

The Association of Corporate Treasurers

Comments in response to

Discussion paper on non-bank lending

HM Treasury, January 2010

February 2010

1. The Association of Corporate Treasurers (ACT)

- 1.1. The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.
- 1.2. Contact details are also at the back of these comments.
- 1.3. We canvas the opinion of our members through our magazine, our monthly e-newsletter to members and others, a members' discussion forum and our Policy and Technical Committee.
- 1.4. The ACT welcomes the opportunity to comment on this matter. Although some of our members work in the financial services industry, the ACT generally comments from the standpoint of non-financial companies¹.
- 1.5. This document is on the record and may be freely quoted or reproduced with acknowledgement.

2. General

- 2.1. The ACT is concerned about the future supply and cost of capital, both equity and debt, and the availability and cost of risk management products. An increasing demand for capital and for risk management products would normally be important in supporting a recovering real economy after a major downturn. Governments, banks and companies will be competing for capital.
 - 2.1.1. Commentators and regulators talk about the shrinking of bank balance sheets. We note regulatory moves which tend to increase the cost of capital for regulated institutions that may supply capital and risk management products to industry in general. And we observe

¹ See <http://www.treasurers.org/technical/resources/manifestoMay2007.pdf>

discussion of disallowing as a business expense for tax purposes interest costs incurred by companies – and this perhaps not balanced by proposals that interest receipts be taken out of tax too.

2.1.2. Reduced levels of capital available to banks, a tendency for banks to concentrate activity where they are strongest – usually their home market – and suggestions of merger and acquisition activity reducing the number of banks and reinforcing the emergence of a small number of super-large banks all give rise to concern about competition in corporate banking (see Appendix).

2.2. With this background, we welcome attention to any unnecessary barriers which may make it less convenient and attractive for regulated and unregulated potential non-bank suppliers of capital to industry to provide that capital. We agree with the discussion paper's view (1.3) that action on many fronts will be necessary to promote the development of effective non-financial company debt channels.

3. Response to questions

3.1. We set out below responses to the questions explicitly posed by the discussion paper. The questions have been italicised to distinguish them from the responses.

3.2. Before responding we think it worthwhile setting out two points which underlie much of what we say below and should be carried in mind in any consideration of the issues raised in the discussion paper.

First, bank and non-bank lending have many distinguishing features and we mention some of them here.

Non-bank lending tends to take the form of fully drawn finance. Investors usually do not want the uncertainty of revolving facilities which can be undrawn or of pure stand-by facilities both of which make investment planning more complicated and require the maintenance by the investor of liquidity to meet drawings. Revolving and stand-by facilities are almost entirely a unique selling proposition of banks. Since the recent crisis, however, some banks have sought to make new lines fully drawn or with minimum outstandings of 50% of the total line, partly in order to be able to have loans to sell to non-bank investors.

With the recent crisis, many companies now no longer see banks as such a reliable source of finance and larger, investment grade companies are moving to fund more from capital markets.

Companies which are able to², usually require their consent before banks in syndicated loans to the company can sell on the loan to others. Partly this is to protect companies from unfavourable tax consequences but can also reasonably be used to prohibit sale to parties unable to (or reputedly unwilling to) handle easily negotiation of revised terms and conditions as needed from time to time. Many non-bank investors find this objectionable³.

² Sub-investment grade companies are not able to require this.

³ Banks find ways around this by selling sub-participations etc. which do not require consent of the borrower. This may sound inefficient, but borrowers often attribute value for them of the bank's reputational risk associated with its continuing to "front" the loan.

Loans to highly levered borrowers are usually structured in tranches of differing seniority/subordination and with differing obligations of the borrower especially as regards covenants etc. Some tranches may be tailored to non-bank lenders needs and to deal with some of the issues raised in the last paragraph.

Mostly, bond investors are not set up to maintain relationships with borrowers and do not have processes for considering running changes to facilities as corporate contingencies evolve. Bond investors can find considering changes relatively onerous. Some bonds can be held by a large number of different investors with whom it is in any case difficult to negotiate. "Negotiating" with holders of bearer bonds is yet more difficult⁴.

Bond terms and conditions are, then, relatively inflexible.

Bonds are often issued with maturities longer, even much longer, than bank loans. Accordingly, the relative inflexibility of the conditions of bonds weighs heavily on companies. Those companies with real choice take this into account in the yield they are willing to pay and the specific conditions they are willing to accept. The kind of covenants which maybe acceptable in senior bank loans are often different from those typically provided in bonds or notes.

Second, we would greatly welcome the development of a UK or European private placement market for bonds and notes more adapted to the local business practices, laws, etc. than the US market to which some firms turn in the absence of that local market. Our comments in response to Questions 11, 19, and 22 particularly refer to this.

A local bond or note private placement market may over time perhaps attract investors who would be prepared to consider varying repayment schedules, not just "bullet" repayments, different approaches to levels of seniority or subordination, to consider different forms and levels of security or use of guarantees from various group members and other features of flexibility⁵ currently found in bank loan markets.

Questions for business

Credit assessment and monitoring questions

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)?

Response

⁴ Appointing a bond trustee gives the trustee limited discretion in agreeing amendments with the issuer. This is more helpful in the UK and Hong Kong but less so in the US where the practice has grown that trustees will not generally exercise discretion for fear of litigation.

⁵ All these types of flexibility require an understanding of the group of the borrower company which requires more staff time than just reading a one page summary of a bond offering, increasing the costs and commitment of the lender in this type of investing but perhaps being rewarded in price or other terms from the borrower.

Cost

The cost to a company of obtaining ratings will vary according to the number of types of ratings sought and the extent to which outside advisors are used in obtaining the ratings. Whether the cost is high is relative to whether the ratings achieved will enable debt to be issued and how much, or reduce its cost and to what extent.

Larger companies will tend to use outside advisors less than smaller companies in their dealings with rating agencies. They are more likely to have the necessary expertise in their own staff. Likely to be contemplating raising larger sums, they also see the relative direct cost as smaller.

Many large companies regard the use of time of directors and senior staff as the more important “cost” of a solicited rating (see next).

Few companies other than large companies will see the benefits of solicited ratings outweighing the costs.

Information

(These comments relate to larger companies where the benefits of ratings outweigh the costs.)

A company seeks a rating as part of its overall corporate communications strategy as well as part of its financing strategy. A rating is a step towards greater transparency by a company.

Information handling weighs heavily with companies. However, in some ways quite full disclosure to a rating agency (which has a contractual and reputational and in some jurisdictions a statutory or regulatory obligation for confidentiality towards non-published information) can give comfort, through the rating, to investors who are otherwise dependent on published information. This can be seen as easier for the company than greater direct public disclosure.

Of course the need for disclosure to the rating agency on a continuing basis is important for maintenance of the rating. This involves time commitment from senior management as well as of staff collating/presenting requested information or information the company wishes to present. As noted above, some companies see this time as the most important “cost” of a rating. The company does see benefits, however. An informed rating agency is normally in a position promptly after any statement by the company to announce its intentions for the rating. This reduces uncertainties and rumour and so market volatility.

Publicity surrounding a ratings downgrade, even a change in outlook from “stable” to “negative”, will mean the company will need to be ready to handle questions from suppliers, customers, pensions trustees, joint venturers, etc. as well as lenders. Smaller companies may find this more daunting.

Some companies find a certain loss of control a concern: rating agencies, once they start publishing a rating for a firm normally will feel an obligation to users to go on publishing a rating (albeit a “public information” rating) even if the rated firm decides to stop paying for it and providing the agency with access to management. But this very reassurance of parties it deals with is part of what a company is renting from a rating agency when it solicits a rating.

- 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?*

Response

It would have an effect at the margin.

Rating agency methodologies and the content of their various reports and what their rating scales mean vary from agency to agency. This is useful and important as there is information in differences between agencies.

As well as agencies rating on a solicited basis with access to management and with access on confidential basis to Relevant Information not Generally Available (some of which may become Inside Information), there are other types of firm publishing information on credit standings. These include, firms publishing ratings derived purely from analysis of published information and firms publishing “market implied ratings” which include use of movements in securities prices as indicators. (Other firms such as Dunn & Bradstreet offer various forms of credit scoring, often aimed at immediate supplier credit issues but covering smaller firms as well as larger. They do a very different job from the main credit rating agencies.)

Investor preference is of overriding importance here. Many investors, direct or through funds, require companies to invest only in companies rated by selected rating agencies, usually the most well-established. This is an important factor for companies issuing obligations. It also is a barrier new ratings agencies have to overcome.

Companies and investors will only pay for ratings if they consider them worthwhile. The competition for a solicited rating for a company is not just other rating agencies or no rating at all, but non-solicited ratings as well, paid for by investors. The “issuer pays” model of solicited ratings arose from various historical events but the need for companies to be rated to access debt capital meant they, particularly smaller companies, could not rely on investor’s volunteering to pay for the company’s rating.

Corporate transparency questions

3 If you do not currently use non-bank lending channels, such as bond or loan markets:

- a. what currently stops you from doing so;*
- b. how burdensome do you find providing your current levels of corporate transparency (if at all), and would increasing this act as a significant deterrent to accessing non-bank lending; and*
- c. are there any regulatory barriers that deter you from using non-bank channels?*

4 If you have sought to use non-bank lending channels but have not been successful, to what extent was:

- a. corporate transparency a factor; and/or*
- b. cost a factor?*

5 If you currently use non-bank lending channels have you found corporate transparency requirements an issue?

Response

While the need to communicate to investors in the companies' obligations adds to their communication burden, the experience of the authors is that this is relatively small even though it may be seen as more important than the direct cash costs of a rating.

We consider that a much bigger consideration is the relative inflexibility of terms and conditions and in respect of cancellation/early repayment of non-bank borrowing.

We note that a company's communications programme can have objectives additional to those simply of transparency⁶ and this can make separating the cost of required transparency for bond markets (or for capital markets generally) quite difficult.

Loan pricing transparency questions

9 *Are you able to compare the prices of different types of borrowing (e.g. bank and non-bank lending)? If not, what might help you to do so?*

Response

In choosing a form of financial capital, price is probably not the first consideration. Availability, reliability and the terms of lending (especially in so far as these involve contingent and possibly immediate actual⁷ surrender of some control to the lender) usually need to be satisfied before price considerations.

Many characteristics of bank loan and non-bank financing differ, not just price. Cost comparisons are only part, and a relatively minor part, of the story.

Differing final maturities and differing ease of repayment mean the risks taken by the borrower vary significantly between different types of debt.

Within that, difficult, background, those investment grade companies with sufficient negotiating leverage to maintain competition among even a group of selected banks find price comparison relatively easy. They will, for example, give few if any financial covenants to anyone and be clear about the few non-financial covenants they will consider.

Companies which are unable to maintain price competition among banks find price comparison relatively difficult. The reason price comparison can become more difficult relates to how banks with pricing power have tended to tailor pricing structures.

The apparently clear single number pricing of a bank loan's margin over the index (commonly LIBOR) is misleading. For weaker borrowers, there will probably be bank fees relating to the agreement, renewal or extension of the facility – those fees needing to be costed in over the effective life of the facility. And the effective life may be, say, a year or more less than the nominal life as borrowers may want, value and be willing to pay for the certainty of renewing or extending a year before final maturity. They may

⁶ E.g. "A Matter of Appearances: How Corporate Leaders Manage the Impressions of Financial Analysts about the Conduct of their Boards", James Westphal and Melissa Graebner, *Academy of Management Journal*, Volume 53, Number 1 February 2010

⁷ E.g. in a loan agreement clauses prohibiting acquisitions or dividends or restricting capital expenditure, etc. have immediate such effect.

need the certainty of funding for “going concern” reporting purposes (see response to Question 8, below).

As the headline margin is simply stated and easily understood by a company’s directors with little financial background, both the company’s staff and the bank have had an incentive to minimise the margin. A bank with pricing power will seek to recoup this by higher than competitive pricing for ancillary business that is awarded either non-competitively or with restricted competition and in respect of which awareness is likely confined to just a few staff in the company. This both distorts pricing in the ancillary business and makes borrowing price comparisons for the borrowing even more fraught.

If a lender takes ancillary business such as long-term derivatives extending beyond the loan maturity but then sells on the loan or declines to take part in an extension or renewal of the lending, it can make attracting a new (bank) lender to the borrower difficult if there is a lack of other significant ancillary business to tempt them.

A non-bank lender, however, does not have usually any ability to take the ancillary business on which to recoup any reduced lending charge. Its consequent higher price demand can make the headline margin look uncompetitive. It is then harder for non-bank lenders to get a serious hearing by borrowers.

The distorting effect of ancillary business linking to bank lending was considered in an ACT internal paper from last year. This is reproduced in the Appendix.

Some continental European companies benefiting from “name recognition” and which have in the past used mostly bilateral relationships with “house” banks rather than syndicates have found a need to extend sources of debt finance due to reduced capacity in their banks. Some companies have been able very recently to add syndicates of new banks which get few or no covenants and no ancillary business and price accordingly. We don’t know if this will become widespread even in continental Europe but we see many behavioural obstacles in the UK.

Preferences of UK investors, questions

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

Response

Companies pay great attention to lender preferences.

A large company will issue bonds or notes into those markets willing to buy them at the most favourable combination of conditions and price, wherever in the world (provided taxes and exchange controls are congenial and necessary derivatives to manage foreign exchange and interest volatility issues are available at reasonable prices⁸).

⁸ The ACT is concerned that new regulation of Over the Counter (OTC) derivatives or the bank capital requirements for bilaterally settled and non-margined non-financial-client OTC business could significantly bar companies from such markets. That would have the effect of forcing companies needing sterling, for example, back into UK domestic markets rather than having access to global sources of debt capital. See comment response to Question 17.

However, the extent to which a lender's or a borrower's preferences are fully met will be determined in the market place. This applies particularly to covenant etc. demands.

Companies concede more in terms of price and of conditions in times of funding shortage and less in times of plenty. One of the costs of borrowing at all is some actual and contingent surrender of control by the management of the borrower and its shareholders. Cost and loss of control must be balanced by management.

So a bank demanding covenants that turn a term loan into a demand facility subject to re-negotiation will be resisted although that is probably the objective of any banker lending to weaker credits. Covenant demands of bond investors who are structurally more difficult to negotiate with will be resisted even more strongly. This is especially true where bond investors are used to US practice and want US style covenants reflecting US business practices, company, insolvency and financial law, accounting, etc. and unwilling to learn new tricks better adapted for both lender and borrower to European and particularly UK conditions. It is noteworthy that some European investors too insist on US style (and US law) agreements because they like the comfort of potentially selling on to US investors. This can make such non-bank finance very unattractive to UK companies.

Another area where companies think twice before accommodating lenders is in cancellability. Bank loans are advantageous to the borrower in that they are usually repayable and cancellable without significant penalty. This enables, for example, a loan with a covenant which has become problematic to be paid off. This flexibility is generally not true even of floating rate notes and bonds, reflecting investors concerns with duration and final maturity and making this type of non-bank finance unattractive to many companies.

Non-bank loan market questions

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?*

Response

It is very important not to try too hard to accommodate a new class of investor in an existing market.

Some non-bank investors do take part in ("bank") loan markets – particularly for non-investment grade borrowers. In principle this may be a way of attracting new lenders to companies.

But, in contrast with bond and note markets, a key underlying part of bank loan arrangements is that banks are available to maintain a relationship with a borrower, to consider modification of terms etc.. Lenders not able to do that are probably better accommodated in different forms of lending with fewer covenants etc. and different pricing as usual in bond and note markets⁹. This approach can be seen in the differing terms of various seniority etc. tranches in sub-investment grade/more highly levered financings.

⁹ Not only are some non-bank investors in loans not set up to handle change negotiations easily, some companies may fear that some investors have invested to gain from any requested changes or to block them as part of a "loan to own" strategy.

Some potential investors fail to recognise that the differences in what they are offering will affect both the pricing and the conditions companies are prepared to offer to them. Such investors sometimes seem to regard companies' reluctance to accommodate them as normal bank lenders as merely awkward when it would take a wholesale rewriting of UK business conditions, structures, practice, law, conditions, etc. for companies to accept the offer easily.

Some lenders are not able easily to accommodate the revolving/standby features of most bank loans (sometimes drawn and sometimes not).

While some bank loans are required to be fully drawn at all times, and some may have fully drawn tranches, use of such provisions will grow or reduce according to market circumstances. Certainly the undrawn but available nature of bank debt is a key attractive selling proposition of (most) bank loans when compared to bond or note markets. Bank loans would be much less attractive without that feature for which companies are normally willing to pay a small premium.

The other differences discussed under Question 11 (above) are also relevant here.

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

Response

Clearly there is scope for improvements in market infrastructure regarding the speed of effecting of secondary market loan sales and many aspects of the interactions between parties (particularly those involving agents), arrangements for defaulting lenders, etc.

Market infrastructure should be as efficient as practicable – it is the borrower that ends up paying for inefficiencies in the end.

However, it should be recognised that many companies carefully select their lending banks and do not welcome the substitution of lenders or growth in numbers of lenders in a syndicate arising by secondary market transactions which can increase communications costs and complicate matters such as information provision, negotiation of amendments to terms, etc.

Most secondary loan trading is in the sub-investment grade sector where companies have less negotiating leverage and to some extent for the large, investment grade, transaction-related financings where the company expects to repay the borrowing from a disposal or capital markets transaction in a short time and does not expect to be stuck with random and uncongenial banks or non-bank lenders for very long.

If loans in general became a traded market more like bond markets, it should be expected that terms and conditions would move towards being more like those of (domestic, sterling) bonds and notes than those currently found in many (“bank”) loan agreements.

The market should be left to find its own level here.

High yield bond market questions

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

Response

Currency of issuance is mostly determined by availability and relative pricing. Recently, for example, spreads in sterling bond markets have been wider than in dollars and euros and this has applied to investment grade as well as high yield paper. Some companies have been retiring sterling bonds from refinancing in dollars or euros.

Companies are able to use global capital markets rather than being confined to domestic markets. Often a company will benefit domestically from name recognition and easier communications. But cost and availability and terms and conditions and more congenial maturities elsewhere may outweigh domestic benefits. However, the legal frameworks in different jurisdictions can significantly affect ease of access for issuers to those markets and currencies.

Whichever currency debt is issued in, it is then swapped back into required currency/currencies. In the same way, whether debt is fixed rate or floating rate it will be left that way or swapped into whichever the company prefers.

If the costs and availability of derivatives are reduced, companies' choices in these areas will be reduced and costs of capital somewhat increased, reducing real economic activity. Derivatives used by companies in these transactions usually have cash flows matched to those of the debt obligations. If companies were required to put up cash margins/collateral for price variations during the life of the derivatives before the cash flows on the related debt obligations, the contingent cash flow risks would be a significant burden for companies. Companies would be more confined to borrowing in final use currencies and less able to manage interest rate risks. The lower availability and higher effective cost of debt would reduce real economic activity.

The origins of swap markets lie partly in exchange controls but also in the differences in pricing of similar cash flows with similar risks in different markets. Use of swap markets materially increased the access of companies to (global) capital and reduced the cost of capital by reducing demand in high-spread markets and tapping into lower cost pools of capital. Anything which acted to re-establish the barriers between capital markets would have negative effects for real economic activity.

This last would be a particular concern in markets, perhaps like the UK, where capital availability (not just to companies but to banks and the public sector too) could be a constraint on recovery after the downturn.

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?*

Response

Please see our comments on investor preferences under Question 11, above.

We confine our comment here to the cost of monitoring question. Monitoring costs are issues for all lenders, banks or non-banks. Use of modern communication methods including filing of reports by companies using

interactive data formats such as eXtensible Business Reporting Language (XBRL) can make an important contribution¹⁰ to reducing monitoring costs.

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?*

Response

The reason for the observed phenomenon is that transaction related bond or note issuance has been the dominant factor behind large-size highly leveraged bond issuance. Size of issue is important to many investors who may have a policy of not holding more than a small portion of any issue.

High yield paper is usually structured to a particular group/type of investor both as regards coupon and, seniority and subordination including structural subordination and so on, and credit rating. It is often a lot of work for issuer and lender and only worth while for large issues – and transactions or major refinancings are often the trigger.

Investors in high-yield paper are often very US orientated – even European investors liking to see US style provisions and New York law (see comments under Question 11 above). This can make high yield bond markets very unattractive for potential issuers.

Private placement markets and US 144A issues (to qualified investors only) share some of the same characteristics but can provide smaller sums suitable for smaller issuers. US private placement investors are often very “picky” and want terms and conditions more similar to those of banks while being much less available for renegotiation of terms during the life of a loan as they lack the well staffed departments to handle it. US 144A issue terms and conditions are similar in characteristic to public deals. While US law etc. is usual, because these routes avoid the requirements of listing for public markets and there maybe some discussion on some tailoring of covenants in private placements there are offsetting compensations which can make those investors a bit more attractive.

The use of any instrument is determined by very many factors and it is important not to focus on narrow points and overlook the general picture. Developments and improvements come narrow point by narrow point however.

We would welcome the development of a UK/European private placement market or market for qualified investors only¹¹ without the distortions caused by using instruments designed for US conditions, laws, etc. in form suitable for both investment and sub-investment grade issuers. The ACT took part in the development of UK loan market documentation standards which survive in the Loan Market Association “investment grade” documents (to which we, the British Bankers Association and the LMA itself are signatories) and there are many applicable lessons from that exercise.

Many less-large companies (and some larger) tend to prefer floating rate finance and non-bank investors often prefer fixed rate investments so the

¹⁰ The US SEC has introduced requirements for reports to be filed in interactive format (see <http://www.sec.gov/rules/final/2009/33-9002.pdf>).

¹¹ We would hope that mutual funds could be encouraged to invest and enjoy a suitable regulatory regime for this.

availability of interest rate swaps in non-margined form for non-financial customers without banks suffering punitive capital for such OTC derivatives would be important.

A private placement floating rate note market (in which an issue could be expanded without further documentation and where repayment without penalty at any the end of any rate setting period) would be an attractive variant of a PP market if any investors were interested in floating rate paper.

General questions

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

Response

We believe that the Treasury can encourage and help educate both investors and borrowers. This task is not to be underestimated.

Treasury can also consult widely and bring forward proposals perhaps to address any unnecessary regulatory obstacles to widening the pool of capital available to industry identified by respondents to the Discussion Paper.

The Treasury should not become salesmen for suppliers of any particular form of capital.

See also the response to Question 22, below.

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

Response

We think that the most important point made is about the essential, non-price differences between different methods of debt financing and between different financings of the same class. These differences are usually more important to the borrower than price.

As regards the ways to make a difference, the encouragement of a locally adapted (UK/European) private placement market with non-US oriented investors seems to have most potential.

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

Response

Non-bank lenders involved in loans or bonds etc. may have particular withholding tax problems obstacles to their being congenial participants in loans or holders of bonds. For smaller companies in particular the costs and time of getting withholding tax clearances even for bank for lenders is an issue in any case – especially as in most “bank” loan documents the lender must gross up for withholding tax on interest payments to lenders. We think the withholding tax impact deserves study especially if a local non-listed bond market could get underway or more non-bank loan investors are to be encouraged.

Questions for Investors

Of course the ACT does not in any way speak for investors. We do comment question 8, however as it has no counterpart in questions for issuers.

Credit assessment and monitoring questions

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?*

Response

We believe this subject raises many difficult questions.

It is often difficult generally to see how features of overseas markets would affect domestic markets as the background of all other aspects of the market will differ.

UK listed companies are obliged to discuss in the report and accounts risks affecting the business. Covenants, etc., for example affecting the availability of funding, may be such a risk and if this is the case it must be covered in the report and accounts.

UK listed companies are subject to "going concern" considerations in which availability of funding and possible covenant breaches are relevant and we commend the FRC's guidance on this topic¹². Companies have to look at least 12 months ahead and auditors will expect 18 months. Companies with relatively "bunched" maturities of loans or few loans and so relatively larger maturities will commonly expect to renew or replace loan facilities or pre-fund redemption of bonds more than a year ahead of formal maturity. Any doubts will be flagged in directors commentary and in expanded auditors reports.

Covenants are rarely standardised – essentially because of the multitude of contingencies affecting a company but also because of the different risk appetites and understandings of different investors. To understand the effects of any particular covenant wording one has to see the rest of the agreement, any other agreements which might have a bearing and to know a great deal about the contingencies of the company, the legal systems in which it operates, etc..

Some covenants are accepted by companies in bank loans only because they are mutable and the banks are available to exercise judgement. So to disclose them to third parties might be to give false impressions. It might make it harder, say, for a recovering company to achieve less onerous covenants over time. It might make it harder generally to issue into markets debt with less onerous covenants.

This compounds the point that almost every term in a covenant is especially defined for the particular company and can't be compared from agreement to agreement even if the wording of the particular term is similar or identical.

UK listed companies undertaking particularly large transactions already put material documents on display for a period and these will often include material loan documents. However this is very different from the routine disclosure referred to.

¹² *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009*, Financial Reporting Council, October 2009.

Listed companies which become highly levered may make their loan documents public in order to sell (now) highly levered bonds or raise new bank loans especially where lenders cannot accept confidential information.

One can learn a great deal about management's strategy, especially in weaker companies, by tracking the way in which covenants differ among agreements negotiated at different times, changes in definitions, seniority and seniority protection, non-financial covenants, various "carve-outs" from covenants, maturity staging, whether particular subsidiaries are in or out of guaranteeing or "core" subsidiary lists, and so on. Routine disclosure would be a very big change for companies to digest and adapt to and an impact assessment of any such requirement would be complex to assess.

Companies would doubtless accommodate to any routine disclosure but the frictional costs of adjustment to the new position and the activity levels at which affairs would settle are hard to evaluate.

ACT February 2010

Competition in (non-financial) institutional banking

Tying of bank lending to companies to ancillary business

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the end of this letter and on our website www.treasurers.org.

In this case, we specifically canvassed the opinion of our members through our Policy and Technical Committee although we have had many comments from members on the general topic over many years and especially during the financial crisis.

We noted the recent initiative by three UK brokers to raise with Lord Myners the question of the anti-competitive effect in provision of financial services to companies from the tying of ancillary business to bank lending. The brokers noted the exclusion of non-lending service providers from the provision of brokerage services¹. This exclusion is part of a much wider phenomenon.

Our members, of course, have taken a keen interest in the developments in the structure of the banking industry following the recent and continuing crisis. In particular, we have noted the increasing concentration within the industry arising both from bank mergers and from (possibly temporary) withdrawal or reduction in activity in many countries by some banks from outside the countries².

Our approach to the growth of super-large banks is one of scepticism. We do not accept that the largest companies *need* super-large banks. Our response to the UK's Turner review from the FSA earlier this year sets this out and the relevant section is reproduced in the box overleaf to this note.

Of course, a part of our concern is that the merger of large banks into super-large banks can reduce the number of large banks such as to reduce effective competition between them for large company business. Even for smaller banks (and especially when dealing with smaller companies), banks' geographical locations and risk preferences and their sectoral views, never mind their views of the adequacy of their capital and about particular companies can limit the number of banks which might lend to a company to too few to allow competition to produce reasonable terms for customers even in good times.

With the state of the overall banking system in the recovery from crisis, coupled with regulatory requirements for more bank capital relative to a bank's business than before, we see a likely continuation of conditions of scarcity of bank provided credit as being the experience of many companies. This is especially likely to be the

¹ See Financial Times, November 10, 2009, <http://www.ft.com/cms/s/0/d6f990c0-cd99-11de-8162-00144feabdc0.html>

² "...one unintended consequence of the market meltdown has actually been a reduction in the competition, which should help banks' market share and pricing power." (Barbara Ridpath, Chief Executive, International Centre for Financial Regulation, LMANews, Loan Market Association, December 2009, page 15).

Extract from ACT response to the Turner Review of banking regulation

Large banks

We have consulted carefully with members at some of the large companies which might be most affected by the availability or otherwise of the largest financial institutions as well as more widely.

We understand that the thinking in the Turner report on large banks will be subject to further review and clearly there are some significant issues around the risks that can be created – too big/complex/interconnected to fail or too big etc. to rescue. As we said above, we think that often such too big etc. institutions are probably too big etc. to be managed efficiently, making the institutions a drag on society as a whole.

We agree that this should be approached after a proper risk assessment, but from the corporate customer point of view we can say that generally companies do not need super-large banks.

There can be minor conveniences in dealing with a very large bank that can provide a good range of service across the globe, but it is not usually the key selection criterion. Even for global cash management, companies tend to restrict a single bank to only a part/region/hemisphere of its group business and seek to ensure they have a second partner bank which could take over seamlessly from the main incumbent in case of need.

Treasurers welcome a diversity of providers in order to access a diversity of products, ideas and expertise. Competition is important too, so market dominance is not helpful, and therefore there should be some limits on size or market share.

For some super-large companies it will occasionally be convenient to be able to deal with one or two super-large banks with correspondingly large balance sheets and ability to take or underwrite significant risks, e.g. a large acquisition financing commitment, but even then the risk is normally rapidly distributed out. Companies could easily learn to transact with a group of banks rather than rely on a sole underwriter and some already do this as a matter of policy.

experience for companies below a size and standing that has permitted direct access to bond capital markets including private placement markets to raise debt and this is compounded by the tendency for lower than commercial pricing of bank loans referred to below which shuts out some non-bank lenders from the market.

These trends increase significantly the leverage of the bank or banks a company is dealing with. The cross-selling opportunity which a bank has in dealing with a familiar loan customer can more often become a cross-selling demand from the bank as a condition of lending. This has a number of undesirable effects.

Provision of ancillary services

It is generally recognised that, in the past and perhaps still today, banks underpriced corporate loans in order to secure client access. They might make up the return on capital from the sale of profitable ancillary business products – some very profitable. The table below was from a banking consultancy firm was used to illustrate this at an ACT conference well before the recent crisis.

Commercial Banking				Fixed Income				Equities		Corp.Fin		
10%	15%	50%	25%	80%	30%	25%	40%	20%	45%	40%	35%	30%
Vanilla lending	Value added lending	Transaction services	Asset finance	Deposits	Rates	Credit	Other FI	FX	Equity derivatives	Secondary equities	M&A	ECM

Illustrative risk adjusted returns on capital

Example risk adjusted returns on capital from various activities are shown: a bank's reasonable return on capital of 12% was generally not reached by normal ("vanilla") lending. Earnings from other activity associated with European institutional banking, however, were expected to permit a much high overall return to be achieved, with significant rent – perhaps a 20% overall return on risk adjusted capital.

The largest and strongest companies did feel free to award ancillary business on the basis of service levels and pricing. Large companies and many medium sized companies would often regard lending as a condition to allowing a bank to tender for ancillary business, allowing competition within the lending group of banks and with selected non-bank competitors. Other medium and smaller companies did not have the leverage to do this.

Recently, of course, the spreads and fees banks can charge on simple lending have greatly increased due to the scarcity of credit. Credit provision however has still been linked in many cases to formal granting of or promise of high margin ancillary business.

Platform speakers from banks often said at conferences during 2009 that ancillary business "must be kept for lending banks" – often in quite strong language.

In the past, larger and higher credit standing companies were able to take advantage of competition between lending banks and, indeed, institutions that were not in the business of lending³ to ensure an overall reasonable quality of service and reasonable (if perhaps high) combined cost of bank funding and ancillary services.

If banks are in a position actually to insist on receiving ancillary service business, whatever the price or other terms or service levels, competition is reduced or excluded, reinforcing the effects of credit scarcity on banks' institutional banking business profitability. Again, companies below the size normally able to access debt capital markets feel this the strongest.

Market access by non-bank lenders

Importantly, another effect of all this is actually to limit even more the availability of debt and loan capital to companies. Non-bank lenders generally do not offer ancillary business services to borrowers. They depend for return on the yield on the lending. But a full return on a bond can make it look a very uncompetitive form of borrowing compared with ancillary-business-subsidised bank loans of similar maturity for many companies. This point was made strongly by one non-bank lender at an ACT conference this autumn.

This exclusionary pricing by banks does seem to limit the growth of the non-bank sources of finance which will probably be needed to supplement bank finance in the coming years.

Because in many companies company directors and staff have become used to the "come-on" pricing of bank loans and the high pricing of ancillary services it is very difficult for anyone in a borrowing company to advocate full pricing of loans and reasonable, competitive setting of prices and service levels for ancillary business. If a loan were fully priced and the

³ E.g. the brokers referred to at the beginning of this note.

price became known when other companies were still on the previous charging basis, third parties would be likely to become worried about the borrower's credit standing. There is no guarantee that the prices of ancillary services over the life of the loan would be competed down sufficiently to offset the higher borrowing cost agreed. This is not an issue which could be tackled by any one company – a good example of the textbook idea of the problem of collective action.

Bundling: “the tie”

It is a common observation that bundling of goods and services is usually more in the interests of the supplier rather than the customer⁴.

As noted above, the largest investment grade companies generally will not allow bundling, but others mostly, in practice, have to accept it at some level, consciously or not.

Of course, some banks are not in a position to provide significant ancillary services. Such banks are prominent among those which have withdrawn from UK syndicated corporate lending since the crisis (examples would be some retail banks from Europe, notably Germany, and from China). Such banks were /will be often regarded as make weights (or “stuffees”) in a loan syndicate, not earning a proper return on lending. Doubtless some of the retail banks in savings-surplus countries will in time return to this role in corporate lending though, perhaps, initially at least, more reservedly.

But some banks have invested in appropriate systems and are able to provide excellent service levels at low costs in some ancillary services. Many of their potential customers, however are tied to other lending banks or feel obliged to share business among lenders. The specialist ancillary service provider banks then land up needing to offer low priced loans to gain customer access and are pressured to price up their additional services (and even to their own captive borrowing customers) in order to make up for inadequate returns on the lending.

For sub-investment grade borrowers who are seeking large sums in debt, there will often be non-banks in lending syndicates, hedge funds for example⁵. Normally, the price for the loan will be set by “the last man in” who completes the sum to be raised. As, probably, the last lender has no profitable ancillary business possibilities, they look for a full return on the lending – further putting up the return for all lenders.

Of course, in the US the low return on the scarce product – credit – would be seen as predatory pricing and the high return on the tied products be seen as gouging. Indeed, in the US making credit availability conditional on purchasing other products (“the tie”) is explicitly illegal⁶ and some general competition laws still apply too.

A few years ago US banks lobbied to repeal the prohibition of the tie, saying that the banks did not have leverage in view of the easy availability of credit. Customer representatives said

⁴ “The attractions of financial conglomerates are more evident to the people who run them than to their customers, employees and shareholders – or the taxpayers who have been faced with bills of startling magnitude by their failure”, John Kay, *Narrow Banking: The reform of banking regulation*, CSFI, London 2009, ISBN 978-0-9561904-6-8, at page 24.

⁵ Some non-bank lenders may buy loan participations in the secondary market, perhaps pursuing a recover play or weakened debt or a “loan to own” strategy.

⁶ <http://www.fdic.gov/regulations/laws/rules/6000-100.html>, Bank Holding Company Act of 1956, see 106(b)(1) etc. as amended (1970) - <http://www.fdic.gov/regulations/laws/rules/6000-1000.html#fdic6000sec.106b>.

that banks had leveraged when it mattered – and the credit crisis has shown this dramatically, of course.

So we were very interested in reading about the three brokers initiative in writing to Lord Myners¹.

In the US the prohibition of the tie only acts as a kind of moral suasion. US banks do not usually impose conditionality in written communications. Merely saying that before they decide to lend, extend or renew they want to understand the full relationship which might develop and maybe the client would outline the kind of ancillary services its business needs is quite sufficient.

The relatively explicit nature of the tie for many companies in Europe makes it harder for non-bank lenders to compete with bank loans. It is difficult to see how general competition law in Europe can weigh against this market distortion. We are unsure if an explicit prohibition of a tie in Europe may be needed.

But perhaps at the right time the competition authorities should consider institutional banking markets in general especially as they affect non-financial companies other than the largest.

ACT, December 2009

The Association of Corporate Treasurers

The ACT is an international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

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Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at <http://www.treasurers.org/technical/resources/manifestoMay2007.pdf> .

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