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STANDARDS IN THE STERLING AND EURO FIXED INCOME CREDIT MARKETS - AN ABI POSITION PAPER

1 Introduction

1.1 Members of the Association of British Insurers (ABI) are large institutional investors controlling funds worth some £1,000bn. This includes substantial holdings of both sterling and euro-denominated bonds. They have an interest in ensuring the market functions well in delivering value to issuers and investors alike.

1.2 It is therefore appropriate that the ABI should seek to promote high standards and contribute to the policy debate at the national level and beyond. This position paper aims to inform its approach both with regard to engagement with issuers and their representatives, and to related issues of public policy.

1.3 It is concerned with principles and best practice rather than with prescription. ABI members believe that high standards of transparency are essential to the functioning of the market. Issuers and investors need to know where they stand. Specific views expressed in the paper are not intended as rigid requirements, but aim to achieve the maximum clarity in informing issuers as to how they may strengthen their own standing in the market. Adherence to best practice should help the market recognise quality and price accordingly.

1.4 ABI members consider this approach has relevance not only for the sterling market but also in the relatively recently established market for euro-denominated bonds. They are keen to play their part as significant investors in the further development of the latter market. Where there is a consensus on the basis of the principles set out below they will seek to collaborate with and support like-minded groups. In this regard the ABI is pleased to help provide a forum for the articulation and representation of bond investors' interests.

1.5 The ABI's primary objective is to promote timely access to information, transparency and clear labelling with regard to the seniority status of individual issues, which avoids misleading use of language. The ABI will consider other issues over time as appropriate.

2 Documentation standards and disclosure

2.1 High standards of disclosure are paramount. Investors would expect a draft prospectus or red herring to be made available to investors in a timely manner before the start of the roadshow, to assist them in making the judgements necessary to invest. A final prospectus should be sent to all investors.

2.2 To be meaningful, a commitment to disclosure requires a covenant committing the borrower to continuing disclosure if it is taken over, taken private or merged with another entity. Such a covenant should set out how the issuer will ensure continued communication with investors, for example through an annual bondholder meeting and commit to timely publication of price sensitive developments on the same basis that would apply to equity issuers.

2.3 Investors strongly welcome new European legislation requiring issuers of debt securities to publish half yearly figures. They believe that this should apply to all corporate issuers of debt, including those which issue securities in denominations of €50,000 or more.

2.4 Transparency of terms as well as clear labelling of seniority status will help avoid confusion and damage to the issuer's reputation, and protect investors from abuses. Once bonds are labelled "senior unsecured" as a result of such limits investors are entitled to expect that this status will not change. Claims of "senior unsecured" status without appropriate covenants provide limited protection.

3 Covenants

3.1 Investors recognise that each credit is unique and the formulation of covenants will reflect the individual circumstances of the issuer. However, they note that real value is delivered by clear wording which sets out the precise nature of the commitment made by the borrower and demonstrates that the commitment will be observed. Clarity of meaning and hence improved transparency will be reflected over time in the market by keener differentiated pricing and market access between issues and issuers.

3.2 Bond investors can suffer a material fall in the value of their investments through a **change of control**. Unlike credit risk, this adverse event risk potential is rarely priced in the bond at the time of issue. Whilst equity holders can exercise voting rights and bank lenders are frequently protected through tight covenant wording, bond investors typically are caught without any mechanism for mitigating this risk.

3.3 To be effective in the eyes of bond investors, change of control provisions should give proper protection against the risk of a borrower being bought by an entity which may result in a materially weaker credit. In this event, investors should have the opportunity to redeem the debt on terms that reflect the original loan agreement.

3.4 Investors will favour a **negative pledge** clause which clearly sets out what an instrument's legal and structural position will be, relative to any current or potential future indebtedness (on, or off balance sheet, regardless of maturity and currency). A negative pledge clause that effectively permits bonds to be subordinated through the accumulation of bank borrowings will command less value from the market.

3.5 Negative pledge clauses will have greater impact with investors in unsecured bonds if they offer meaningful protection against the subordination of existing bonds through pledging, securitising or entering into sale and lease-back transactions of assets, and other mechanisms involving the assumption of prior-ranking debt. Whilst investors do not wish unduly to restrict financial flexibility, the negative pledge clause should clearly safeguard the position of the current debt holders.

3.6 A general **disposal of assets** clause should spell out the way in which investors are to be protected. Investors should be able to understand the degree to which the status of their investments would be affected by disposal of assets by the issuer.

3.7 Investors do not wish to restrain the flexibility of issuers to manage their affairs but they would place little value on a disposal of assets clause that allowed companies to dispose freely of assets "in the normal course of business" as such clauses are so general as to render other protection worthless. It would be preferable to seek to define in advance the type of circumstances under which the borrower might dispose of substantial assets in the normal course of business, bearing in mind that some business activities such as shipping and property do routinely involve the disposal (and acquisition) of substantial assets.

3.8 Investors are prepared to consider **call options** which provide the issuer with flexibility to redeem and refinance the debt at a fair and reasonable level. While the ABI has been actively engaged in facilitating this process in the sterling market for many years, similar arrangements are not generally available to investors and issuers in the euro market. Where not adequately dealt with in the documentation, ABI members believe that, as a matter of priority, consideration should be given to the establishment of an orderly process for early redemption and refinancing in the euro market.

4 **Trustees**

4.1 Proper consideration should be given to ensure that the trustee chosen will be able to fulfil all their duties in a conscientious and impartial manner. The importance of the trustee's role can easily be underestimated, particularly for complex instruments.

4.2 Confidence of investors will be enhanced by the appointment of an independent trustee, but it is also incumbent on investors to undertake the due diligence that ensures they have a proper understanding of the documentation and of the roles of the various parties. In particular, the indenture must make clear how legal and other costs will be apportioned in the event that a restructuring is undertaken.

5 **Conclusion**

5.1 Higher standards of documentation and disclosure will give confidence to investors and benefit issuers by making their securities more marketable. A best practice approach is preferable to prescription or regulation. Further development of best practice will improve the functioning of the market for issuers and investors alike.

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