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By e-mail to: [non-banklending@hmtreasury.gsi.gov.uk](mailto:non-banklending@hmtreasury.gsi.gov.uk)

Dear Sirs

### **HMT Discussion paper on non-bank lending**

The IMA represents the UK-based investment management industry. Our members include independent fund managers, the investment arms of retail and investment banks and life insurers, and the managers of occupational pension schemes. They are responsible for the management of over £3 trillion of assets (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds such as pensions and life funds and a wide range of pooled investment vehicles.

IMA members manage around £1.2 trillion in fixed income securities (as at end 2008), mainly insurance assets and pension scheme mandates but also retail bond funds, and therefore are the major investors in the non-bank debt markets.

The IMA is pleased to respond to HMT's discussion paper and the IMA's answers to the questions posed to investors are attached to this letter. IMA members welcome HMT's paper and believe that it addresses the main issues facing companies accessing the bond market. It is however the case that the major bond investors are very large institutions and their main requirement from an efficient market is that it is liquid; this therefore skews their investment preference towards large issue size. Client mandates and regulatory requirements can also constrain the types of bond a manager can invest in. These are the key issues which faces less large and medium sized companies when they are considering bond issuance.

IMA members however support any initiatives to improve transparency and appropriate disclosure, thereby increasing market efficiency and price formation. New issuers who are not public companies however might find disclosure requirements and the need to engage with bond holders overly onerous. Nonetheless any diversification of funding sources is welcome, albeit that it would likely be at the margin.

Should you have any queries please do not hesitate to contact me.

Yours faithfully

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## Questions for Investors

### Credit assessment and monitoring

1 Do you consider any of the following to act as a barrier to companies obtaining public credit ratings, and which are the most significant:

- a. cost;
- b. businesses' concern about revealing information (particularly in circumstances of a difficult trading environment); and/or
- c. other (please provide more information)?

*Cost is certainly a barrier, not only that bank borrowing may be cheaper than a bond issue, in terms of the interest rate applied, but that the cost of arranging a public issue can be significant when investment banking fees are taken into account as well as the amount of documentation required and the amount of management time required to obtain and maintain a rating. Having said that however companies do have to provide a significant amount of information when borrowing directly from their bank.*

*For a non-quoted enterprise the public disclosure of financial information may well be not appeal to management, for various reasons e.g. opening up to its competitors.*

*The issuer pays model of the credit rating agencies is probably expensive at least initially, and certainly proportionately more expensive for less large companies.*

2 Would lowering the cost of credible credit measurement processes in the UK encourage more:

- a. businesses to issue more non-bank debt; and
- b. more non-bank investors to buy UK corporate debt?

*a. Making ratings cheaper may well encourage companies to access the bond market rather than rely on bank borrowings. The issue however is how "credible" is the rating. Rating agencies also take the size of a company into account when assigning a rating, whereby the larger the company the better it scores.*

*b. We assume that the question relates not to non-bank investors but to investors buying non-bank debt. Certainly more retail investors may invest in individual issues if they believe there is comfort given by a credible credit rating. The risk is that retail investors do not understand what a credit rating means; that it is not a statement about value or volatility but is a statement about the prospect of being repaid over the life of the bond and of the likelihood of default.*

*The IMA disagrees with the assumption in 3.2 that UK institutional investors do not have the in-house credit scoring expertise that many US investors have. Most institutional investors do have the resources to assess credit quality independent of credit rating agencies. They are however often subject to constraints in what they are allowed to invest in. For example, if life insurance companies were to hold unrated or sub-investment grade bonds they would be required by the regulator to hold higher levels of capital. In addition client mandates, from for example pension funds, often specify that the portfolio only invest in rated bonds and often those over a certain rating. A lower cost of credit measurement should therefore encourage corporates to obtain a rating and open up a wider investor base.*

*Notwithstanding the above however institutional investors are not set up to do the sort of intensive due diligence that banks do as part of their lending operations.*

### **Corporate transparency**

6 Would improved quality of corporate transparency increase your appetite for corporate debt significantly, and result in you investing in a wider range of companies? If so what type of additional transparency might be important?

*IMA members believe that improving the quality and transparency of corporate information would attract more investment interest, although new inflows into (or outflows from) corporate bonds are more dictated by asset allocation decisions, especially for pension funds.*

*Covenants should be made public and be standardised. Prospectuses should be made simpler by perhaps introducing the requirement for a key points fact sheet which would contain some important financial metrics. The IMA in addition supports the FSA's project to establish a database to warehouse publicly available financial information on UK listed firms.*

*IMA members would strongly encourage the public disclosure of more loan covenant information. The IMA, along with the NAPF, is supporting the ABI's initiative in attempting to introduce a benchmark for covenant wording in sterling and euro bond issues. It is important that investors know where they rank in the company's capital structure in the event of e.g. change of control of a company. Better covenants would increase the efficiency of the bond market and open up access to longer term finance for corporates.*

*It is however the case that wholesale financial markets are geared towards large issue size and institutional investors have a limited appetite for smaller issues no matter how good the transparency of corporate information. If managers were to increase their exposure to smaller issues then the result will be a rise in the number of holdings in portfolios. This increases research costs as more companies have to be researched and monitored.*

7 Do the potential costs of greater transparency, whether regulatory or otherwise, deter firms from seeking non-bank finance?

*It depends on the cost of the borrowing differential and whether that offsets the costs of disclosure.*

8 If companies made more information available about loan covenants (the terms under which a loan was made):

- a. would it increase investor appetite for corporate debt; and/or
- b. would it reduce existing and future debt holders' expected default risk?

*The answer to both questions is that it would depend on the specific covenants and the protection they offered investors but in general the more information that is available then the more comfort investors can take that they know what they are buying. It does not however mean that if a company runs into serious financial trouble because of the business that it is in, if it is badly managed or if serious fraud has been committed that investors are any safer, but it does allow them better to assess default risk.*

*Bond investors do not know the details of bank loans e.g. covenants etc. although credit rating agencies have probably been privy to this information when assigning a rating. Bond issue documentation therefore should at least show where bondholders rank in the company's capital structure but ideally should have full disclosure of bank covenant information (See Q6).*

### **Loan pricing transparency**

10 Is loan pricing transparency also important for non-bank lenders? If so, why?

*Loan pricing transparency would enable investors to assess the company's total cost of capital as well as its free cash flow.*

### **Preferences of UK investors**

11 How significant an issue do you believe investor preferences to be when accessing non-bank lending?

*Investor preferences are clearly significant as they will determine at any point the pricing and type of issuance for which companies will find an appetite. As explained in Q2 most institutional investors have some regulatory or client requirement to hold certain types of bonds.*

12 What factors influence non-bank investor (including overseas investor) appetite for UK corporate debt?

*The following factors influence investor appetite for corporate bonds: a stable currency, government finances (is the Government likely to crowd out corporate borrowers?), secondary market liquidity, the yield spread over gilts, strong covenants and sound contract law. Recently companies have been issuing "covenant lite" bonds which is an undesirable situation; IMA members have campaigned in the past for better, more secure covenants but these recent issues have been successful due to the huge recent inflow of cash into corporate bonds which has resulted in a sellers' market. IMA members believe that bond issues with strong covenants would attract a wider investment base. Covenants should also include provisions for good disclosure and regular access to management. (See Q6.)*

*In addition the economic outlook will determine whether investors should favour economically sensitive investments, e.g. cyclical companies, as opposed to safer investments such as gilts. The current level of interest rates on savings accounts may have encouraged the strong inflows from retail investors into corporate bond funds in 2009 in order to pick up income.*

13 What role might guarantor entities play in guaranteeing debt issued by UK companies?

*Quasi government guarantor entities, such as KfW, EIB and IBRD, do lower the cost of borrowing for corporate enterprises. As to monoline insurers, however, there were major problems during the credit crisis with their business model and therefore credit enhancement of this kind is now treated with much scepticism by investors.*

14 How could secondary bond market activity be improved?

*It is the case that during the worst of the credit crisis the secondary market in corporate bonds ceased to function. As an OTC market it is dependent on investment banks being prepared to use their balance sheets to hold inventories of bonds to facilitate market trading. Clearly the banks were more keen to shrink their balance sheets and as a result liquidity in the secondary market dried up and trading all but ceased. Agency brokers stepped in to the gap for a while by matching trades but were unable to support a normal level of activity.*

*The IMA has endeavoured to engage with the sell-side as to the future structure of the secondary bond market but with little success. It is unclear what the ideal structure is although some members would support the introduction of a buy-side to buy-side electronic trading network. The structure could be comparable to an exchange or MTF but there would be legal and regulatory issues to do with the agency nature of the buy-side business. (The traditional inter-dealer market however operates on an agency basis.)*

### **Non-bank loan market**

15 Are the barriers discussed above relevant in limiting less large firms' ability to issue loans to non-bank investors (including overseas investors)? If so, which are likely to be the most significant? Are there other factors?

*The barriers are certainly all relevant. In addition however investing in loans involves either agreeing to become an insider to the terms of the loan or not. If an investor agrees to be made an insider then this limits his trading activity in other forms of the company's debt. If he does not agree to be an insider then he may be investing in something without knowing its most important features.*

*In addition, for UCITS managers, loans rank as non-transferable securities and therefore as non-eligible assets not allowed under the Eligible Assets Directive. The objective behind the Directive is to protect retail investors from being exposed to illiquid assets through what is an ostensibly liquid vehicle. The restriction on non-transferable assets has actually been in place since the first UCITS Directive in 1983.*

16 To what extent might loan market infrastructure be improved? What costs might be involved?

*We have no comment.*

### **High yield bond market**

17 What factors determine the currency of issuance? Is demand for high yield bonds higher in foreign currency? How is currency risk managed?

*Investor demand for high yield issues tends to be higher in non-sterling areas i.e. Europe and the US. UK pension funds, insurance companies and retail investors are biased towards investment grade. Currency of issue will be determined on where investor demand is based and currency exposure can be hedged out if the view of the currency of the issue is negative. Swap markets can also affect the currency of issue as can the currency in which the company's liabilities are valued.*

18 How far might the following be constraints in the growth of UK high yield bond markets:

- a. market infrastructure (if so which aspects);

- b. investor preferences and constraints (including overseas investors);
- c. cost of monitoring; and/or
- d. other factors?

*It is hard to gauge what the constraints are in the UK to the growth of a high yield market. It is not clear whether companies are less willing to commit to what may be a high cost of capital or whether investors are more risk averse (due to constraints outlined in Q2).*

19 In the past a significant share of high yield bond market activity has been corporate buyout focused. How could the high yield bond market be developed as a source of primary funding?

*The high yield market is mostly used to refinance existing bank debt and it is difficult to envisage how the bond market could replace the banks' role as initial loan provider. The advantage that banks have is that they can, subject to solvency constraints, "create" the money required to lend to a business. This makes the process simpler than would be the case if a company tried to come direct to the high-yield bond market to structure its initial capital requirements.*

### **General**

20 Do you believe that HM Treasury should be promoting more diverse sources of funding for companies?

*In an ideal world the market place would normally develop the infrastructure and products to satisfy what appears to be a gap. If HMT is really convinced that there are corporates who would like to access non-bank funding but cannot find an appetite for their debt, then some incentives would have to be put in place to make those entities' issues more attractive on a risk/reward basis to investors. Any incentives would have to be examined for unintended consequences e.g. that they skew the market so that the banks lend to their higher quality customers and lower quality corporates issue in the debt market.*

*One suggestion from a member is to create some form of pass through bond based on a pool of a number of (not necessarily similar) company borrowings. If eligible companies were able to borrow by taking part in some form of regular issuance under a common umbrella, this might provide a way of giving less large companies direct access to bond markets. Companies would have to accept however that the borrowing terms would be based on the average quality of all the companies involved.*

21 Which of the issues covered in this discussion paper do you believe to be the most significant?

*The IMA believes that the most significant issue is to find where the appetite for less large and medium-sized corporate bonds lies. As we have noted, there are regulatory requirements and mandate constraints which serve to skew investor appetite towards large, liquid issues. In addition the cost of researching and monitoring smaller corporate issues, as well as a larger number of them, probably proves prohibitive. Ideally investors with very long time horizons where liquidity is not a constraint would be well placed to participate, in particular where they have access to a large, parent company balance sheet.*

22 Are there any additional significant barriers that should be considered?