Growing European corporate bond markets show little bondholder protection

Introduction

The European market for corporate bonds has shown dramatic recent growth, particularly at lower credit quality levels. In 1999 the issuance in the EU corporate bond market after growing from about some € 550 billions to some € 610 billions in 2002, increased at a very high rate to some €870 billions in 2004 and probably even some € 920 billions in 2005[1]. As a result the European bond market is almost twice the size of the US corporate bond market today.

This development has been driven by a number of factors including,
(1) Lower bond market transaction costs in particular caused by the introduction of the Euro at the beginning of 1999. The Euro also acted as a catalyst for further corporate debt development. It gave a positive impulse to more transparency and uniform pricing as it led to an enlarged single currency market. Together with prospects of a gradual removal of all kinds of financial barriers for many companies it enabled large issues to be syndicated over many more investors in the Euro-zone.
(2) The Stability and Growth Pact of the European Union, prescribing the governments of EMU-countries to reduce government debt.
(3) A move away from equities by market participants. This was spurred by the decline in most European economies and bad experiences with the internet / IT hype.
(4) A change in bank behaviour. In the aftermath of the burst of the internet bubble banks also tightened their lending policies to defend against corporate defaults. The banks became quite reluctant to provide corporate loans and instead preferred bonds.
As a consequence of factors (1), (3) and (4) corporate demand for bond financing came to flourish.
(5) The very large growth in credit derivatives
(6) The advent of electronic trading
In particular the factors (1), (5) and (6) contributed to enhanced liquidity, risk diversification and hedging opportunities
(7) Increased savings together with the future prospects of increased liabilities of institutional investors. These investors mainly pension funds and insurance companies have long term obligations and have to match their assets and liabilities. That is why they are to a large extent committed to invest in bonds, governmental as well as corporate bonds. Moreover they care more about avoiding losers than picking winners, so investments in equities and likewise in real estate are relatively less attractive. As investment performance is of relevance one looks to yield to maturity and the spread over government bonds or interest rate swaps and for portfolio development to indices and or the performance of peers

Though the bond markets have grown at a very fast speed they remain quite fragmented. There are segments with more liquid issues (e.g. government debt) which are were relatively transparent, but many other segments concern bond issues that have little transparency. As there is no central source of price information on bonds investors and other market participants have to rely on a variety of avenues to obtain data. At times information can be expensive to access and or analyse. Another aspect is the different degrees of competition at the demand side in geographical different markets in particular owing to retail investors.
The yields that investors require from corporate bonds vary with the credit quality that they assign to those bonds. Spreads typically rise as credit quality declines. That is why credit ratings are of importance to a varying degree, in particular for those investors that can not rely on own research and

[1] These and similar figures are derived from the common response of the Bond Market Association, The European High-Yield Association, the Association for the Emerging Markets, the European Primary Dealers Association and the European Securitisation Forum to FSA discussion paper 05/05 on trading transparency in the UK secondary market, December 2005.

do not trust outside advice from analysts. Still many investors are sceptical about the ratings and opinions of the rating agencies as the ratings at times did not reflect deteriorating company financials.

As secondary trading in many issues is also relatively small, pricing of new issues could in principle be difficult. However several factors indirectly brought more efficiency in bond pricing.
There was first of all the development of liquidity and pricing accuracy in the asset swap and credit default swap (CDS) market. Together with the availability of other derivatives it contributed to an increase in the depth of secondary markets of securities including bonds. It has become easier for market participants to hedge positions. CDS are used for hedging risk in portfolios, interest rate swaps for hedging interest rate risk[2].
Secondly risk management evolved and led to more efficient new issues.
A third factor was the growth of electronic trading through electronic platforms, made possible by advances in information technology. It helped to improve price formation for the bonds traded and to reduce transaction costs (especially for relatively small trades). It also allowed for bonds and derivatives to be provided on the same platform, which was also beneficial to investors.
A fourth factor was the development of multi-contributor indices (comprising daily prices of bonds that do not trade frequently) that provide the market with references to several industry sectors' prices.
Finally, the introduction of the Euro led to the birth of the interest rate swap curve in the Euro-zone as the benchmark against which bonds were priced. CDS curves also became fashionable as another benchmark for secondary market pricing[3].

As a result the European market has gained a relatively high degree of pre-trade transparency compared with the US. As a result a virtuous circle of bond market liquidity has been created.
Yet the limiting factors mentioned earlier most likely contributed to a far lesser growth in volume of secondary trading than in the US fixed income market. Estimates are € 29 trillion for the EU against $ 88 trillion for the US.
Transparency, in particular post trade transparency is still incomplete. There are costs involved to obtain the required market information. Measures to increase transparency particularly in the markets of high yields and in the structured markets could still be welcome. And it would be in the interest of several market participants to address the problem of relative illiquidity of many bond issues.

Investors in European corporate bond markets

As can be derived from the table the banks and institutional fund managers are major investors in corporate bonds. Institutional investors like pension funds and insurers invest far less. Direct retail participation (private clients) is rather small. Retail investments are mainly through funds specialised in the specific asset class.

Table 1. Relative participation of investors in specific European bond markets

	Investment grade corporates	High-yield market	Structured securities CDO type	Structured securities ABS type	Emerging markets
Institutional fund managers	28	34	17	24	23.3
Hedge funds	9	23	9	5	16
Corporates	3	2	3	1	1.4
Private clients	4	4	1	1	9.3
Central bank	7	2	8	4	3.0
Banks	31	22	47	52	34.7
Institutional ins/ pensionf.	18	13	15	13	12.3
Total	100	100	100	100	100

Sources: TMBA estimates, January 2004 to July 2005[4]

[2] High-yield issues do not lend themselves to credit default swaps as the average issue size of the obligations is still low.
[3] One should keep in mind that prices of CDS and bonds can diverge owing to several factors. Credit specific factors such as documentation, convertible issuance and the market's expectation of debt buy backs, as well as macro factors such as liquidity differences and segmentation between markets, low bond market supply and structured credit flows can all exert different pressures on bond and CDS spreads. See "The relationship between CDS and bond spreads", Daniel Berman, in the Treasurer May 2005.
[4] The Table is derived from the sources, mentioned in footnote 1.

Overall, the markets are primarily institutional and trading is dominated by institutions established in London. Our impression is that many traders and fund managers are not interested in opening up the markets to retail investors and to contribute to more transparency[5]. The cost of supplying bond market data would be a barrier. At the same time direct participation in bond issues and bond trading would be detrimental to the business of institutional und managers.
As retail investors lack the expertise and knowledge to discriminate chances are that they will not enter this market.

The table also illustrates that investors hardly can be expected to act as one group to market or regulatory developments. When investing parties like banks, institutional fund managers and hedge funds in general have a shorter rather than a longer term focus. This is in contrast to insurance companies and pension funds. Moreover banks are frequently also providers of funds and at times involved in trading activities.

Reasons for protection against event risk.

Apart from the low degree of participation of retail investors there is another major factor that hampers market growth, event risk, i.e. the possibility of leveraged takeovers, buyouts and shareholder-friendly actions in bond issues.
Take the case of an unfriendly take-over or a leveraged buyout. In the latter case bondholders are hurt because purchasers typically invest little of their own money and borrow the rest, putting a large amount of debt onto the company acquired. At the same time the bonds are usually downgraded by the rating agencies.
Similarly the prospect of a take-over often drives down prices of unprotected bonds. Speculative grades can result quite quickly. And even in case of a successful defence against the take-over bond prices can remain relatively low. A permanent deterioration of credit quality can hardly be prevented.

These kinds of events cannot be anticipated or analysed in the same way as credit risk. Some protection is given by credit default swaps to hedge against deteriorating credit quality. But statistical models are not possible for sudden developments in bonds of specific companies, neither are there suitable insurance arrangements at reasonable prices. Moreover arbitration between the swap and the bond market is at times incomplete. So protection through the use of derivatives can be expensive. Furthermore there are bond investors that are not allowed to engage in acquiring derivatives.

In the beginning of 2006 European corporate bond investors had to find an answer to the increasing number of mergers and acquisitions that thwarted their investments. The risks from leveraged buy-outs (LBOs) remained particularly acute in the UK and European investment grade markets.

In the past it was predator companies that were active. They financed their takeovers of companies through bank borrowings, which they would then secure on the shares of the issuer acquired. But increasingly private equity firms entered the scene. They were also able to engage in such purchasing transactions as they had access to leveraged bank loans and high-yield bonds. Not only banks and hedgefunds but also institutional investors provide funding..

The number of possibilities for leveraged buyouts had grown fast as low interest rates make almost every company a vulnerable target and as there were a large number of potential target companies.
Only the financial sector seems to be relatively insulated from LBO activity.

This development resulted in investors demanding more protection. Quite a few investors were only ready to purchase bonds if borrowers agreed to a change-of-control covenant in the documentation to issue new bonds. The covenant gives investors the right to sell the bond back to the company if its credit rating is downgraded following a takeover. In some instances the terms of an already existing bond issue was changed afterwards to take account of the takeover protection clause.

As takeover clauses do not protect against any deterioration in credit quality caused by existing management, some investors even wanted protection against any rating downgrades owing to a weakening of credit fundamentals. They advocated so-called coupon step-ups, however in vain.

[5] From April 30, 2007 the Markets in Financial Instruments Directive will impose greater transparency in the equity markets. The European parliament has asked the European Commission to investigate whether or not greater transparency should be extended to the fixed-income market.

In most cases investors were and are not able to realise bond issue arrangements with suitable protective covenants.

Attitude of corporate management and other stakeholders

Why should corporate management bend to the wishes of investors? This leads to the question what is the optimal policy for corporate management when it issues bonds.

Refraining from selfish actions due to ownership of shares or options, management of debtor companies try to act as they must in the best interest of the company. In general they try to defend themselves against takeover bids and a protective clause can be helpful as it makes a takeover more expensive for predators. The clause it self is rewarded by some 5 to 10 basis point lower funding costs.

In times of low interest rates new share issues are relatively expensive. On the contrary management than frequently prefers to issue more debt to finance share buy backs. Protective covenants are in general not in the interest of shareholders as in case of an "event" the value of shares is relatively less. The protective covenant for example prescribing a buy back of outstanding bonds would lead to a reduced take-over value of the existing shares. And as in contrast to bondholders shareholders can exercise voting rights normally their position with respect to management is relatively strong, the exception being a situation with an unfavourable development of the financial fundamentals.

Other stakeholders like banks that provided credit and loans are not in favour either.

For management of the company there is a fine balance to strike between finance from borrowers' relationship banks, often the final port of call for rescue funding) and potentially cheaper funding from bond markets.

The protective clauses would undermine the chances for rescue financing from relationship banks. Moreover it is unknown if it really would deter the "vultures" to buy bonds in the secondary market at probably still somewhat discounted prices.

As there is an intense competition between bond investors and banks and between banks themselves a real alternative for corporate management is (leveraged) bank loans.

Banks are at an advantage over institutional investors. In most European countries bank lenders are afforded primacy for finance in case of insolvency. The recovery of funds by these creditors is realised through the imposition of administrators and liquidators in place of management. European bank lenders are moreover frequently protected through tight loan covenants. As negative pledge and other restrictions in bond covenants often exclude bank debt, such restrictions in general are not in the interests of banks. On the contrary they can profit from increased volumes of leveraged loans. Moreover banks have the advantage that they know a lot of their corporate customers, most likely far more than bond investors.

And as banks are frequently providers of loans and or act as intermediaries for new share issues there more often than not is a conflict of interest between these creditors. Even in case banks are also holders of bonds they most likely prefer the protection provided by bank loans.

The institutional investors are very much hindered by the profound change in attitude of banks. Banks have nowadays become friendlier to most creditworthy borrowers. Bank competition has returned. In turn it was the result of three factors:

(1) After the tightening of lending policies mentioned earlier banks a result they obtained surplus equity capital. This was reinforced by the non occurrence of major losses from corporate bankruptcies.

(2) The banks have improved their risk management policies and got used to the consequences of the new capital adequacy regime.

(3) Renewed economic growth and improved economic prospects.

Credit standards loosened. Banks were including fewer and fewer financial covenants in their loan packages[6]. In several instances they even abandoned the "major event with a negative impact on the bank clause". They also acted to provide additional leverage to the leveraged buyout market in the form of second-tier and mezzanine loans ranking above bondholders but below senior debt. As such this development also reflected the demand for higher yielding loans from institutional investors, including via collateralised loan obligations.

[6] Nevertheless they were at the same time more inclined to indexing loan spreads to financial ratings.

Banks are traditionally the main providers of debt finance of European companies. And as bank loans have the advantage over bonds of much larger flexibility as to changes in the credit conditions and the amount of debt involved there remains a bias toward bank financing at the detriment of bond financing.

Consequences

Many companies can revert to bank loans and so decline proposed bond issues with undesirable covenants. Companies that can resist takeover bids with or with out the help of their banks or other white knights do not need bondholder protection.
Companies that might be inclined to accept bond funding with protective covenants do so for various reasons. These range from funding diversification, maturity optimisation, maintaining a proper credit rating and proper recourse to bond financing in the future. These reasons point to compromises depending on the quality of credit being offered. Emotional arguments like the one that management can not leave their bondholders in the rain in case of events are probably of secondary importance.
Only companies without the availability of adequate bank financing probably have to concur with protective bond covenants. The alternative for them is a steep rise in the spread demanded. If however there is a stiff competition between suppliers of bond finance this spread still could be limited.

Only if suppliers of fixed income finance act as a group is it likely that the desired protection will be realised. If that is not possible than the only way out is demanding higher spreads for higher perceived event risks. But even then the question remains whether the assessment and pricing by the market of the possibility of such risks is adequate. Bondholders have to defend themselves primarily through research, use of risk management tools and the reverse of investor relations, i.e. influencing management.

So a case-by case approach by bondholders as well as by management is probably likely. In the present highly liquid bond markets and relatively low interest rates with increased concern as to event risk one can expect some bond issues with protective covenants and spreads probably reflect somewhat more the perceived differences in risk. However it is unlikely that the relative market position of bondholders will improve much.

In our view there is much room for further growth of the Euro bond markets. The credit derivative markets are still very young and experience concerning how these markets perform under stress is lacking, so their value to trading and transparency for the bond markets can be improved. Moreover those investors that are nowadays less sophisticated will learn to benefit from the possibilities provided by the derivatives markets. But platforms only concern commoditised products, and a large proportion of trading in bonds and derivatives continues to be done outside electronic trading venues. More pre and post trade transparency would be in the interest of both institutional and of retail investors.
A more liquid secondary market would be the result. Possibilities of suitable exits would increase and so the attractiveness of the Euro bond market.

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