid.
49 Ibid.
50 Ibid.

The funding is provided to FrenchCo and is subsequently channeled downwards to the two operating entities via domestic transactions. FrenchCo has no other operations beyond these. Given this fact pattern, there are two potential approaches that can be relied upon for assessing FrenchCo's creditworthiness:

(i) the first approach is based on FrenchCo's (FrenchCo and the OpCos) consolidated financials (i.e., treating them as one consolidated company); and
(ii) the second approach is based on the creditworthiness of the main subsidiaries that is then adjusted for debt in FrenchCo, the holding company.

The second methodology is typically relied upon when rating conglomerates that have three or more operating subsidiaries that operate across varying sectors.[51] FrenchCo has only two subsidiaries that both operate in the same sector. The authors therefore rely on the former approach to determine the default risk of FrenchCo (the shadow rating) on a consolidated basis.

For this purpose, the Business & Consumer Service Industry Rating Methodology published by Moody's Investor Services in October 2016 was selected. Rating methods and risk matrices are continually updated over time as the market changes. Thus, to simulate a rating that would have been achieved in 2019, it is important to use rating methodologies that were available at the time of the transaction for the sector under review.[52] This rating methodology remains the most recent version published by the rating agency.

3.1.4.1.1. Standalone Rating

The selected methodology depends on five broad factors and eight sub-factors that are displayed in Table 2 along with their weightings. These factors are specific to each sector methodology and, while there may be a partial overlap between specific sector methodologies, the weightings will ultimately be different between different sectors.

Factors	Factor Weight	Sub-factors	Sub-factor Weight
Scale	20%		
		Revenues	20%
Business Profile	20%		

51 Analytical Considerations in Assessing Conglomerates, Moody's Investor Services, September 2007.
52 Economic circumstances and using information available at the time of the transaction is an important comparability consideration when evaluating financial transactions. See, for more information, OECD, Transfer Pricing Guidance on Financial Transactions, Inclusive Framework on BEPS: Actions 4, 8–10, February 2020, Economically relevant characteristics of the actual financial transaction, Section B3, p 10–12.

Factors	Factor Weight	Sub-factors	Sub-factor Weight
		Demand Characteristics	15%
		Competitive Profile	5%
Profitability	10%		
		EBITA Margin	10%
Leverage and Coverage	40%		
		Debt/EBITDA	15%
		EBITA/Interest	15%
		RCF/Net debt	10%
Financial Policy	10%		
		Financial Policy	10%

Table 2 – Business & Consumer Services Industry Rating Methodology Criteria and Weightings. Source: Moody's Investor Services, Business and Consumer Service Rating Methodology, October 3, 2016

In the business and consumer services rating methodology, all of the factors are quantitative with the exception of Business Profile and Financial Policy. Furthermore, this methodology requires the use of past and forecasted data. Moody's affords the raters with the discretion to select the final choice of the chosen time period to be evaluated.[53] This is done to reflect possible differences in the material situations of different companies. Often a 1-year period is sufficient for accurately estimating the credit rating of a firm in this sector.

To apply the method, careful consideration should also be given to how each of the subfactors are calculated. Differing assumptions may influence the financial calculations and results thereby impacting the final ratings. Furthermore, as highlighted in the OECD Guidance, "… the credit rating derived in light of such intra-group transactions may not be reliable"[54] since related parties' financials can be influenced by the non-arm's length nature of other transactions. Thus, it is key to ensure the arm's length nature of these transactions prior to performing the credit assessment.

Insight into qualitative criteria can typically be obtained as part of the factual review conducted on the group. Moreover, a thorough analysis of the value chain, functions, assets, risks, and industry will provide an extensive level of insight into

53 Moody's Investor Services, Business and Consumer Service Industry Rating Methodology, October 2016, p 3.

54 Transfer Pricing Guidance on Financial Transactions, Inclusive Framework on BEPS: Actions 4, 8–10, February 2020, para10.75.

these factors. As noted by the OECD, there is a tendency to rely more on quantitative inputs at the expense of qualitative factors. However, these factors can significantly influence the final rating.[55] Concerning the methodology under discussion, qualitative factors account for 35% of the final rating. Other methodologies may include either more (e.g., REITs and Other commercial Real Estate Firms, 40%) or, most likely, fewer qualitative factors (e.g., Insurance Brokers and Service Companies, 0%).

For each quantitative and qualitative sub-factor, a rating ranging from Aaa to Ca is selected. They can be transformed into a numeric value from 1 to 19 using the conversion table provided by Moody's. Finally, these numeric ratings are averaged across all factors using the relevant weightings and translated back into an alphanumeric credit rating.

For the case study that is being examined, FrenchCo received a rating on the Baa or B – range scales for each subfactor. To illustrate, the authors have created the hypothetical assessment of FrenchCo below and show the numeric translation of the implied ratings.

Weights	**Factors**	**Sub-factors**	**Implied Rating**	**Numeric Rating**
20.00%	Scale		B	15
20.00%		Revenues	B	15
20.00%	Business Profile		Baa	9.75
15.00%		Demand Characteristics[56]	Baa	9
5.00%		Competitive Profile[57]	Ba	12
10.00%	Profitability		Ba	12
10.00%		EBITA Margin	Ba	12
40.00%	Leverage and Coverage		Ba	11.25
15.00%		Debt/EBITDA	Ba	12

55 Transfer Pricing Guidance on Financial Transactions, Inclusive Framework on BEPS: Actions 4, 8–10, February 2020, para 10.73.

56 Demand characteristics consider stability of product demand, service offering differentiation, and the importance of the products and services to customers. In this context, **Baa** represents a steady demand expected over the medium term; moderate exposure to economic or industry cycles. It has significant service line differentiation and some track record. Service offerings are perceived to be important.

57 Competitive profile considers firm diversity, nature of market competition, and the firms market share relative to competitors. In this context, **Ba** represents a firm that operates in a few business segments with a broad portfolio in at least one segment. It is somewhat diversified in its major market and has a moderate customer concentration. There are limited barriers to entry or low switching costs to encourage new entrants. It is among the top providers in key markets or a strong niche player.

Weights	Factors	Sub-factors	Implied Rating	Numeric Rating
15.00%		EBITA/Interest	Ba	12
10.00%		RCF/Net debt	Baa	9
10.00%	Financial Policy		Baa	9
10.00%		Financial Policy	Baa	9

Table 3 – Shadow Credit Rating Scores Example Calculation

The final score is calculated by estimating the weighted average of all factors (i.e., multiplying the weights in the first column and the numeric rating). Based on the described approach, FrenchCo received an aggregate numeric rating of **11.55** which corresponds to Ba2 using the Moody's rating system (equivalent to BB using the S&P rating system).

The shadow rating derived is a standalone rating and does not consider any positive or negative factors that FrenchCo may be exposed to by operating as part of the group. Thus, although it is a beginning for calculating default risk, further consideration is required.

3.1.4.1.2. Implicit support from the Group

Implicit support is presented in the OECD TPG as an example of the synergies that are inherent in large groups and should be accounted for in transfer pricing analyses.[58] In reality, it is not straightforward to determine a highly accurate credit rating that the market recognises for a subsidiary company. Varying approaches and implications are observed when studying different financial services market participants. The approaches used by banking institutions are not publicly available and, as a result, the authors must examine what methodologies are publicly available to be used as a proxy.[59]

All three major rating agencies provide descriptions on how they consider implicit support. Regardless, the level of it and the effect it has on the standalone rating can vary when applying different methods. In fact, any analysis involving implicit support is perceived as highly subjective. The authors explain the various rating agencies approaches below in the context of the case study under discussion.

3.1.4.2. Application of the Moody's Approach

According to Moody's, the likelihood of providing support is based on both the willingness and the ability to do so. The tables below further explain these criteria.

58 See para 1.164 of the OECD TPG.

59 Transfer Pricing Guidance on Financial Transactions, Inclusive Framework on BEPS: Actions 4, 8–10, February 2020, para 10.77.

The authors attempt to apply Moody's approach to assess whether the group is likely to support the borrower. Typically, the insight required to perform this assessment is obtained from the factual review, including the value chain, functional, asset, and risk as well as the industry analyses outlined above.

Factor	Result	Reasoning
Reputation and Confidence Sensitivity	No adjustment	Limited financial risk arising from reputational damage since FrenchCo uses a different brand and was incorporated in the group via acquisition to expand the French market. FrenchCo has a dominant position in its local market with a steady demand expected in the medium term.
Strategy	Some strategic importance (potential rationale for an adjustment)	FrenchCo represents a sizable proportion of the group's European revenues. However, the French business overall is one of the group's smaller business segments. Leaving the French market may be problematic given market postponing but, nonetheless, the business is not in a core business area for the group. The group would indeed be willing to divest the business to protect shareholder value.
Operational Integration/ Marginal Return on Required Investment	Some operational integration (potential rationale for an adjustment)	UKCo does not depend on FrenchCo for any of the activities performed in markets other than in France. The group shares the central treasury, and FrenchCo provides input into product development. It is doubtful whether the parent would be willing to provide further rounds of funding if a subsidiary is in financial distress or is experiencing a significant liability impacting shareholder return. UKCo sets goals, but FrenchCo management is independent to a large extent.
Role of Financial Regulators	N/A	Not relevant in this sector.

Table 4 – Moody's: Willingness to Provide Support.[60]

60 Source: Moody's Investor Services, Rating non-guaranteed subsidiaries: credit considerations in assigning subsidiary ratings in the absence of legally binding parent support, Moody's, December 2003.

Table 4 indicates that there may be some willingness to support the subsidiary due to strategic and operational considerations, though this is potentially limited.

Moody's acknowledges examples of parent companies that have decided to let their subsidiaries default despite having publicly articulated their "strategic" nature and the promise of ongoing support.[61] Parent companies might not support their financially distressed subsidiaries if it compromises their ability to maximize shareholder value. Thus, the next factor to consider when assessing a rating uplift in the Moody's framework is the ability to provide support.

Factor	Result	Reasoning
Parent Credit Rating	Positive	As of 2019, the group had an overall credit rating of Baa1. This is an investment grade rating that is evidence of the strong financial capabilities of the group.
Correlation of Business Risks	Positive	FrenchCo revenues are mostly derived from a business line that is of minor importance to the overall group. Nonetheless, given that all of the parent's business lines are in the business and consumer sector, it is likely that severe economic shocks could impact all of the business lines. However, this is unlikely in normal times given the relative mix of products allowing for a certain level of risk divestment. In summary, there may be a minor correlation of business risk.
Relative Magnitude and Timing of All Such Expected Investments	Positive	The loan represents the refinancing of a previously granted loan. In the absence of extraordinary circumstances, this level of funding can be supported. Additionally, 2019 did not represent an abnormal period for the group or the industry that required frequent investments.

Table 5 – Moody's: Ability to Provide Support. Source: Moody's Investor Services

Among the factors mentioned above, the correlation of business risks is probably the most relevant. Moody's states that "… the amount of 'lift' that the jointly supported obligation can achieve relative to the stronger obligor's rating will depend

61 Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in The Absence of Legally Binding Parent Support; Moody's Investors Service, 2003, p 3.