The Association of Corporate Treasurers

Comments in response to
Request for Comment on
Moody's Indenture Covenant Research & Assessment Framework
October 2006

October 2006

The Association of Corporate Treasurers (ACT)

Established in the UK in 1979, The Association of Corporate Treasurers is a centre of excellence for professionals in treasury, including risk and corporate finance, operating in the international marketplace. It has over 3,600 members from both the corporate and financial sectors, mainly in the UK, its membership working in companies of all sizes.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education. The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

General

The ACT welcomes the opportunity to comment on this matter. Contact details are provided at the end of this document.

This document is on the record and may be freely quoted or reproduced with acknowledgement.

Overview

We are pleased to have an opportunity to respond to your paper "Indenture Covenant Research & Assessment Framework". Our comments reflect the considerations of an issuer, although the issuer view must itself take account of the investor perspective and the overall functioning of the market. Our members have expressed various views which we have collated in this response.

In summary your proposal involves Moody's developing a systematic approach to financial covenant research and assessment with associated commentary. Additionally your intention is to review standard market practice by industry sector and region.

By and large for markets to operate efficiently one would expect there to be a high level of access to information and understanding in the market. In the equity markets it is accepted that companies need to communicate well with shareholders. In the bond markets this is now largely accepted too, although it is perhaps a more recent phenomenon.

Transparency on the terms and conditions in a bond is to be welcomed, and the issuer will always provide the full details of any covenants in the relevant bond prospectus. It is then up to investors to review, analyse and consider if the covenant package is satisfactory from their point of view. Some investors have called for the issuer to help in explaining the important terms. The issuer cannot necessarily do this since by summarising or flagging what it thinks is important there is a danger that the issuer may be accused of misleading the investors. However if investors feel it useful to have assistance in performing this review then the CRAs could take on this role.

Response to specific questions

For ease of reference we have responded directly to the questions you have raised with additional comment where appropriate.

- *How important are covenants in the investment decision and would comments from Moody's be useful?* Although we would agree that investors do consider covenants in their credit analysis, we believe that for investment grade issuers their impact is severely limited relative to more important factors such as business performance, free cash flow generation, management capability and so on. We would expect however that comments from the Agency in respect of the existence and general terms of covenants would be appreciated by investors.

- *Should Moody's highlight that covenant information is not available at the time of an assessment?* Our view would be that information on covenants should be part of a credit assessment at the time of debt issuance. The covenants are easily accessible to investors via the relevant documentation. If covenant information is not available at the time of issue it would be right for Moody's to highlight this uncertainty. Sector or regional reviews of covenants would be expected to be part of the normal output from the Agency.

- *Should Moody's score individual covenants or focus on the overall covenant package?* We do not think that ranking or scoring individual covenants will add positively to a rating process for an investment grade credit. We would expect there to be considerable disagreement over the make-up and scoring of any constituents of the grid. In particular we would suggest that a number of the covenants you have proposed are suitable primarily for sub-investment grade (especially highly leveraged) issuers, bankruptcy remote vehicles, or project-finance evaluation, certainly not for investment grade issuers.

  In addition, a formal rating scale for covenants is perhaps giving undue attention to just one component of an overall credit rating and in fact to something that has traditionally been a very minor influence on ratings. There is a danger that it would give disproportionate attention to this particular aspect, and create a degree of confusion as well as misleading some investors into attaching too much importance to covenants – which, after all, in many instances of corporate failure, add nothing to the prospects of recovery and indeed could make those prospects dimmer by over-complicating and drawing out the rescue process[1].

  For example in the case of investment grade bonds covenants have less relevance and in the Eurobond markets are rarely found, or at least they are relatively modest. On the basis of your proposed scoring system an investment grade bond would therefore be likely to come out with a low covenant rating, but in overall credit terms is it safer to invest in a highly rated bond with low rated covenants or vice-versa?

  - *Are there covenants not included in this paper that would be of interest to investors?* We would be concerned that the creation of a prescriptive grid evaluation process could restrict necessary flexibility in covenants across business sectors and regions. In addition there might be circumstances where statutory regulation fulfils the role of a covenant package rather than terms negotiated with investors in securities documentation but this will not be covered in this proposal. The issuance process allows issuers and investors to follow the principle of freedom of contract to review and negotiate the relevant terms and conditions of any specific issuance. This interaction will determine if there is a direct relationship between the covenant package offered and bond value and pricing
    As an observation we note that your paper does not include any reference to cross-default or cross-acceleration clauses and any benefits investors may perceive from such clauses.

[1] We draw a distinction between the existence of covenants – restrictions on the issuer's freedom of action – and an event risk put, which though not improving the issuer's position, does at least give the bondholders the opportunity to participate in the workout discussions

- *For which ratings / securities would covenant research and assessment be most valued by investors?* We would expect the proposal to be appropriate only for non-investment grade securities or those involving complex financial structures where there may be different layers of credit rating, e.g. LBO debt.

Our members had further concerns with respect to the likely discovery process for covenants, both in terms of resource and additional time. This could add unwelcome delays to the time-critical issuance process. This would apply equally to providing detail on particular covenants to the Agency as well the broader issue of explaining the appropriateness of individual clauses for the issuer. Our members also expressed the view that Moody's current approach to assessment – using the relevant jurisdictional, legal and credit contexts to understand if covenants might impact an overall risk profile – continues to offer some value to the credit markets.

That said, credit ratings offer a significant added value since the credit agencies have access to confidential management information. A covenant research package, on the other hand, has less value add since it would merely be collating and reviewing public information.

There is also a substantive argument that for investment-grade credits certain types of covenant could be bad for creditors as well as shareholders in inhibiting management from proceeding with transactions that could be for the benefit of the issuer. In the case of an investment grade issuer, the balance is surely in favour of management being given its head rather than restricted by unnecessary covenants.[2] Additionally there is the seemingly perverse danger that the inclusion of very strong covenants in favour of the investor could reduce management's reasonable financial flexibility which has a negative impact on the issuers overall credit rating.

[2] We believe that some issuers, even some of investment grade, are likely to be relatively sympathetic towards an **event risk put** – triggered only if the event gives rise to a change of control of the issuer and as a consequence a rating downgrade beneath investment grade – as opposed to the imposition of covenants that inhibit management's freedom of corporate action. The former is triggered, very often, by action outside the control of and perhaps hostile to the issuer and it is thus understandable that bondholders should seek a put in deteriorating circumstances caused by external action. The outside party would take the risk of the put being exercised.

In conclusion the ACT's view is that whilst a commentary on the existence and general terms of covenants would be helpful to the credit process for sub-investment grade or highly leveraged issuers and could possibly be helpful to the credit process for investment grade issuers – not because covenants or the lack of them is important for these issues but because investors seem to think that such a commentary would be helpful - we remain highly sceptical of the efficacy of the suggested grid scoring mechanic for investment grade credit and indeed think it likely to be misleading to investors and to lead to time and cost wastage for issuers.

In the light of this conclusion we have not commented in detail on the section 'Key Indenture Covenants'. In the event that you are minded to progress the idea of a quantitative assessment matrix we would appreciate the opportunity to comment further.

Contacts: John Grout, Policy and Technical Director (020 7213 0712; jgrout@treasurers.org) Martin O'Donovan, Assistant Director, Policy and Technical (020 7213 0715; modonovan@treasurers.org) Peter Matza, Policy and Technical Officer (020 7213 2033; pmatza@treasurers.org)	The Association of Corporate Treasurers Ocean House 10/12 Little Trinity Lane London EC4V 2DJ Telephone: 020 7213 9728 Fax: 020 7248 2591 Website: http://www.treasurers.org