

## A Discussion of

### *Improving Market Standards in the Sterling and Euro Fixed Income Credit Markets*

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Con Keating

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#### **Introduction**

I welcome the publication of this discussion paper as it has stimulated a timely and necessary debate on the role of covenants in the structure and pricing of debt market instruments. The proposals in the discussion paper appear to be overly concerned by event risk and could have considered the role of protective covenants more fully. The paper also considers, amongst other things, disclosure and information, the issuer investor relationship and market liquidity. Whilst having sympathy with the aims of the working group and supporting some of their conclusions, I do have some reservations. There is little doubt in my mind that these proposals would constitute better practice than currently evident in these markets, but this is far from the sought-after best practice. My observations are discussed below under section headings that mirror those of the working paper. Expressions in Times Italic are extracts from the original discussion paper.

#### ***Executive Summary:***

The executive summary of the published paper forms a good place to start this discussion:

*An industry working group has been established to consider ways of promoting better standards in the European credit markets.*

This preamble to the summary raises several questions. How representative is this group? It is, after all, effectively self-selected. How many investment managers declined to join in the call, for example? (The reasons they declined, if any did, might also illuminate.) It would have also been interesting to see some of the rejected alternates to the suggestions advanced by the paper.

*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.*

This may be read to suggest that the group would like to see regulation introduced. The first point to note is that the majority of members of the European Union are not represented within the group and that it is unlikely that the group could predict or know with any reasonable certainty the consequences of legislation in the markets outside of their domicile and experience. Note in particular that with debt instruments,

the law of the contract and the law of, for example, bankruptcy proceeding may require resolution under a range of different national legal systems. In any event, in order to regulate any market place rationally it is strictly necessary first to demonstrate a market failure and this is frankly far from evident. There are usually two bases for regulation – consumer protection or loss to the social welfare. Again it is far from evident that either holds true. The first of these is decidedly soft ground for these investment professionals, where there is a long tradition of fiduciary responsibility to consumers. It is also evident that many of the investor group have split incentives in that the majority of the arguments contained within the paper lie in the observation that there is a transfer of value between equity and debt holders which is inequitable. In many circumstances, however, they occupy both roles. The second would require that any costs arising from the observed deficiencies to the investment community are not fully offset by the welfare gains to shareholders and employee stakeholders – this is particularly difficult to justify when regulation brings with it compliance costs. Further it is well known that regulation frequently results in stifled innovation and a lower rate of increase of the social welfare and this also would need to be priced in any full cost benefit analysis.

That said, it is indeed unreasonable that, for example, prospectuses are frequently unavailable when issues are being marketed. The question of *lack of adequate protections in bond indentures* is more complex. It is undoubtedly true that many issues contain terms and conditions that leave the investor at risk, either deliberately or through ambiguity, which may be intended or unintended. However, the issues have been sold successfully. Unless there has been some deception on the part of the issuer or intermediary, it is difficult to see that this is *inadequate*. It may be that the resultant exposure, and consequently the conditional losses, is large but that is not sufficient proof of inadequacy.

*Bondholders have been left vulnerable to significant capital deterioration in the advent of changes in a firm's capital structure or credit profile.*

I assume the sentence to mean that: Bondholders are exposed to significant losses of their capital invested if a firm's capital or cash-flow generation is impaired, *by the action of the firm's management*. (This could be, inter alia, a change in strategy or takeover.) Even this is not completely adequate in that we might argue that even some exogenous events might be argued to result from management action. For a fuller description, we would need a statement of management objective. The overarching point here though is a central weakness of the paper; there is an absence of discussion of the full incentive structure and management figures large in that. Covenants are actually good for shareholders as the benefits of covenants, in a competitive investment market, accrue entirely to the firm and it is shareholders who receive most of these benefits. The real question lies in how much of the benefit management manages to extract. In other words covenants serve to discipline management. This is the principal reason that we find covenants difficult to negotiate. This in turn leads back to the question of management objective. If the objective is mutual and equitable benefit to all stakeholders, then we should have no reservations – but sadly this is too often not the case and one of the main drivers behind the formation of the group and publication of the discussion paper.

Another point, which needs consideration, is that the incentives to management, shareholders and debt-holders vary with the level of capital. Both management and shareholders have incentives to gamble for resurrection if the value of firm assets is close to or below the value of firm indebtedness. The incentives to undertake risky projects are much reduced if the shareholder stands to lose material sums. Further in such a situation management incentives to gamble are also reduced, as they stand to lose employment and continuity of income. (This is not to say that these changes are identical.). This tends to support the argument that corporate situations are unique with respect to their financial structure and business prospects and as such no standard set of covenants will be applicable. This, though, is not an argument for an absence of covenants; it merely supports the idea of tailoring the covenant package to the individual borrower.

*The working party 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.*

This paragraph is best dealt with in the body of the paper. One observation is probably worth inclusion at this point. **The role of trustees in the application and enforcement of documentation goes unmentioned in the discussion paper, but yet in precisely the events that are of concern, the trustees are a major participant.** Somewhere I expected some (quantitative) support for the minimum covenant requirements subsequently advanced.

### ***Background***

It is difficult for me to believe that the sterling market is *very young*. The comparison to the US domestic market is not strictly valid. The US domestic market was, of course, for most of its life well known for the delays incurred in the compliance process. One of the principal attractions of the international or euro-markets was the speed and simplicity of documentation. **In wishing for regulation, one should always be wary of unintended consequences.**

*The lack of meaningful covenant protection against event risk increases market volatility and hampers liquidity.* It is true that a lack of covenant protection will result in conditional volatility of the security. Then two questions arise: Why is this conditional volatility not priced? It is an issuer or security specific risk. By what mechanism, if any, does conditional security (specific) volatility aggregate to **unconditional market** volatility? We shall leave discussion of the liquidity concept here until later.

*Investors in the sterling and euro bond markets are disadvantaged as a result of the lack of covenant protection.* For this to hold true, then the lack of covenants would have to be unpriced – in which case systematic arbitrage would be possible, if not necessarily economic, in practice. The subsequent sentence, *This is particularly true*

*in the sterling market, which has a bias towards long-dated instruments is also problematic. It is true that the effect of uncertainty is to admit a wider range of outcomes as horizons increase but surely this is priced. The constituency for long-dated sterling bonds is almost exclusively institutional and sophisticated, and clearly aware (This discussion paper is itself one form of evidence) of the possibility.*

## **A Minimum Covenants for Corporate Investment Grade Issuers**

This heading causes some concern as it advances yet another linkage to the ratings agencies, who are themselves already delegated, and unregulated, monitors with control rights.

*Covenants should not be seen as a sign that a borrower is “weak” or otherwise inferior. I agree entirely with this. 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 could have been much stronger than it is – the benefits of covenants accrue entirely to the firm in a competitive investment market. The benefit to investors is twofold: Increased protection benefits their existing (investment) assets and increased protection promotes new investment, raising the demand for capital and consequently equilibrium rates of return in capital markets. The overall market volatility statement is contentious in the prior context, but here it might also be taken to mean that the absence of covenants results in a pricing of an overall market volatility, which is some way exaggerated – if this is true, investors are the beneficiaries of an unwarranted risk premium (and should scarcely be complaining).*

*This is important to establish a funding platform. At best, this is a nebulous concept, and, at worst, a marketing ploy. The best conditions for an issuer to bring a new issue exist when there is an existing bond issue that has performed well and has not been volatile. No this is simply untrue as stated. It might be possible to arrive at this statement conditionally with full definition of the “funding platform” concept, but I suspect this would be insufficient.*

*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. This apparent distinction between credit risk and event risk is whimsical. Event risk as subsequently defined is one form of credit risk. As for not being paid for it, this doesn't sit well with the earlier “uncertainty premium” concept.*

*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. This definition is incomplete. A more comprehensive definition might be: any action, current or future, of management or other stakeholder that alters the relative strength of claim of a creditor on the assets and income of the firm.*

The next sentence illustrates event risk quite well but perhaps it would have been better to show that these may arise by omission as well as commission.

*Event risk cannot be adequately priced into new issues, because, if the event were to happen, the bonds could drop in tens of points, whereas the pricing range generally for a new issue is typically tens of basis points. As written this is simply untrue. It is perfectly possible to price a conditional expectation. It is not obvious how to arrive at the likelihood but the pricing is feasible. 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. This is untrue in context but covenants are the best way to avoid volatility in spreads arising from revisions of investor estimates of the event likelihood and magnitude of loss. It is important to realise that the likelihood of event risk varies over the life of a security (as also might the magnitude of consequence), and that the initial pricing, at least, contains an element of pricing for this variation over time.*

*Fears of event risk lead to volatility and spread widening, not just for an issuer but also for a whole sector. A single issuer event does not **have** to lead to sector revisions – these are firm specific events, but a single event **may** lead to sector revisions. The next sentence also appears to be an overstatement of the case. The final sentence *Minimising or eliminating event risk through appropriately structured covenants can substantially reduce pricing volatility* is true but actually an understatement of the overall benefits – they reduce cost to the issuer firm.*

In the next paragraph, the only point of contention is the final clause of the last sentence: *none of these imply any meaningful restrictions on a borrower's operating or financial flexibility.* All covenants bring with them at least contingent costs.

### *1 A change of control provision*

Why do you wish to involve ratings agencies yet again – surely the trustee should have a role here? Not that there is a contingent cost.

### *2 A Negative Pledge*

I agree in principal with this section as to intent but would have reservations over the 20% figure, and the questions of sale and leaseback, and securitisation, which may be situation specific. The negative pledge should encompass guarantees and other contingent liabilities. What magic is there in a label based upon a difference between indebtedness and liabilities? In the UK this would present difficulties for trade creditors, who have the right to repossess goods supplied.

### *3 A Disposal of Assets Restriction*

The covenant as specified is incomplete – what proportion in cash and what period in which to re-invest or apply proceeds? I assume that this intended to refer to operating assets – the position for food and other retailer could be problematic otherwise.

The “normal course of business” exemption has certainly been abused on occasion. I do not understand why investors have not challenged the Trustees in this regard.

### ***B Issuer Call Options: “A fairer standard for call provision”***

The morality of offering a quid pro quo of the form “we will soften this criterion because it may already be too severe but only in exchange for some other concession” is unclear. Surely as is noted later, the fact that softening Spens terms would remove the incentives to attempt to circumvent the clause is sufficient. Other than this minor point, I am in agreement the objective

### ***C Documentation Standards***

I am in full accord with this section.

### ***D Disclosure***

Having already made my points about regulation earlier, I would just add the caution: Be wary of what you wish for. This regulatory filing procedure would of course have costs – are these to fall entirely on the firm or is there a Hirschmann “exit and voice” argument or Akerlof “lemons” argument underlying? In any event there should be arguments in support of a proposed distribution of compliance costs, as well a cost benefit analysis offered in support. We do all after all like free goods, infinitely usually.

### ***E Credit Ratings***

I am no fan of credit rating agencies, as may by now have been evident. Rating shopping is something to be discouraged as also in my opinion is the practice of taking investment management mandates linked to them.

The only significant point of contention in this section lies in the sentences: *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.*

Do they serve by increasing scrutiny or do they absolve many of the responsibility – are they not in fact delegated monitors (with no real recourse)? Do they push for greater disclosure; in my experience they make much of the fact that they are privy to inside information over and above that available publicly. The influence of ratings agencies is evidence of their possession of control rights, but where is the financial involvement or responsibility?

### ***F Secondary market Liquidity***

The whole subject of liquidity is poorly understood even in academic circles. In my opinion the document would have been better had this section not been included. The question of liquidity is fraught even from the point of definition and probably worthy of much research and analysis. Credit is after all only an expectation of liquidity. What is the price of liquidity? What cost benefit applies? There really is a multitude of questions unanswered here.

### ***G Bondholders are Stakeholders***

Indeed they are but the document weakens this in the very next sentence *we would like to have stakeholder status.*

## **Conclusion**

This discussion paper is a positive contribution to a difficult area. It is perhaps over-ambitious in some aspects but surprisingly also not as assertive as it may have been in others. This discussion is intended to inform the debate and advance many of the ambitions and aims of the discussion paper.