

Improving the functioning of European bond markets: towards a consensus

Introduction and background

Europe's bond markets are growing rapidly reflecting factors such as the so-called "search for yield" by investors and the portfolio demands of funded pension schemes. But the markets – particularly for *euro*-denominated bonds - are still relatively young. It is in the interest of all market participants to develop practices which will serve borrowers and investors satisfactorily under a range of different conditions, and thence help to support the broader economy.

Regulation can play a role, but it is better that practitioners themselves should work together to remove obstacles to the market's development. Recent debate has centred on the flow of information from issuers to investors and the need for clarity with regard to covenants. With this in mind, a representative group of practitioners from all sides – issuers, investors and intermediaries - have come together in an informal forum¹, the Bondholders' Dialogue, sponsored by the Association of British Insurers (ABI) and the BVI Bundesverband Investment und Asset Management (BVI) to develop mutual understanding and look for practical approaches to resolving current issues.

This paper reflects the initial results of that dialogue. It is deliberately not prescriptive, but is instead intended as a pragmatic approach highlighting best practice. Participants in the dialogue were united in their belief in freedom of contract. There is no agenda to arrive at standard terms. But they were also clear about the potential for improvement in information flows and about the need for better understanding of the practical effect of covenants.

Previously, dialogue between issuers and investors was all too rare, and mutual suspicion all too common. Participants in the forum believe that their dialogue is helping to break this down, although there is clearly further to go. Their forum is informal and is not intended to be exclusive. It is up to the

¹ Members of the forum were: Rupert Beaumont (Association of Corporate Treasurers), Valerie Blanchin (AMTE), Tim Butcher (Scottish Widows Investment Partnership), Paul Hearn (BNP Paribas), Cliff Dammers, Georg Lambertz (RWE), Nick Medd (HSBC), Peter Montagnon (ABI), Martin O'Donovan (Association of Corporate Treasurers), Rod Paris (Standard Life Investments), Han Rijken (ING), Jean-Paul Rigaud (AFTE), Rudolf Siebel (BVI), Peter Walburg (DWS), Stephen Wilson-Smith (M&G)

Each individual was acting in a personal capacity and the views expressed by the forum do not necessarily represent those of organisations to which members belong. The forum wishes to acknowledge its special gratitude to Alastair Clark, of the Bank of England, for chairing the discussion in a personal capacity.

At the same time, AMTE (Euro Debt Market Association) has initiated a similar dialogue involving issuers, investors and intermediaries with two working groups. The first is dedicated to promoting primary market standards for corporate and financial investment grade issuers. The second is related to bond market transparency in Europe and is focused on the secondary market. Members of the forum will look to collaborating with AMTE in developing their conclusions.

markets as a whole to decide whether to take up the recommendations set out below. But participants would welcome a wide and lively debate, hopefully leading to adoption or refinement of the ideas set out here.

Summary of conclusions

While all sides recognise the complexity of the issues discussed by the group, there was a belief that some steps could be taken now to help make the markets function better. Three main areas were identified.

- There was consensus on the need for more timely availability of information on new issues and more information on certain aspects of the issuer and the issue. The International Capital Market Association has agreed to work with its members on practice with regard to new issues. Members of the forum will continue to explore with regulators and others ways of ensuring timely website access to all public prospectus information.
- The need to address some ambiguities in terminology which could potentially be confusing or misleading. Specifically, there was a need for education and better understanding about the use of the word *senior*, which all members of the forum agreed to pursue. They also urged that those involved in the distribution and rating of issues should exercise extreme care in the use of the term.
- With regard to covenants, acceptance that these can be complicated and hard for investors to understand, especially for those working in a different language. The forum was clear that it would be unrealistic and undesirable to seek harmonized standards. It recognised that issuers should have the freedom to propose conditions, which reflected their needs. This led to the conclusion that greater education about the scope of typical covenants would be helpful and that there are ways of flagging the key features in covenants so that the market is better able to judge their implications and value. The credit rating agencies could perform a useful role in this, and the forum propose to initiate a dialogue with them.

The remainder of this paper sets out the forum's thinking in more detail.

Documentation standards and disclosure

There is general recognition that high standards of disclosure are critical. The forum therefore examined current practice with a view to identifying aspects where both issuers and investors agreed there was scope for improvement.

There was agreement, for example, that when an issuer is tapping the market for the first time, including through the launch of a Medium Term Note Programme, a draft prospectus or red herring should be made available to investors at least three days before the pricing of the deal, to assist them in

making the judgements necessary to invest. A final prospectus should be sent to all participating investors.

Documentation should set the issue in the context of the capital and corporate structure of the issuer, specify the amount of funds to be raised by the intended issue, and describe the intended use of proceeds.

It was recognised also that investors would find it useful if issuers were to indicate where public prospectuses relating to other bonds in issue, as well as details of relevant investor relations contacts, could be found. The group recognises that the documentation on private contractual arrangements may not be disclosed because of its confidential nature. Ideally, however, investors would find it helpful to have access to the wording of covenants for the protection of the investor in such arrangements (e.g. in privately placed bonds, and/or in bank debt).

It was also recognised that, to be meaningful, a commitment to disclosure requires the borrower to continue disclosure if it is taken over, taken private or merged with another entity. The forum did not, however, feel it would be appropriate to try to prescribe how this should be done.

Disclosure would also ideally involve the publication of half-yearly figures even where paper is denominated in units of a size (more than €50,000) which would mean this was not a formal requirement under the European Transparency Obligations Directive.

Finally, significant benefit would come from timely website access to public prospectus material. Forum participants intend to pursue options in this area actively, through consideration of market solutions, through the encouragement of European Union competent authorities to post on their websites all public prospectuses and supplements as soon as they have approved them, and in other ways. They urge that in the future all such prospectuses are made available to potential investors promptly and by electronic means, and agreed to look for ways of overcoming any legal constraints.

The value in covenants

The group was clear that, given its commitment to freedom of contract, it would be inappropriate to develop model covenants; but it considered that common understanding of wording typically used would help improve clarity. It focussed on key features, which affect the value imparted by covenants and looked at ways of promoting clarity and discipline. Both investors and issuers saw advantages in moving in this direction.

For example:

- investors clearly wish to avoid the losses that can arise when a leveraged buy-out or similar corporate event causes bonds to lose

their investment grade status. For issuers the benefit could be continued access to a more stable market.

- covenants are not always clear at present in relation to negative pledges. The key issue for investors is whether the covenant protects against subordination only in respect of further debt securities, or also in respect of new bank borrowing. A negative pledge clause can have less value where issuers are free to pledge assets to bank lenders, thereby placing bank creditors ahead of bond investors. The problem of misunderstanding could be mitigated if the coverage of the negative pledge was clearly flagged both in the detailed documentation and in the selling process.

Such examples led the forum to consider ways in which the key features of covenants might be flagged. The Risk Factors as provided for under the Prospectus Directive were identified as a possibility in highlighting material risks or abnormalities in terms and conditions. However, there were doubts about whether this would really help investors as the disclosure of key features might end up being swamped by extensive disclosure of legal risk.

Another possibility might be for credit rating agencies to assess the main features of covenants. This did not mean that agencies should rate documentation per se; but they could comment on documentation and possibly identify the key features in a factual way, which did not involve them in expressing an opinion.

The forum felt this approach should be further explored with the agencies themselves.

Developing best practice

In order for best practice to develop, participants in the forum felt the main current focus should be on promoting education, understanding and clarity as set out above. However, there was already agreement on some high level principles, which ought to help develop best practice over time.

The suggested elements were as follows:

- Those who draft covenants should aim for simplicity and brevity and, as far as possible, use terms whose meaning is clear and unambiguous to the informed reader. Issuers and intermediaries have a responsibility for ensuring that covenants are intelligible to investors. Investors must be presumed to read the terms and conditions carefully.
- Investors should be able to read the documentation before they make an investment decision. This means the documentation should be available to them in time. Understanding will be enhanced if issuers and investors are willing to talk directly with each other about documentation.
- Once covenants have been incorporated into an issue, issuers should respect their commitment. With regard to medium term note

programmes, covenants cannot be changed on notes already in issue without consent of the holders. If the terms for future issuance under an existing note programme are to be changed as part of the annual update of that programme, prospective investors must be given good notice of the revised terms before the pricing of the first tranche under the amended programme. Intermediaries launching a new issue from an MTN programme should include the date of the base prospectus or supplement which contains the relevant terms and conditions in the screen announcement for the issue in accordance with the ICMA Recommendation. If the terms and conditions of a new issue differ significantly from those contained in the current MTN programme documentation, this should be reflected in a supplementary prospectus and prospective investors in the new issue should be given good notice of the change before pricing.

A role for education on seniority

An issue identified early on was confusion over the meaning of the word *senior* as it is applied to debt. The term is widely used in the US and this usage has spread to the European markets. Investors buying senior debt may be under the impression that *senior* implies some form of enhanced status or ranking in an insolvency. In the case of ordinary unsecured debt, this impression would be mistaken: such debt neither ranks senior to any other ordinary unsecured debt, nor does it carry any assurance that subsequent debt cannot be senior to it, e.g. by being secured.

It was evident to the forum that the term *senior* lacks a clear and universally understood meaning. At best it is ambiguous and open to misunderstanding: at worst it is positively confusing. Given the extent of the potential confusion, participants in the dialogue believe there needs to be an education effort, accompanied by more discipline in the selling process so that investors are properly aware of what is on offer. Associations involved in the dialogue would be encouraged to use their own information channels to promote clarity and understanding and to discourage the use of the term without explicit clarification.

Conclusion

In summary, the forum concluded that there is scope for the market itself to take action to achieve more timely information flows and easier access to documentation as well as to promote understanding about what covenants mean. They believe that there is room for consensus about some high level principles of best practice and that an education process will help avoid confusion.

These conclusions represent the considered views of a balanced group of practitioners from all sides of the market and from a range of different European markets. The forum hopes that these views will be more widely shared. It is therefore publishing this paper with the aim of promoting a wider debate. It would welcome comment and hopefully, support.

If the forum has been able to act as catalyst in the development of best practice and measures to make the market function better, it will be very happy with that result. The forum has no desire to establish for itself an exclusive role; its members will continue to engage with other interested parties, including market practitioners, regulators and service providers such as rating agencies, to seek progress and promote debate.