



HM TREASURY

Discussion paper on non-bank lending

January 2010



HM TREASURY

Discussion paper on non-bank lending

January 2010



Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

© Crown copyright 2010

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Where we have identified any third party copyright material you will need to obtain permission from the copyright holders concerned.

For any other use of this material please write to Office of Public Sector Information, Information Policy Team, Kew, Richmond, Surrey TW9 4DU or e-mail: licensing@opsi.gsi.gov.uk

ISBN 978-1-84532-679-1
PU913

Preface

Subject of this discussion paper:

This discussion paper covers non-bank lending channels for companies. Non-bank lending channels are routes used by firms for financing which are not based principally or necessarily on the functions of the banking sector; for example, the bond market or the non-bank loan market. This discussion paper explores:

- potential barriers to the use of non-bank lending channels by large and upper mid-sized firms;
- the scope for reducing these barriers so as to facilitate a more diversified funding base; and
- whether there are ways for non-bank investors to more effectively invest in corporate debt.

This paper does not consider specific measures, but instead aims to promote discussion in order to develop a comprehensive understanding of non-bank lending channels, and of options to facilitate the functioning of these channels.

Who should read this:

The Treasury is interested in promoting discussion of this issue among all interested parties, but in particular among firms, investors and their representative bodies.

Next Steps:

HM Treasury will provide an update on the development of this work into non-bank lending channels at Budget 2010.

If you wish to respond to issues raised in this discussion paper or raise an enquiry about the scope of the discussion, please email:

nonbanklending@hmtreasury.gsi.gov.uk

Telephone enquiries: Richard Holmwood on 020 7270 5884 or Thomas Hemingway on 020 7270 6097

Comments are invited by 14th February 2010.

Contents

		Page
Chapter 1	Introduction	3
Chapter 2	Background to non-bank lending	5
Chapter 3	Discussion and questions	9
Chapter 4	Summary of discussion	19
Annex A	List of questions	21
Annex B	Non-bank lending data	25

1

Introduction

Subject of the discussion paper

1.1 Working closely with the Bank of England, HM Treasury has been exploring with a range of stakeholders the different factors that shape the options firms face in obtaining debt finance from non-bank lenders. With more clarity over the factors that are at play, and as announced in the 2009 Pre-Budget Report, HM Treasury is now keen to explore these more widely with investors, businesses, their representative bodies and other interested parties. HM Treasury is being advised by the Bank of England and FSA, working with the Department for Business Innovation and Skills.

1.2 At this stage the intention is not to consult on specific measures, but instead to develop a comprehensive understanding of the way non-bank channels currently operate and seek views on how they might develop in the future. In particular we are keen to hear from:

- investors that have recently invested in or foresee themselves investing in UK corporate debt; and
- businesses that currently seek or who could potentially seek non-bank finance in the future.

1.3 A number of different factors are likely to be influencing the current shape of UK company debt channels, and it seems likely that their further development will not be achieved through action on a single front but will require a holistic approach.

1.4 This discussion paper provides background on non-bank lending channels (Section 2) and then goes on to discuss some of the key factors that are shaping them (Section 3):

- **credit assessment and monitoring**; fewer UK companies are credit rated than in the US;
- **corporate transparency**; how much company information needs to be disclosed;
- **transparency in the pricing of loans**; whether there is sufficient transparency to enable companies to compare the prices of bank and non-bank loans;
- **preferences of UK investors**; whether these are a barrier to expanding non-bank lending to more corporates;
- **non-bank loan markets and high yield bond markets**, whether the characteristics or structures of these markets deter investors.

1.5 Section 4 summarises the document, Annex A provides a list of discussion questions for reference, and Annex B provides more detailed data on non-bank lending channels.

Policy context

1.6 UK firms have historically relied predominantly on banks to meet their borrowing needs. Non-bank channels play a role in the financing of large UK firms, but less so than in the US for example. Developing non-bank lending channels and therefore enabling more businesses to obtain financing from a greater variety of sources has the potential to reduce the impact of financial shocks on the economy¹. A greater diversity of sources of financing could also serve to enhance competition in lending to firms and support the competitive pricing of loans.

1.7 2009 witnessed a surge in corporate bond issuance. This shift in corporate financing towards non-bank channels is likely to have been, in part, as a result of cyclical movements in the relative price of bond and bank finance, some of which could be persistent in the longer run due to the re-pricing of risk.²

1.8 The increase in bond issuance has however been mainly concentrated on larger firms with investment grade ratings. The current characteristics of non-bank lending channels are the result of a number of different influences, both on the company and investor sides. These characteristics shape the relative costs of the different channels, as well as broader perceptions of their relative attractiveness to borrowers and lenders. The key question this paper seeks to address is whether there are ways of developing those channels in a way that increases the choices that are available to more companies, in particular large and upper mid-sized firms. These channels are unlikely to be appropriate for the vast majority of firms as most firms will not be large enough to support access to non-bank channels.³

1.9 The focus of this discussion paper is on how non-bank lending channels for companies might develop in the longer term in a way that could enhance economic efficiency and resilience⁴. More targeted and shorter-term measures to address some of the issues currently facing business were announced in the 2009 Pre-Budget Report. The 2009 Pre-Budget Report also announced that the Treasury⁵ would explore ways of encouraging more sustainable, transparent and standardised UK mortgage-back securities markets.

1.10 HM Treasury will provide an update on the development of this work at Budget 2010.

¹ Particularly where non-bank channels access less cyclical real money investors.

² Kate Barker, Bank of England Monetary Policy Committee Member, Speech "*Monetary Policy and Debt Sustainability*" 23rd September 2009. <http://www.bankofengland.co.uk/publications/speeches/2009/speech402.pdf>

³ Chart 1.G in Annex B shows the distribution of UK enterprises by employees compared to turnover.

⁴ HM Treasury's work to develop UK lending channels complements the EU Financial Services Action Plan (FSAP). The FSAP sets the legislative framework for developing the Single Market in financial services across the EU. This plan seeks to reduce the cost of accessing capital, improve the allocation of capital across the EU and give firms increased opportunities to access markets in other Member States.

⁵ The Treasury will work with the Bank of England and the FSA through the Council for Financial Stability, and in discussion with issuers and investors.

2

Background to non-bank lending

2.1 To understand non-bank channels, working closely with the Bank of England, the Treasury looked to the US financial system for inference. Although the US is very different in terms of market size and institutional structures, it provides an example of a financial system that has both a well-developed diverse debt capital market system and a well-developed bank loan system. Indeed, in 1998 in the US, bank intermediation replaced the frozen-up debt capital markets, reducing the impact on the economy of the failure of one of the primary channels of lending. Furthermore, following the Asian crisis in 1998-99 commentators referred to the need for a “spare tyre” in the financial system. Asian economies had relied heavily on a bank system without another well-developed and significant lending channel being available (e.g. a debt capital market). This meant the financial shock was more amplified than had an alternative unaffected channel for corporate financing been available.

2.2 The structure of financial systems differs between countries. Differences between the US and Europe, and between countries within Europe, reflect clear historical, legal, and cultural legacies. While UK companies obtain a relatively large share of debt finance from non-bank channels, US companies source a larger share from these channels (see Table 2.A). By contrast German and French companies obtain a lower share of debt finance from non-bank channels, with large, often Government backed institutions playing a key role in debt markets.

Table 2.A: Comparison of corporate¹ financing structures in the UK, US, France and Germany (per cent of total) 2007

Corporate Liabilities (2007)	UK	US	France	Germany
Equity	58	59	71	58
Corporate bonds (debt)	9	14	5	3
Loans (debt)	32	26	23	39
Money market instruments (debt)	1	1	1	0

Source: Office for National Statistics, Federal Reserve Board, Eurostat.

2.3 While other types of capital such as equity markets also provide a source of business finance our focus in this paper is debt finance for large and upper mid-sized companies. Differences in the characteristics of debt and equity mean that they are suited to often fundamentally different purposes.²

¹ Non-financial corporations.

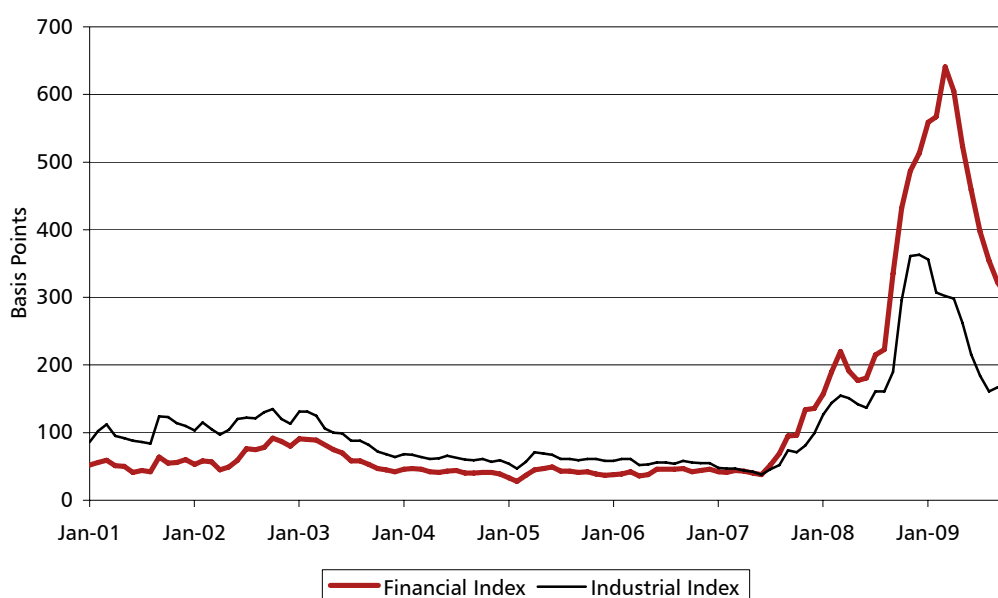
² For instance, for less large companies, equity finance can provide a good source of funding as investors can be more adequately compensated for the risk by sharing ownership and the prospect of a significant capital gain. Plain vanilla debt instruments such as bonds and loans do not provide an investor with an upside to the successful growth of a business (i.e. a significant increase in the principal investment); instead the investor (debt holder) receives a fixed income (coupon) or in the case of company default does not receive a coupon and may lose the principal investment.

Relative cost of lending channels

2.4 Bond issuance by UK firms has been concentrated in the past on the very largest firms, which regularly tap non-bank financing channels. Although the quantum of corporate bond issuance increased in 2009,³ there has been relatively little change in the types of issuers, and those who have traditionally relied heavily on the banking system for finance have largely not accessed the capital markets.

2.5 The relative price of bond finance compared with bank finance is likely to be one of the main drivers of the recent growth in bond issuance. In the UK, historically, banks could more easily raise wholesale finance and lend at more competitive rates than the capital markets. Chart 2.A provides an illustration that post crisis, on average UK investment grade rated firms were able to borrow more competitively than financial institutions, including banks. The chart shows that the relative price of financial institution financing (financial index) and corporate financing via bond markets (industrial index) had been slowly narrowing over time until switching in October 2008.

Chart 2.A: Corporate and financial sector borrowing costs (bps) above risk free rate (based on asset swaps)



Source: Merrill Lynch

2.6 The fixed costs inherent in non-bank lending channels,⁴ both on the company and investor side, may historically have constituted a natural bar for some companies that do not currently issue debt. However, to the extent that the recent shift in the relative prices of bank and non-bank finance is sustained, it seems likely that the behaviour of both borrowers and lenders will change, and that non-bank finance may become more attractive to less large companies. There may, however, also be a role for carefully designed government policy measures to facilitate this.

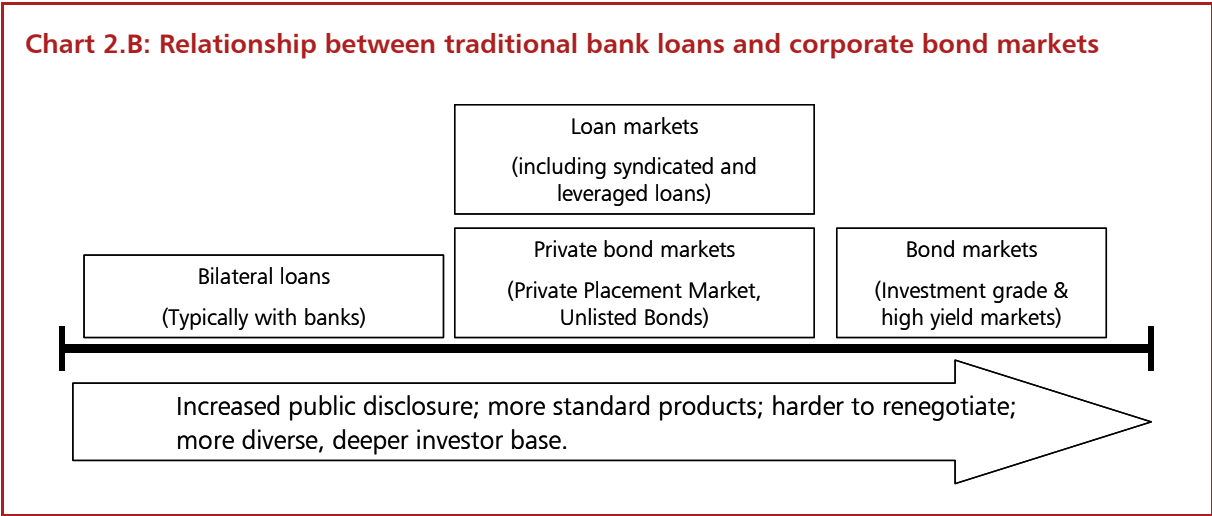
2.7 For some firms, particularly smaller firms, banks may well carry some inherent advantages over capital markets. Banks tend to have better information on the client and are better equipped to monitor them because of their wider commercial relationship. The smaller scale of

³ See chart 1.A in Annex B

⁴ Clearly issuing debt, such as bonds to non-bank investors is likely to have higher fixed costs and so becomes more economically efficient when undertaken on a certain scale.

some companies' financing will also tend to exclude them from the debt markets, which typically prefer to deal in relatively large tranches of finance. This is due to the relatively high cost of monitoring smaller companies, and the relative illiquidity of smaller debt issues. Comparisons with the US, however, call into question whether these factors alone are driving the current structure of lending to corporates in the UK. Other drivers may have been present leading companies, particularly upper mid-sized ones, to rely on bank provided finance instead.

2.8 There are a variety of non-bank lending channels ranging from those that are similar to bank provided loans to those that are more akin to publicly issued debt instruments. Chart 2.B shows the relationship between traditional bank loans and corporate bonds in terms of transparency, standardisation and the attractiveness of debt to a broad range of investors. For instance, syndicated loans are less private and can often be more standardised than traditional bilateral bank loans, while bonds are even more transparent and standardised. Transparency and standardisation is generally found in more liquid markets with a more diverse range of investors.



2.9 Section 3 examines in detail:

- credit assessment and monitoring;
- corporate transparency;
- transparency in the pricing of loans;
- preferences of UK investors; and
- non-bank loan markets and high yield bond markets.

3

Discussion and questions

Credit assessment and monitoring

3.1 In seeking finance from non-bank channels, in particular the corporate bond market, a public credit rating may increase investor awareness and serve to reduce overall financing costs and risks to investors and businesses. Compared with the US, a significantly smaller proportion of UK companies are rated.¹

3.2 Some of the following factors may be possible reasons behind the relatively low share of UK firms with a rating:

- Most UK firms have not historically seen the need to obtain a rating as they have relied on bank-based finance.
 - In that context there may be a perception that obtaining and managing a credit rating is expensive and uncertain, relative to the ease with which firms have been able to obtain bank finance.
 - The private information firms reveal to banks in the normal course of their business activities (making payments etc), may also have enabled banks to better assess and price credit risk using internal credit scoring systems, and provide relatively cheaper finance as well as a variety of ancillary products.
- It may be the case that UK investors do not have the equivalent in-house credit scoring expertise that many US investors have. (Industry credit scoring infrastructure such as the US NAIC² rating system may be a factor in reducing the risk monitoring cost for US non-bank investors.)
- Markets where company information is more private, such as the US private placement market,³ which is open to UK firms borrowing in US dollars, mean that a public credit rating is not always necessary.
- It seems possible that for some, both on the corporate and investor side, inertia may also be a factor, particularly in the previously benign macroeconomic environment where low cost bank debt was more freely available.

¹ 30 per cent of FTSE 350 (UK companies) and 60 per cent of S&P 1500 (US companies) are rated. Source: Bloomberg data, HM Treasury analysis. See chart 1D in Annex B for details.

² National Association of Insurance Commissioners.

³ The US market for privately issued loans or bonds, predominantly to insurance companies. See <http://www.federalreserve.gov/pubs/staffstudies/1990-99/166sum.htm> for more information. While a small UK based private placement market also exists, the ability for investors to trade loans on the secondary market is more limited than in the US.

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 quality measurement processes in the UK encourage more:
 - a. businesses to issue more non-bank debt; and/or
 - b. more non-bank investors to buy UK corporate debt

Corporate transparency

3.3 Market investors rely on publicly available information to assess the quality of a company's credit. In principle, therefore, the better the quality of that information, the less the uncertainty investors will face in pricing the risk of lending, and the less likely they will be to charge the borrower a premium to protect themselves from uncertainty. The costs to investors of collecting that information may also have an impact on the pricing of debt. The greater the ease with which investors can access information, the lower the cost of assessing a company's credit. This should in turn reduce the cost to the company of borrowing.

3.4 While enhanced corporate disclosure carries the potential to improve the assessment of corporate risk by investors, this needs to be balanced against the burden of providing and disseminating that information. Any actions that reduced the disclosure burden on firms seeking non-bank finance would also serve to increase the relative attractiveness of these channels to firms. This points towards assessing whether there might be ways to reduce disclosure requirements (including regulatory ones), while maintaining adequate transparency for investors to make informed decisions. In addition, different disclosure regimes might be suitable for different types of non-bank finance. It may be that by reducing the disclosure burden on firms, a greater proportion of upper mid-sized companies will choose to diversify their finance towards non-bank channels.

3.5 It has been suggested by some that the corporate information disclosure regime in the US is more transparent and that reporting is more frequent. Therefore monitoring of investment risk is easier and less costly for investors. A larger proportion of US firms disclose more detailed, frequently updated and easily accessed information, via the SEC's internet-based "EDGAR" database.¹ As part of its implementation of the Transparency Directive, the FSA is in the process of setting up a database that will warehouse publicly disclosed information of UK listed firms. Similar in concept to the SEC's EDGAR database, this aims to improve the ease of access by investors to information provided by companies. The UK database does not, however, affect the nature of the information firms are required to disclose.

3.6 Quality and completeness of information can be important. It could be the case for instance that in the UK, uncertainty about the credit quality of companies, and in particular the quality of investors' claim on the company can be clouded by the presence of (often undisclosed) covenants imposed by lenders. Again, those with experience of the US suggest that more loan covenant information is publicly disclosed, creating more certainty for non-bank investors.

¹ The US Securities and Exchange Commission hosts the EDGAR (Electronic Data Gathering, Analysis, and Retrieval system) database of records of all US listed companies. See <http://www.sec.gov/edgar/aboutedgar.htm> for more information.

Corporate transparency questions

Questions for business:

- 3 If you do not currently use non-bank lending channels, such as bond or loan markets:
 - a. what currently stops you from doing so;
 - b. how burdensome do you find providing your current levels of corporate transparency (if at all), and would increasing this act as a significant deterrent to accessing non-bank lending; and/or
 - c. are there any regulatory barriers that deter you from using non-bank channels?
- 4 If you have sought to use non-bank lending channels but have not been successful, to what extent was:
 - a. corporate transparency a factor; and/or
 - b. cost of information disclosure a factor?
- 5 If you currently use non-bank lending channels have you found corporate transparency requirements an issue?

Questions for investors:

- 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?
- 7 Do the potential costs of greater transparency, whether regulatory or otherwise, deter firms from seeking non-bank finance?
- 8 If companies made more information available about loan covenants (the 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?

Loan pricing transparency

3.7 For some firms, particularly less large firms, banks are likely to carry some inherent advantages over non-bank lending channels. These may include: better information and monitoring regarding the client, general ease of access and proximity, and a broader menu of related products (deposits, flexibility in other credit facilities, etc.). So, for example, a bank can use information gained from provision of payment services in considering the creditworthiness of a company. In theory, this could make them more efficient providers of finance particularly to smaller firms.

3.8 Although these advantages exist in principle, in practice it may not always be easy for companies to assess the extent to which this is reflected in the relative pricing of different types of borrowing. For example when banks include the cost of other ancillary products in the price of a loan, it may be difficult for customers to compare the actual price of bank finance with finance from other sources.

Loan pricing transparency questions

Questions for business:

- 9 Are you able to compare the prices of different types of borrowing (e.g. bank and non-bank lending)? If not, what might help you to do so?

Questions for investors:

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

Preferences of UK investors

3.9 This section considers the current and potential demand from investors for corporate debt. In particular, the demand for sub-investment grade (high yield assets) and upper mid-sized firms' debt, and whether structural market constraints are a limitation on investor demand.

3.10 Investor preferences are likely to influence borrowers' ability to access non-bank lending channels. In the UK the investor base is dominated by pension funds and insurance companies. In this respect, and in its overall size, it differs from the US. Overall, pension and insurance funds may have a general bias towards less risky and more liquid assets, partly due to the nature of their business and partly due to regulatory requirements.

3.11 The regulatory framework for pension funds is based upon the prudent person principle. Broadly speaking, defined benefit (DB) pension funds have a preference for matching the maturity of their liabilities with similar length assets, particularly around the time when they experience a peak in pension holders beginning to draw-down income. Defined contribution (DC) pension funds generally allow the member to make an investment choice, as each individual's fund is "ring-fenced". However, when funds are annuitised, annuity providers (e.g. insurance companies) take on the liability for maintaining the ongoing payments (and the associated longevity risks). They then therefore also have an appetite for long-dated gilts and corporate bonds to back the liabilities.¹

3.12 Insurers' investment choices are also influenced by the regulatory environment and the need to meet their liabilities, in particular capital and liquidity requirements. Although it is possible for insurers to hold alternative instruments (assets with lower permanent liquidity), to do so can often mean higher capital requirements (as the level of the capital requirement is based on the risk associated with the investments held).

3.13 The UK corporate bond market is made up predominantly of issuance by highly rated and larger firms operating in the UK, either those with a well-recognised brand name and/or with an investment grade credit rating. In comparison with the US, more UK investors are believed to hold corporate bonds to maturity and secondary market activity is more limited.

3.14 UK issuance of high yield bonds (issuance with a lower credit rating) is also much more limited relative to the US. Some UK-based firms access the UK and US private loan and bond markets, although these markets only form a small share of UK business financing.

¹ See chart 1.F in Annex B for an example of the maturity profile of different fund types

Preferences of UK investors, questions

Questions for business:

- 11 How significant an issue do you believe investor preferences to be when accessing non-bank lending?

Questions for investors:

- 12 What factors influence non-bank investor (including overseas investor) appetite for UK corporate debt?
- 13 What role might guarantor entities play in guaranteeing debt issued by UK companies?
- 14 How could secondary bond market activity be improved?

Non-bank loan market and high yield bond market

3.15 As discussed above, there are inherent costs associated with access to non-bank channels, such as bond and loan markets, which may act as a natural bar to more firms accessing them. The further development of the UK high yield bond market and non-bank loan market, may however, offer opportunities to lower the level of this bar. This is notwithstanding evidence that prior to the crisis the supply of credit became too freely available, driven by commercial loan investment vehicles, such as Collateralised Loan Obligations (CLOs) and bank loans, resulting in the current overhang of poor quality CLO liabilities and underlying leveraged loans (from leveraged buyouts), which may act to slow loan market growth.

Non-bank loan market

3.16 This section considers the scope for non-bank lenders to participate more actively in the UK non-bank loan markets. Loans can be issued by borrowers (firms) to a number of different institutions. Commercial banks, investment banks, or other financial companies generally facilitate the transaction by underwriting the loan. In the UK, commercial banks have played a significant role in the loan market and ultimately hold a significant share of the assets¹. This might be expected given their relatively large presence in the UK financial system. In the US, however, institutional investors and other non-bank based investors have played a much more significant role and secondary market liquidity has been higher.

3.17 From discussions with the investment community a number of potential barriers may be limiting the involvement of non-bank lenders, although these need to be tested further:

- the lack of a well-developed UK loan market index may reduce investors' appetite as benchmarking returns and measuring asset liquidity is more difficult;
- the absence of a credible third party credit rating process both for securitised loans, non-securitised loans, and corporate credit is likely to be a factor limiting secondary market liquidity and increasing investment risk;
- uncertainty around the secondary loan market settlement process (when loans are sold between investors) contributes to the opacity and liquidity risk of the market making the asset less attractive;
- the UCITS Directive (Undertakings for Collective Investments in Transferable Securities), aimed at protecting retail investors, prescribes certain criteria for securities to be sold to retail investors. The heterogeneity of loans normally prohibits their transferral to retail investors, thus making the pool of potential investment finance smaller; and
- the lack of standardisation across the European corporate loan market, may be limiting the extent to which investors are able to transfer assets to other investors.

¹ See chart 1.E in Annex B for more details on ownership.

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

High yield bond market

3.18 High yield bonds are those rated below investment grade by the major credit rating agencies. The market is known as “high yield” as investors in these more risky corporate assets demand a higher return for their investment. As with other debt markets the UK market is less developed than the US market.

3.19 A significant share of high yield bonds issued by UK firms are issued in other major currencies (such as US dollars and euros). With UK investment grade firms choosing to issue more predominantly in sterling¹, this may suggest that investors (both UK and overseas) are constrained in their appetite for high yield sterling debt.

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

¹See Chart 1.C in Annex B for more details.

4 Summary of discussion

4.1 Expanding non-bank lending channels to more firms points towards reducing barriers on both the company and investor sides. In the current hitherto largely bank-based corporate funding equilibrium, many companies have not accessed non-bank lending channels. A number of different factors are likely to be influencing the current shape of these lending channels, and it seems likely that their further development will not be achieved through any single measure. Instead, a holistic approach encompassing a number of different areas might be needed to open up the channels for more firms.

General questions

- 20 Do you believe that HM Treasury should be promoting more diverse sources of funding for companies?
- 21 Which of the issues covered in this discussion paper do you believe to be the most significant?
- 22 Are there any additional significant barriers or issues that should be considered?

A List of questions

A.1 For ease of reference the questions are split into two sections, questions for business (below) and questions for investors (page 23).

Questions for business

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 UK corporate debt?

Corporate transparency questions

- 3 If you do not currently use non-bank lending channels, such as bond or loan markets:
 - a. what currently stops you from doing so;
 - b. how burdensome do you find providing your current levels of corporate transparency (if at all), and would increasing this act as a significant deterrent to accessing non-bank lending; and
 - c. are there any regulatory barriers that deter you from using non-bank channels?
- 4 If you have sought to use non-bank lending channels but have not been successful, to what extent was:
 - a. corporate transparency a factor; and/or
 - b. cost a factor?
- 5 If you currently use non-bank lending channels have you found corporate transparency requirements an issue?

Loan pricing transparency questions

- 9 Are you able to compare the prices of different types of borrowing (e.g. bank and non-bank lending)? If not, what might help you to do so?

Preferences of UK investors, questions

- 11 How significant an issue do you believe investor preferences to be when accessing non-bank lending?

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

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?
- 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?
- 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?

General questions

- 20 Do you believe that HM Treasury should be promoting more diverse sources of funding for companies?
- 21 Which of the issues covered in this discussion paper do you believe to be the most significant?
- 22 Are there any additional significant barriers that should be considered?

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 UK corporate debt?

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?
- 7 Do the potential costs of greater transparency, whether regulatory or otherwise, deter firms from seeking non-bank finance?
- 8 If companies made more information available about loan covenants (the 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?

Loan pricing transparency questions

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

Preferences of UK investors, questions

- 12 What factors influence non-bank investor (including overseas investor) appetite for UK corporate debt?
- 13 What role might guarantor entities play in guaranteeing debt issued by UK companies?
- 14 How could secondary bond market activity be improved?

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

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?
- 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?
- 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?

General questions

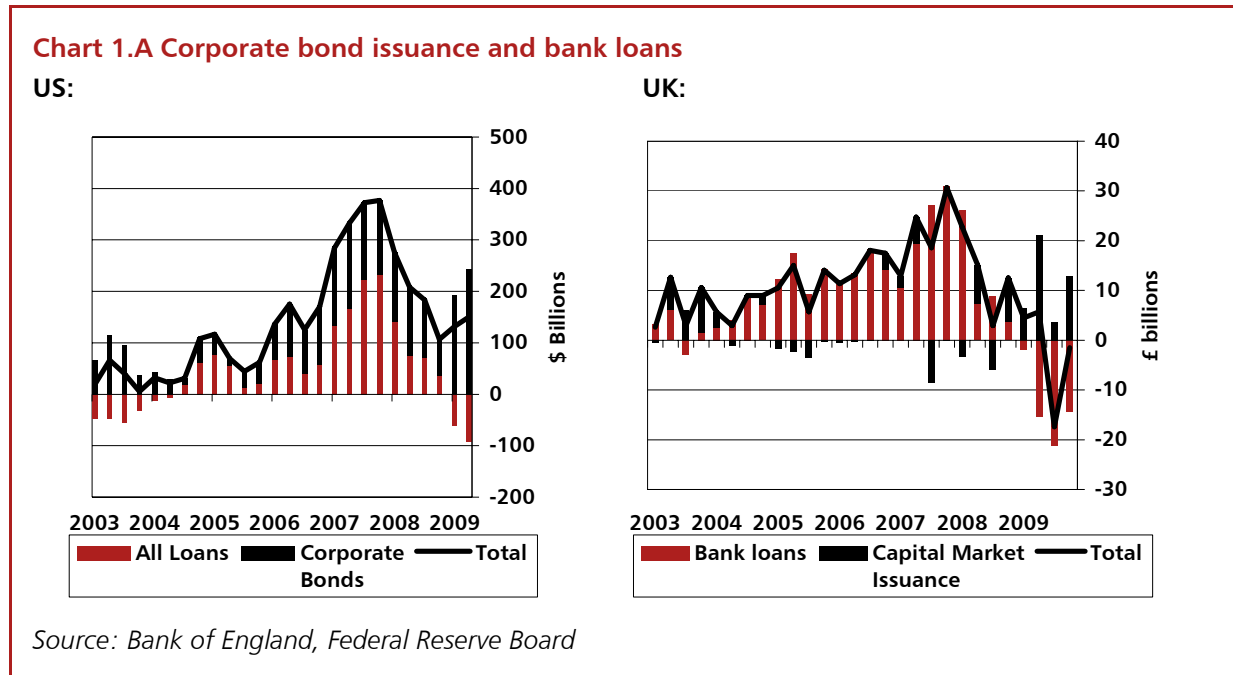
- 20 Do you believe that HM Treasury should be promoting more diverse sources of funding for companies?
- 21 Which of the issues covered in this discussion paper do you believe to be the most significant?
- 22 Are there any additional significant barriers that should be considered?

B

Non-bank lending data

Corporate bond issuance and bank loans 2003 – 2009

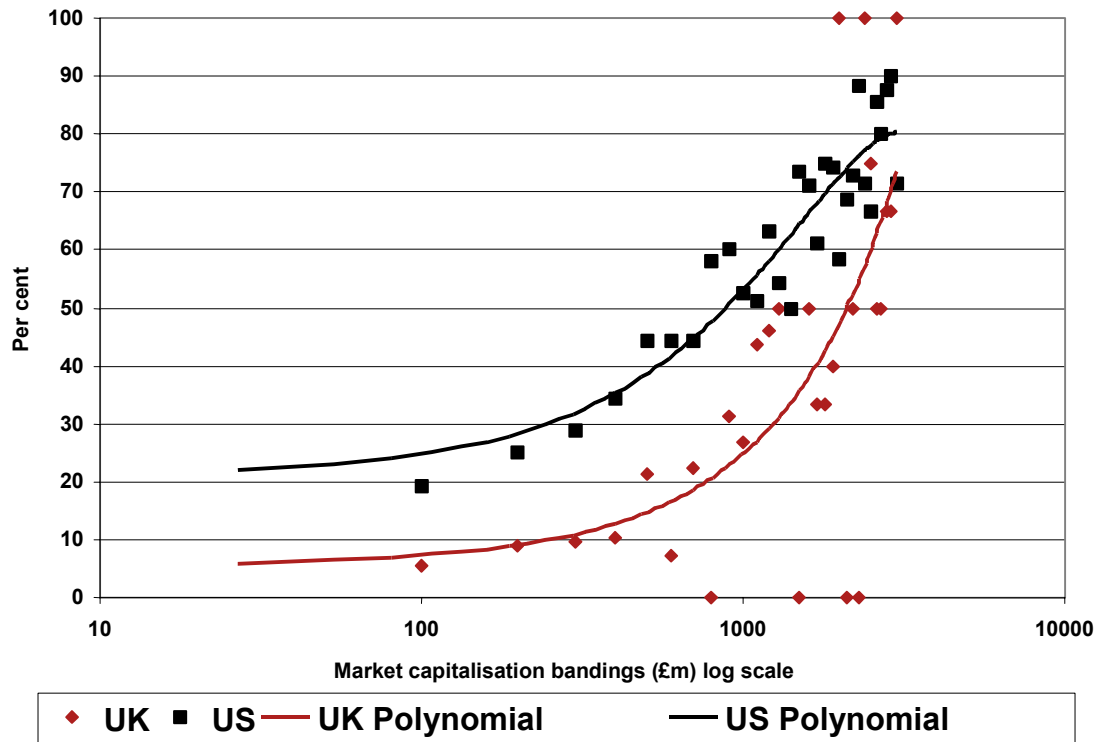
B.1 Chart 1.A shows corporate bond issuance in 2009 in the UK and US. This growth partly follows the change in the relative price of bank versus bond finance (see chart 2.A in section 2).



Firms with bond market issuance by company size, UK and US

B.2 Chart 1.B indicates that in the US the bar to less large firms obtaining non-bank lending channels is clearly lower than in the UK, with around 20 per cent more firms (normalised for size) issuing more bonds. Furthermore, towards the larger end of the company size spectrum (right-hand side), the share of firms with bond issuance becomes more aligned.

Chart 1.B Per cent of firms with bond market issuance compared to market capitalisation (a measure of company size), UK and US.

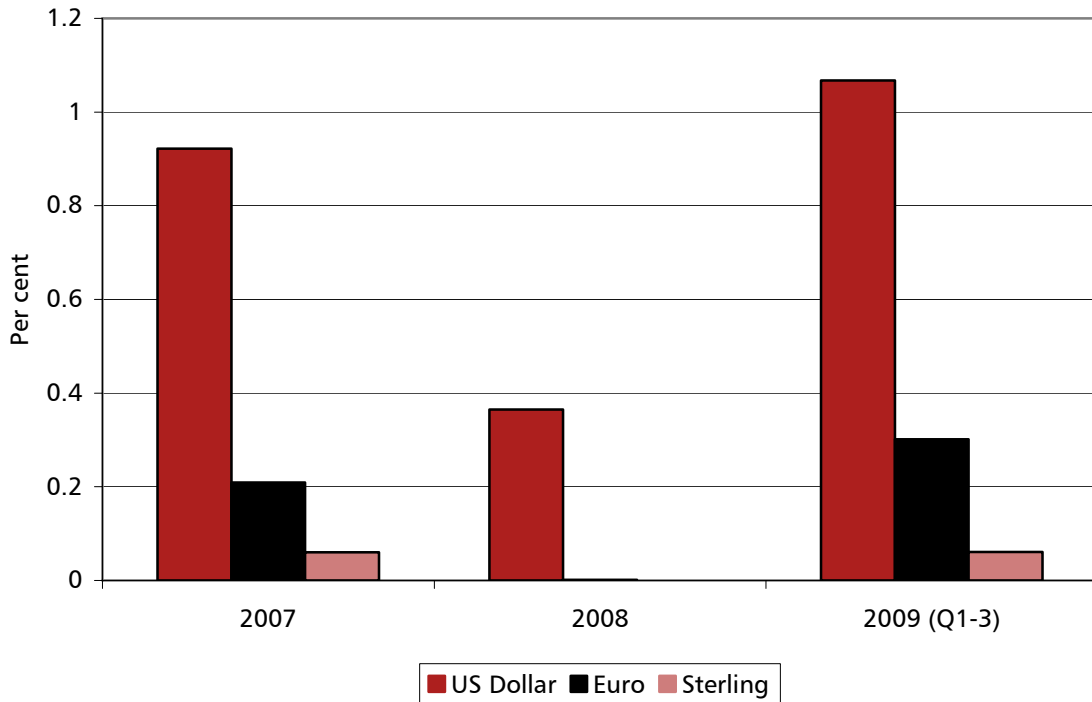


Source data: Bloomberg

High yield bond issuance by currency, 2007 to 2009

B.3 Chart 1.C shows high yield bond issuance in US dollars, euro, and sterling as a share of local currency GDP. For example, high yield bond issuance in US dollars amounts to around 0.9 per cent of US GDP in 2007. High yield issuance in euros amounts to 0.2 per cent of Eurozone GDP in 2007, and sterling issuance less than 0.1 per cent of UK GDP in 2007.

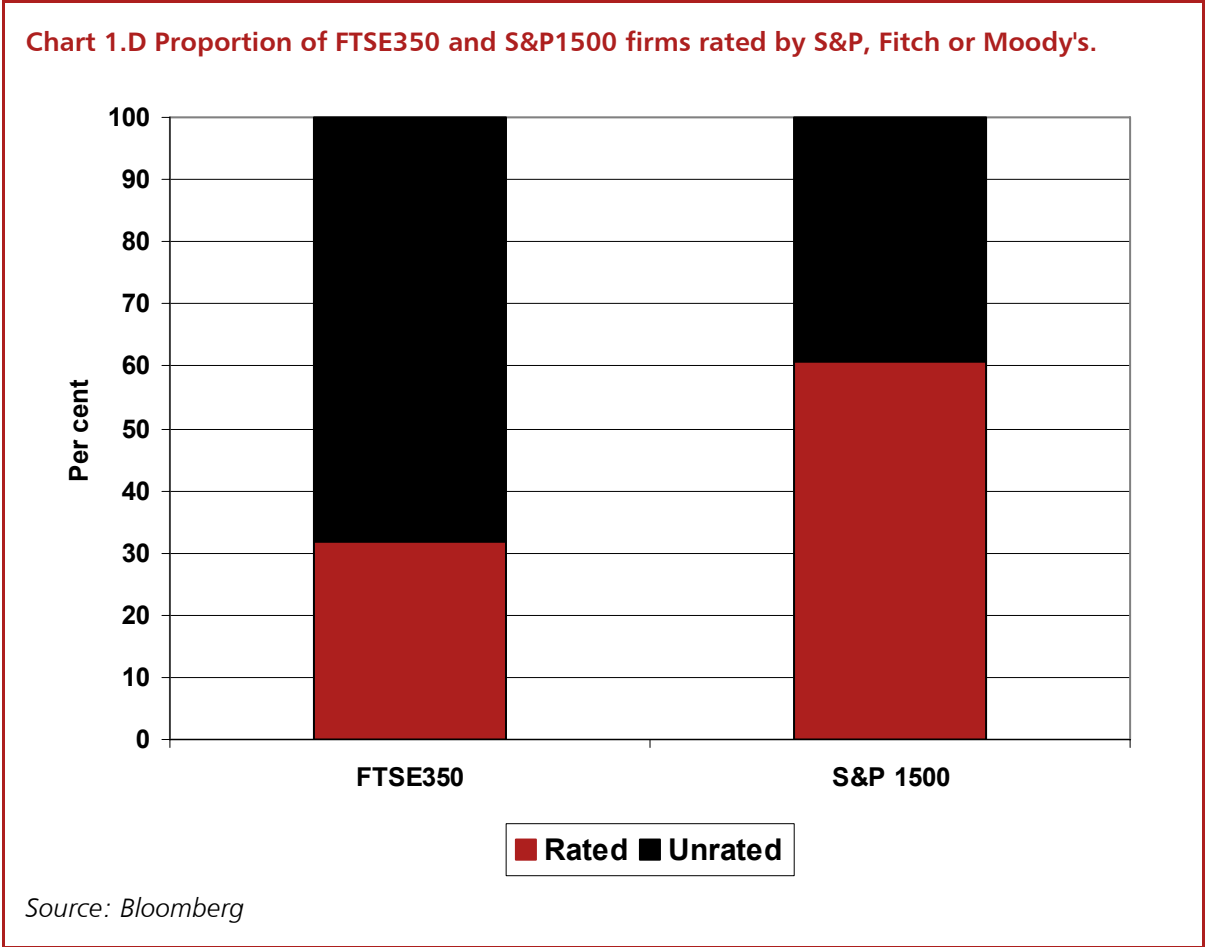
Chart 1.C High Yield Bond Issuance, by currency as a share of local GDP (\$, €, £)



Source: Barclays Capital, PIMCO, Office for National Statistics data, Bureau of Economic Analysis and Eurostat

Share of UK and US listed firms with credit ratings

B.4 Chart 1.D shows the proportion of firms in the FTSE350 and S&P1500 that have a public rating by one of the three major rating agencies.



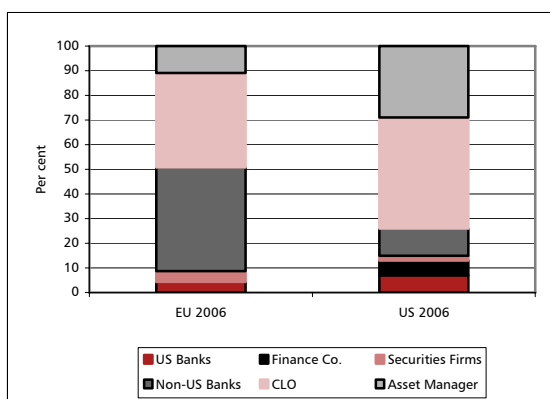
High yield and leveraged loan market investors

B.5 Chart 1.E shows a breakdown of the high yield bond and leverage loan assets held by different investor types in Europe and the US in 2006 and 2009. The data indicate that non-bank lenders, such as asset managers and finance companies, hold a larger share of these assets in the US than they do in Europe.

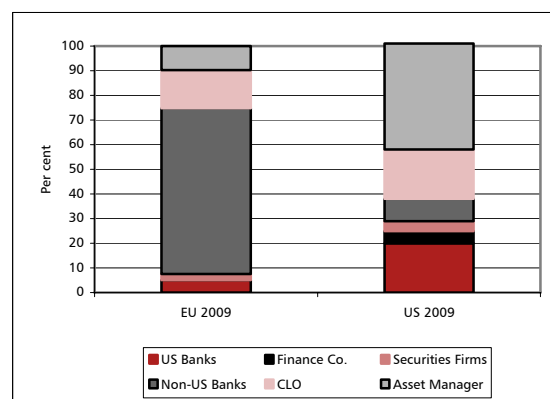
B.6 A comparison between the two charts (2006 and 2009) shows that in the US non-bank lenders such as asset managers have taken a larger share of the market in 2009, following the contraction of the CLO market. In Europe, non-US Banks (mostly European banks) have taken up an increased share of the market.

Chart 1.E Comparison of high yield and leveraged loan market investors, by value, Europe and US

2006



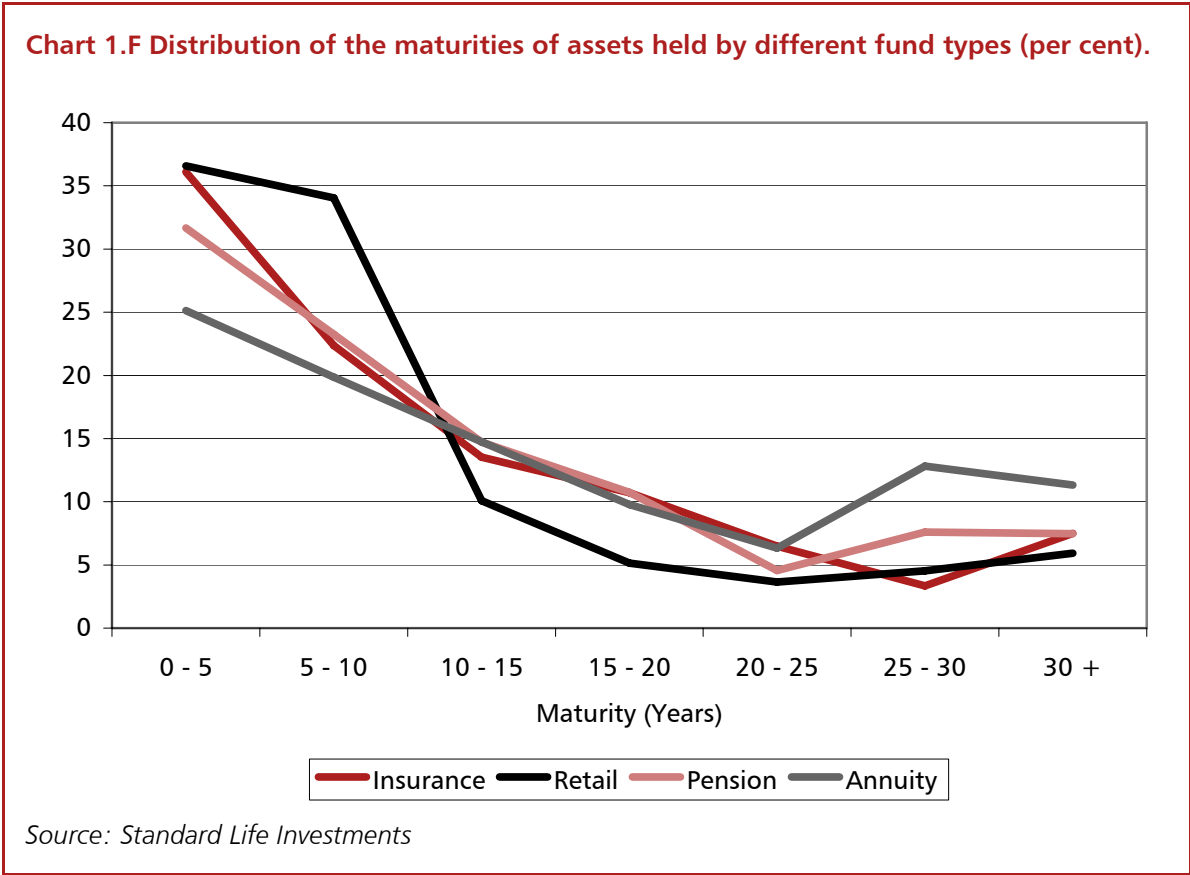
2009



Source: Standard & Poors

An example of maturity distribution by fund type

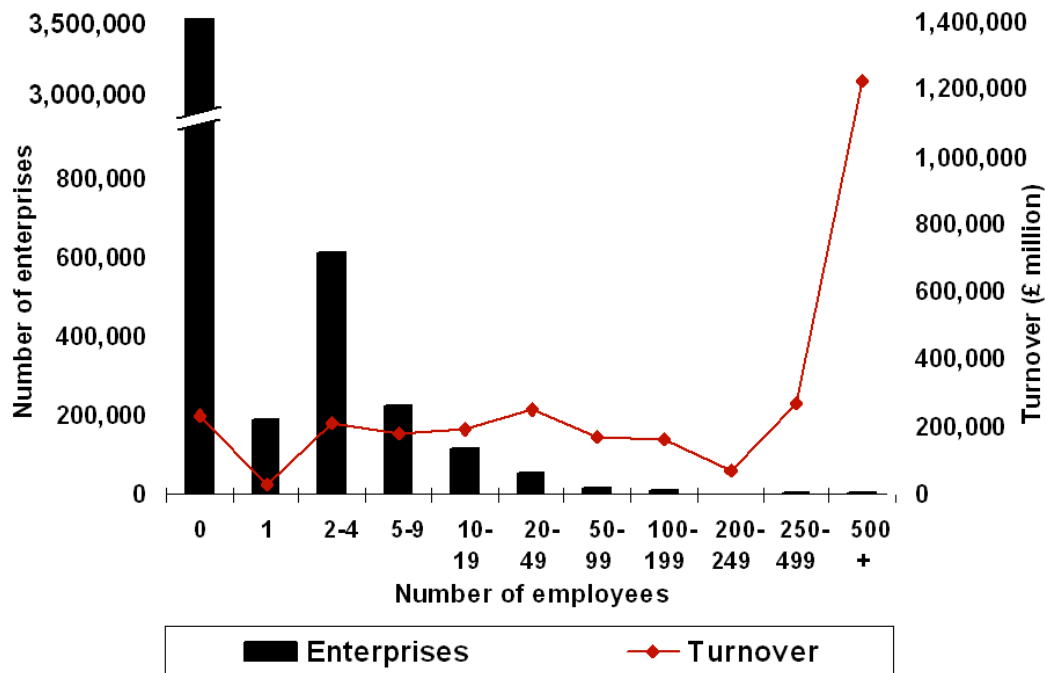
B.7 Chart 1.F is an example of the distribution of the maturities of assets held by different investor types. As might be expected it suggests that annuities and pension funds hold a larger share of longer-term assets than other funds, and as discussed previously (in paragraph 3.10) pension funds constitute a large weight in the UK investor base.



Distribution of enterprises by employees compared to turnover

B.8 The chart provides colour on the shape of the business landscape in the UK. The vast majority of UK firms are small in terms of turnover and employees. Clearly these firms cannot expect to access debt from non-bank channels directly, instead banking channels are expected to be a more efficient route (as discussed in paragraph 2.6).

Chart 1.G Distribution of UK enterprises by number of employees compared to turnover (£m).



Source data: Department of Business, Innovation and Skills

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London

SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hmtreasury.gov.uk

ISBN 978-1-84532-679-1



9 781845 326791 >