Improving market standards in the Sterling and Euro Fixed Income Credit markets

October 2003

Executive Summary

- An industry working group has been established to consider ways of promoting better standards in the European credit markets.
- The lack of European-wide regulation or legislation, together with the relative immaturity of the European credit markets has led to poor market practices, such as unavailability of proper documentation for investment decision-making, and lack of adequate protections in bond indentures.
- Bondholders have been left vulnerable to significant capital deterioration in the advent of changes in a firm's capital structure or credit profile.
- The working group has concluded that the long-term development of the market can be supported by:
  - ✓ Reducing Event Risk by establishing minimum covenants for investment grade corporate issuers
  - ✓ Improving disclosure and documentation standards for better investment decision-making
  - ✓ Encouraging issuers and intermediaries to increase their emphasis on providing reasonable secondary market liquidity
- The paper summarises the views of the working group.
- The Investment Institutions listed on the back cover of this consultation document are committed to supporting improved market standards.

Background

The fixed income credit markets have grown at a rapid pace. Although the sterling market is significantly more mature than the euro market, both markets are still very young. In particular, disclosure and documentation standards in the sterling and euro bond markets are poor compared to the US dollar market, where SEC registration and disclosure requirements bring discipline to the US bond market. The lack of meaningful covenant protection against event risk increases market volatility and hampers liquidity. Investors in the sterling and euro bond markets are disadvantaged as a result of the lack of covenant protection. This is particularly true in the sterling market, which has a bias towards long-dated instruments.

This paper sets out proposed best practice in regard to:

A. Minimum covenants for corporate investment grade issuers

B. Issuer call options

C. Documentation standards

D. Disclosure

E.Credit Ratings

F. Secondary market liquidity

G. Relationship between issuers and investors

The working group hope that the best practice proposals will help to improve market standards and support the continued growth and development of the sterling and euro credit markets. We also hope to engage in a dialogue with bond issuers and their advisors, which should benefit all parties.

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A Minimum Covenants for Corporate Investment Grade Issuers

Covenants should not be seen as a sign that a borrower is "weak" or otherwise inferior. Rather, they should be seen as tools that can deliver value to both borrowers and investors by reducing the "uncertainty premium" priced into bond spreads and overall market volatility. This is important in order to establish a funding platform. The best conditions for an issuer to bring a new bond issue exist when there is an existing bond issue that has performed well and has not been volatile.

From an investor standpoint, fixed income investors are in the business of evaluating and pricing **credit risk**, and are generally not paid for being exposed to **event risk**. Event risk can be defined as a *deliberate change of the risk parameters of an issuer, a change that results in an immediate benefit to equity investors at the expense of fixed income investors*. Examples of event risk include leveraged buy-outs, leveraged break-up bids, or a borrower itself substantially changing its risk characteristics through a balance sheet restructuring. Event risk cannot be adequately priced into new issues, because, if the event were to happen, the value of the bonds could drop in tens of points, whereas the pricing range generally for a new issue is typically tens of basis points. Consequently, the only way to avoid the spread widening that accompanies fears of event risk is by having covenants that adequately protect investors against it.

Fears of event risk lead to volatility and spread widening, not just for an issuer but also for a whole sector. There is no shortage of examples of companies that, through no fault of their own, could not come back to the market on reasonable terms as the market has started to worry about event risk. Minimising or eliminating event risk through appropriately structured covenants can substantially reduce pricing volatility.

Although the specific terms and conditions of a bond should be a commercial decision for individual borrowers, there are three structural features that we would like to see as standard for investment grade issues. These are all designed to reduce the risk from the most serious forms of event risk, improve liquidity and reduce pricing volatility. Importantly, *none of these impose any meaningful restrictions on a borrower's operating or financing flexibility*.

1. **A Change of Control Provision** linked to a rating downgrade (normally to below investment grade). The basic principle is that if the borrower is acquired, the deal has to be financed so that it is consistent with the pre-determined ratings level, otherwise existing bonds will have to be re-financed as well. The change of control provision should result in a put at the higher of:

   a. Par, and

   b. The reference government bond plus launch spread.

   In cases where the issuer is already sub-investment grade, a change of control should occur in the event of a single-notch downgrade. A change of control clause does not in any way restrict a company's operating or financing flexibility. Nor does it act as a "poison pill". It simply means that, *if* the borrower is acquired, the acquisition has to be financed in a way that is consistent with the original loan agreement; otherwise the existing bonds have to be re-financed as well.

2. **A Negative Pledge** that ensures the structural integrity of the instrument is preserved. It is unacceptable to issue "senior unsecured" bonds and later subordinate the instruments through, for example, pledging, securitising or entering into sale and lease-back transactions of assets, or cause subordination, by contract, security, or structure.

   The most common negative pledge in the European capital markets is so weak it is virtually meaningless, as it often excludes bank debt.

   We regard this to be a documentation and disclosure issue. A proper negative pledge should clearly set 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). It does not need to prohibit other forms of financing that may be cost or tax efficient for the borrower, but it should clearly safeguard the position of the current debt holders.

   The position of senior unsecured debt instruments should be protected by a restriction on the ability of the issuer to pledge assets, securitise cash flows, or enter into any other contracts that subordinate unsecured bondholders. In order to label debt instruments "senior unsecured", a maximum of 20% of total indebtedness (on or off the group's consolidated balance sheet) should be able to rank ahead of the instruments. If more than 20% of total liabilities can rank ahead of the instruments, the bonds should no longer be labelled "senior unsecured", as they would be de facto subordinated. No carve-outs or general exemptions should be permitted that would allow for this limit to be exceeded (for example exemptions of debt issued in certain currencies, maturities or debt types).

   Clearly a market for more subordinated corporate bonds could exist, as investors already buy subordinated bank paper as well as subordinated debt in asset-backed transactions, but these bonds should be clearly labelled.

3. **A Disposal of assets restriction** that limits the scope for asset stripping and financial engineering that is detrimental to the instrument's structural integrity.

   A borrower should not be able to dispose of more than 20% of group assets within any rolling 12 month period unless the proceeds (which should have a minimum proportion in cash) are either a) re-invested in new operating assets of a similar nature, or b) applied to pay down debt that is either senior to, or ranks pari passu with, the bonds, or c) is used to offer to buy the bonds back at par.

   The common wording of "except in the normal course of business" has as a practical matter turned out to be a general "get-out clause" that has allowed asset stripping and therefore renders the covenant virtually meaningless. This clause should be eliminated in bond documentation.

B Issuer Call Options: "A fairer standard for call provision"

While meaningful covenants are important to us as investors, we fully appreciate that borrowers are reluctant to restrict their operating flexibility for very long periods of time. We therefore propose a standard that would provide borrowers with a higher degree of flexibility in return for better covenant protection. If a borrower's circumstances change and it needs to do something that is inconsistent with the covenants in an instrument, it should be possible to redeem and re-finance the bonds at a fair and reasonable level.

The traditional call provision in the sterling market has been the so-called "Spens-call" that allows a borrower to redeem its bonds at a price that is flat to the reference gilt. This standard has been put in place to protect investors against interest rate risk and to prevent borrowers from getting a free interest rate option.

As a practical matter, the Spens-call is seldom exercised, as it is prohibitively expensive for borrowers. In fact, it can act as an incentive for borrowers to find ways of circumventing bond covenants and to violate the spirit of the loan documentation.

We would be willing to see a move away from the Spens-call provision in favour of a less onerous standard, or set of practices depending on the credit quality of the issuer. A swap-based level would be less onerous to the issuer and still fair to investors. The exact conditions of the call can be negotiated on a case-by-case basis at the time of issue. As a practical matter, we are willing, in principle, to negotiate fair redemption levels. It is not in the interest of investors to insist on onerous levels that can potentially encourage some borrowers to find ways to circumvent covenants or breach the spirit of the loan agreement.

C Documentation Standards

Even though documentation standards have improved somewhat over the past couple of years, they are still poor in the sterling market and unacceptably poor in the euro market.

The prospectus for a new issue, or at least a draft prospectus, should always be available before a borrower's roadshow. Structural analysis is an important part of any investment process. Investors must be able to assess the constitutional documentation. Moreover, this should be the prime source for disclosing relevant information to bondholders. Without appropriate documentation in place it is not possible for investors to perform proper due diligence.

As a rule of thumb, we would like to see the prospectus, or draft prospectus, made available at least three working days prior to the roadshow beginning. A finalised prospectus should be sent to all investors as a matter of course for all bond issues. This is not the case at present.

We would welcome issuers routinely making their prospectuses for new and existing issues available on their web sites.

D Disclosure

Disclosure standards are generally poor in Europe. The situation is made worse when an issuer does not have publicly traded equity, which often means there is no ongoing disclosure. There are many examples of companies that have been acquired and no longer disclose enough information to facilitate an orderly market for their bonds.

In the longer term, we would welcome a European equivalent of the Securities and Exchange Commission filing, whereby issuers with publicly tradeable debt outstanding would have to disclose information in a standardised format and on an ongoing basis.

In the shorter term, we would like to see all bond documentation include a disclosure covenant. For companies that are publicly listed it should not require any extra commitments. However, if a company is taken over, taken private, or merged, the covenant should ensure:

a. that detailed accounts continue to be made available on, at least, a semi annual basis both for the legal entity that has issued the debt and – if applicable – the group

b. that there is an annual bondholder meeting to coincide with the full-year results, and

c. that information that can reasonably be expected to impact the pricing on debt is disclosed in a timely manner to the whole market in the same way as if the company were publicly listed.

Issuers should disclose details of bank and bond covenants in annual reports, including any rating change clauses.

E Credit Ratings

We would welcome issuers obtaining at least two ratings, from the three principal agencies active in Europe - Moody's, Fitch and Standard & Poor's. All bonds should at the very least have one rating. Two ratings improve liquidity of the bonds, as many investment mandates insist that investment managers buy only securities rated by two of the largest rating agencies. More ratings reduce the scope for rating shopping, where issuers approach three rating agencies and only publish the highest of the three ratings. Clearly, it would not be in the interest of bondholders to have rating agencies compete with each other to provide the most flattering rating to an issuer. As a matter of course, most investors currently tend to assume that a bond that only carries one rating would have been rated lower by the other agencies.

Whilst rating agencies are imperfect, they do serve investors by increasing the scrutiny on an issuer. They also tend to push for greater disclosure and transparency from issuers, and clearly have more of an influence when they rate the issuer. We would welcome issuers making arrangements to post all rating agency press releases on their websites.

F Secondary Market Liquidity

Liquidity in the secondary market is of fundamental importance to most fixed income investors. Many funds are open ended, meaning that investors need to be able to buy or sell securities to match cash flows in and out of funds.

Secondary market liquidity is generally poor for corporate credit paper, but it varies between different issuers, issues, and depending on who the lead managers are. It is undoubtedly the case that the expected level of secondary market liquidity in an issuer's bond will affect that issuer's funding cost. A good lead manager with a commitment to providing an active market in the bonds they bring to market, will be able to achieve lower funding cost for the issuers and establish a solid funding platform for future access to the bond market.

The willingness and ability among lead managers to provide an active market in the instruments they underwrite varies significantly. Investors and issuers can jointly work to improve secondary market liquidity by encouraging intermediaries to take their secondary market obligations seriously and deliver the most value to both issuers and investors. Intermediaries tend to get most of their revenue from lead managing new issues. The various "League tables" (listing the volume of new issues brought to market) are important tools when competing for new business. We consider these tables to have limited value. Potential issuers can achieve much better execution, and lower funding cost, by focussing on which lead manager provides the best secondary market liquidity in the issues they bring to market. We recommend that:

- Issuers consult surveys where investors vote for the lead managers who take their secondary market responsibility seriously.
- Issuers who have bonds outstanding, monitor the bid/offer spread provided by different intermediaries. It can be worth occasionally having these levels independently verified by asking an investor to ask for firm levels.
- Issuers who have no outstanding public debt, take references from a few investors before awarding their valuable primary market business.

Issuers can also promote liquidity in their paper by ensuring a good flow of information to the market. Building a reputation for honesty, being forthcoming with information and recognising bondholder interests should pay off in the form of lower funding costs and improved access to liquidity.

G Bondholders Are Stakeholders

As bondholders we would like to have stakeholder status in the companies we invest in and develop long-term relationships. If a borrower has a track record of treating bondholders fairly, being forthcoming with relevant information and generally demonstrating that they consider bondholders to be important stakeholders, investors are much more likely to be supportive of their bond issue. For example, bond investors will try to provide liquidity in difficult market conditions.

Most investors are very happy to have a direct and ongoing dialogue with both existing and potential bond issuers. We are convinced that better direct communication between investors and issuers can help to reduce the "uncertainty premium", improve market liquidity and is an important element of best market practice.

List of Investment Institutions

- ABN AMRO Asset Management
- ABP Investments
- Aegon Asset Management
- Barclay's Global Investors
- CDC Ixis Asset Management
- Credit Lyonnais Asset Management
- Delta Lloyd Asset Management
- F&C
- Fortis Investments
- Gartmore Investment Management plc
- Groupama Asset Management
- Henderson Global Investors Limited
- Hermes Investment Management Limited
- HSBC Asset Management
- ING Investment Management
- LODH Asset Management Ltd
- M&G Investment Management Limited
- Morley Fund Management
- Newton Investment Management
- Nordea Investment Management Bank A/S
- PGGM
- Robeco Asset Management
- SG Asset Management
- SNS Asset Management
- SPF Beheer
- Standard Life Investments Limited