23 September, 2010

Business Finance Green Paper
Fourth Floor
Department for Business, Innovation & Skills
1 Victoria Street
London SW1H 0ET

Re: BIS Consultation on Financing a Private Sector Recovery

Dear Sirs

As I discussed with David Roberts this week, AFME expressed its views on nonbanking lending and the development of the debt capital markets in its response to the HM Treasury Discussion Paper on Non-Bank Lending dated February 2010.

In connection therewith, AFME wishes to resubmit its response for purposes of responding to your Consultation on Financing a Private Sector Recovery.

We remain at your disposal to discuss our views with you. We are particularly interested in meeting with BIS to discuss how AFME and ACT could collaborate on educational programs for UK corporate CFOs and treasurers on the underwriting process for accessing the high yield debt capital markets, and the reporting process that follows.

Kind regards,

Gilbey Strub
Managing Director
afme /
Association for Financial Markets in Europe

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afme / ehya

18 February 2010

HM Treasury
Attn: Richard Holmwood
Thomas Hemingway
1 Horse Guards Road
London
SW1A 2HQ

RE: HMT Discussion Paper on Non-Bank Lending

Dear Messrs Holmwood and Hemingway,

We welcome the opportunity to comment on the HMT Discussion Paper on Non-Bank Lending and we laud HMTøs efforts to expand the sources of capital available to UK based borrowers in a bank-constrained environment.

This submission responds to the questions posed to investors and has been prepared by a working group of the AFME / EHYAøs Investors Issues Committee and reviewed by the board of directors of AFME / EHYA.[1] We believe that the principle measure that policymakers could take to substantially increase non-bank lending would be to remove current UCITS III restrictions on investing in loans so that long-only investors such as insurance companies, pension funds and open-ended (mutual) funds and other institutional investors can invest in loans.

The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets, and its approximately 200 members comprise pan-European and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the European operations of the Securities Industry and Financial Markets Association, with which the European High Yield Association was affiliated. AFME / EHYA now functions as the Division of Leveraged Finance which addresses the high yield bond and loan markets. For more information, see www.afme.eu.

Yours sincerely

Gilbey Strub
Managing Director
AFME / EHYA

[1] For a list of the members of the board of directors of AFME / EHYA, the Investor Issues Committee and the working group, see Exhibit A.

afme / ehya

AFME / EHYA Response
Discussion Paper on Non-Bank Lending – Questions for Investors

Credit assessment and monitoring questions

1. ***Do you consider any of the following to act as a barrier to companies obtaining public credit ratings, and which are the most significant?***
   a. ***cost;***
   b. ***businesses' concern about revealing information (particularly in circumstances of a difficult trading environment); and/or***
   c. ***other (please provide more information)?***

2. ***Would lowering the cost of credible credit measurement processes in the UK encourage more:***
   a. ***businesses to issue more non-bank debt; and***
   b. ***more non-bank investors to buy corporate debt?***

We believe the principal barriers to issuers obtaining public credit ratings for debt securities are: (1) the stigma of a possible sub-investment grade rating, driven by the historical emphasis that the European equity markets place on investment grade ratings and the traditional European bond (or eurobond) market being principally an investment grade market; and (2) the fact that historically, UK companies have not had to obtain ratings in order to obtain debt financing. This is a legacy of the pre-Euro market, when credit markets were essentially regionally isolated. In these smaller, national markets, local reputation, as opposed to a standardized credit rating system, frequently drove credit risk perceptions.

Furthermore, the bank-dominated, private nature of the European debt markets has not made ratings a condition to obtaining financing. In addition, UK banks have often provided investment grade-like loan pricing to unrated borrowers that would likely be rated sub-investment grade. In such an environment, borrowers have feared that a rating would cost them õinvestment gradeö terms and conditions. As a result, we do not believe cost is a material barrier to obtaining a rating, but we do note that the obtaining, and in addition the maintenance, of a rating does consume resources. Therefore, issuers may perceive the hurdle of establishing ratings related infrastructure, when combined with the additional administrative burden of producing public, interim financial reports on a quarterly basis (as is customary in the high yield market), is a disincentive to entering the capital markets, particularly when bank financing, without these burdens, is available.

Ratings provide an element of additional transparency to investors and ultimately to their end-clients. Most investors are only able to invest a relatively small portion of their capital in non-rated assets, with the majority of the capital allocated to credit investing requiring ratings. Ratings are a cost efficient and cost effective method for end-clients to place broad risk management guidelines on their investment advisors. The transparency provided by ratings is not only beneficial to investors in specific corporate credits but also enables consistent comparability of the overall risk profile taken in various portfolios by different investment advisers. A retail investor (or pension or life insurance fund) investing in a credit fund may have no idea of the total level of credit risk in that fund and cannot compare it with another fund without knowing this information. For a comparison to be robust and objective, metrics that retail investors use should ideally be provided by independent third parties. Relying on one fund managerøs estimates of risk makes comparability among funds more difficult.

Further, we believe companies seeking debt financing should be strongly encouraged to become rated because once a rating is in place, an issuer can more readily (and quickly) access a more diversified pool of capital, including the public debt markets.

Corporate transparency questions

6. ***Would improved quality of corporate transparency increase your appetite for corporate debt significantly, and result in you investing in a wider range of companies? If so what type of additional transparency might be important?***

Greater corporate transparency may indirectly increase investorsødemand for high yield notes insofar as it would allow them to more efficiently price the risk premium that lower credit rated issuers require, which in turn reduces secondary market volatility and ultimately lowers the cost of capital for issuers.

First, a background note on the disclosure regime for high yield bonds. High yield bonds are not a retail debt product. Accordingly, issuers are not subject to the disclosure requirements of the European Prospectus Directive (PD), as the notes are issued in denominations of þ50,000 or more and are listed on an õexchange-regulated market,ö such as Luxembourgøs Euro MTF or Irelandøs Global Exchange Market, as opposed to a õregulated market.ö Issuers listing on exchange-regulated markets are also not subject to the ongoing financial and other reporting requirements of the Transparency Directive (TD).[2] Disclosure requirements for high yield are therefore dictated by the individual standards of the exchange-regulated markets and market practice which is contractually embedded in indentures governing the bonds. Issuers that wish to sell to US accounts must also satisfy the disclosure requirements of Rule 144A under the US Securities Act. Market practice for European high yield issuers not selling into the US market is more or less based on the Rule 144A requirements.

[2]EU Member States may choose to extend the TD to companies not listed on regulated markets, a practice known as õgold-plating,ö which the UK has not done in relation to the high yield market.

However, following completion of the offering, European disclosure practice begins to deviate from US practice in two respects: issuers do not provide copies of material contracts nor file reports with any electronic central repository where they may be accessed by all market participants. These differences are a result of US deals ultimately being registered under the US Securities Act of 1933, with material contracts and other filings being made available via the SECøs EDGAR database, whereas in Europe, high yield deals remain õprivate.ö

While investors in European high yield are generally satisfied with the current level of disclosure by European issuers, two specific areas stand out:

- first, issuers should disclose material terms under loan agreements (including any changes from time to time in such terms) and full intercreditor agreements (including any amendments) governing enforcement rights as between high yield bondholders and senior lenders; and
- second, issuers should make disclosure reports available to the entire market via an electronic central repository and not solely to bondholders on protected websites.

Disclosure of material terms of credit agreements (and subsequent waivers and amendments) would enhance a high yield investorøs assessment of an issuerøs liquidity and working capital. By analysing the contractual basis governing an issuerøs indebtedness, investors would be better able to develop their own view of the issuerøs liquidity profile.

In addition, intercreditor agreements (and amendments) determine investors rights upon a default with respect to those of other lenders. They are particularly important in the current climate where recoveries following default may result in little or no recovery for subordinated creditors. They are also important in current new high yield issues where bonds are issued ÷pari passuø with, as opposed to subordinated to, bank debt as to rights of payment due to the unavailability of bank capital to refinance liabilities. Each high yield issue, and associated intercreditor rights are bespoke in a European context and enforcement rights vary substantially from deal to deal.

We welcome the TDøs instruction to each EU member state to designate an õofficially appointed mechanismö (OAM) to constitute a pan-European network for a single central repository. However, the TD specifies that the OAMs need hold only õregulated information,ö i.e., information required to be disclosed under the TD, which would not encompass high yield offering memorandum disclosure. We are concerned by the FSAøs statement that it intends to do no more than the minimum required by law under the TD and that it would not seek industry feedback on its OAM proposals. Ultimately, to be successful, any OAM must have the ability to retain and disseminate all contractually obligated filings plus any filings necessary to meet all public disclosure obligations.

For London to be a global financial centre, we strongly encourage the UKøs dedication of resources to establish an electronic central repository that is free to all users and filers, including intermediaries, the media and the public, is easily searchable, and has the capability to receive non-regulated information. In addition, any UK OAM should have the capability of receiving documents in XBRL format (extensible business reporting language) because UK companies are going to have to file in XBRL with the Inland Revenue and Companies House starting 2011. In addition, UK companies filing with the SEC that use IFRS will also have to file in XBRL from 2011.

Failure to develop a pan-European central repository will maintain the reality that investors in debt securities of in Europe operate in a less transparent disclosure environment than in the US, thereby increasing the risk premium paid by European issuers and thereby their cost of capital. We believe the UK should take the lead on this issue in the development of the European capital markets.

7. ***Do the potential costs of greater transparency, whether regulatory or otherwise, deter firms from seeking non-bank finance?***

While the cost of maintaining a credit rating and filing ongoing public quarterly reports (when alternative bank financing is available) may act to deter issuers from entering the capital markets, we believe the incremental costs are offset by a lower cost of capital brought about by a wider range of financing options.

8. ***terms under which a loan was made):***
    a. ***would it increase investor appetite for corporate debt; and/or***
    b. ***would it reduce existing and future debt holders' expected default risk?***

a. Yes, see response to Question 6 above.

b. Disclosure of loan covenants and performance would not impact default risk but would improve investorsø ability to gauge loss-given default rates (i.e. the amount expected to be recovered in an insolvency). As discussed above, better disclosure permits investors to more efficiently price risk, which may facilitate a more rapid exit from a distressed credit, which in turn reduces market volatility.

Limited or uneven access to information generates uncertainty around a companyøs liquidity and market rumour. It fosters a platform for asymmetric information, inefficient markets and an opportunity for market abuse in both bonds and related CDS trading.

Loan pricing transparency questions

10. Is loan pricing transparency also important for non-bank lenders? If so, why?

Loan pricing transparency to an issuer is irrelevant in pricing secondary market risk. Investors look to an issuerøs financials and overall credit-worthiness when pricing risk. As long as the cost of a loan facility is known to investors, that is sufficient. It is irrelevant to this analysis how a lender arrived at that price (which may in fact be priced below market to reflect other factors in the lenderøs relationship with the borrower).

Preferences of UK investors questions

12. What factors influence non-bank investor (including overseas investor) appetite for UK corporate debt?

In terms of capital deployed, there are far fewer long-only sterling high yield and loan investors compared to Euro and USD investors. Most credit investment funds therefore focus on Euro- or dollar-denominated debt. To the extent a UK issuerøs debt is denominated in sterling, this may deter investors as it will require investors to incur the cost of hedging sterling exposure.

The certainty of outcome under local insolvency laws also influences investorsø appetite for debt. The ability to restructure companies in the UK outside of administration by using schemes of arrangement ó without having to put an administrator into place ó is viewed as more favourable, particularly to senior lenders, than continental European law regimes. The UKøs lack of a moratorium on creditors while a scheme is negotiated is perceived as a shortcoming, but we welcome the recent proposals by the Insolvency Service to address that.

13. What role might guarantor entities play in guaranteeing debt issued by UK companies?

We do not think it would be useful to have third parties guarantee corporate debt. Third party guarantors currently play no role in the high yield market in the US or in Europe unlike insurance õwrappersö for whole business securitization or ABS.

14. How could secondary bond market activity be improved?

As discussed above, we believe more public ratings, consistent disclosure throughout the life of the bond, disclosure of credit and intercreditor agreements and a central repository would improve transparency and reduce the risk of selective disclosure, and accordingly improve secondary market activity.

Secondary bond market activity would be improved simply by virtue of a bigger, more robust market. As discussed above, we believe more public ratings, consistent disclosure throughout the life of the bond, disclosure of credit and intercreditor agreements and a central repository to remove the unlevel playing field of dissemination of information would improve secondary market activity.

Non-bank loan market questions

15. Are the barriers discussed above relevant in limiting less large firms' ability to issue loans to non-bank investors (including overseas investors)? If so, which are likely to be the most significant? Are there other factors?

The principal barrier to non-bank lenders providing loans to borrowers (whatever their size) is the UCITS III treatment of loans as ineligible assets due to the perception that they are not liquid. Insurance companies, pension funds and closed-end or mutual funds are barred from the European loan market, but not the US loan market. We believe that widening the UCITS III definition of eligible assets to include loans is the single most significant measure policymakers could take to improve funding channels for UK companies.

This modification is critical in the current market because the primary non-bank providers of loans in the last decade (and a major driver of growth in the European leveraged finance market) have been hedge funds and CLOs. The retrenchment of leverage has sidelined these players, making long-only institutional investors more critical to market liquidity.

16. To what extent might loan market infrastructure be improved? What costs might be involved?

Loan settlement needs to be improved in Europe. European settlement times lag significantly behind the US for par and distressed loans. Loans are more difficult to settle than bonds (being contracts and not securities) and therefore require an assignment or novation to be transferred. Whereas securities are transferred by electronic book entry in a central clearing system, loans are transferred õover the counterö and settle outside a clearing system framework. Loans are less homogeneous than securities, often having multiple tranches and variable repayment schedules which also adds to the complexity of transfer and settlement. We believe that settlement can be addressed by a market solution and we are currently working with DTCC (Depositary Trust Clearing Corporation) and other trade bodies to improve settlement infrastructure. There are also private sector initiatives seeking to resolve a solution to this problem, such as Markitøs recent acquisition of Wall Street Office. We are happy to meet with you to discuss loan settlement issues in greater detail should you so desire.

High yield bond market questions

17. What factors determine the currency of issuance? Is demand for high yield bonds higher in foreign currency? How is currency risk managed?

See response to Question 12 above.

The easiest and most efficient way to hedge currency risk in a high yield portfolio is to purchase 1 ó 6 month exchange traded foreign currency futures or OTC

forward contracts and consistently roll them forward at the end of the relevant period.

18. How far might the following be constraints in the growth of UK high yield bond markets:
  a. market infrastructure (if so which aspects);
  b. investor preferences and constraints (including overseas investors);
  c. cost of monitoring; and/or
  d. other factors?

See responses to Questions 1, 2 and 6 above.

19. In the past a significant share of high yield bond market activity has been corporate buyout focused. How could the high yield bond market be developed as a source of primary funding?

See responses to Questions 1, 2 and 6 above.

General questions

20. Do you believe that HM Treasury should be promoting more diverse sources of funding for companies?

Yes. There is a need for a more robust and diverse institutional non-bank loan market, as in the US. This goes directly to the limitations of UCITS III we have

Exhibit A

AFME / EHYA Board of Directors

Eric Capp, **RBS,** Chairman
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