Financial Conduct Authority

MS15/1.2: Annex 3

Market Study

Investment and corporate banking market study

Interim Report: Annex 3 – Client case studies

April 2016

Annex 3: Client case studies

Introduction

1. A part of our engagement with stakeholders we sought views from a wide variety of issuer clients that source primary market services from banks and advisers.

2. We undertook a series of meetings and bilateral calls with more than 50 issuer clients covering $586bn of debt capital market (DCM) and $25bn of equity capital market (ECM) issues in 2015.[1] These issuers ranged from large corporate and sovereign, supra-national and agency (SSA) issuers, to small corporate issuers. In our discussions, we sought views on the themes set out in our Terms of reference. We also provided issuers with the opportunity to raise any other concerns they had in relation to competition in primary market services.

3. In this section, we summarise the views we received from issuer clients. For ease of reference we have grouped these clients into the following categories:
   - large or frequent corporate issuers (16 issuers)
   - small and medium-sized corporate issuers (21)
   - private equity houses (5)
   - SSA issuers (10)
   - financial institutions as issuers (3)
   - housing associations (3)

4. As part of our consultation process, we would welcome any additional views from issuers and any further comments on the themes discussed below.

Large corporate issuers

5. We received views from 16 large corporate issuers, through roundtables, bilateral discussions and written submissions in response to our request for information. These issuers are all FTSE 100 companies and were active in a range of sectors. As large and sophisticated clients, they are frequently active in debt capital markets, having collectively issued $31bn in 2015.[2] Our discussions were primarily with corporate treasurers and finance directors, where we sought to understand the dynamic of their relationships with lending banks and their DCM (and other) requirements.

Relationships

6. All large corporate issuers stated that they had banking relationships with more than ten investment banks, with some very large issuers maintaining a banking group of over 20 institutions. The funding model many issuers identified with was to borrow from investment banks in the short/medium term, and subsequently to source longer

[1] FCA analysis of Dealogic data for each issuer.

[2] FCA analysis of Dealogic data for each issuer.

term funding from the debt capital markets. Revolving credit facilities (RCFs) are central to most issuers' funding models as a low cost source of floating rate funding.

7. Large corporate issuers stressed the importance of the RCF in driving their banking relationships, stating that investment banks that provide them with committed funding are 'rewarded' with ancillary business or primary markets mandates. One finance director likened the provision of committed funding to a 'cinema ticket' that investment banks need to 'buy' in order to be involved in higher margin primary market transactions. This allows corporate issuers to negotiate competitive pricing on committed funding while building service commitment and loyalty from their lending banks.

8. Large corporate issuers noted that competition to join their RCF is strong and banks may begin to position themselves for a lending role well in advance of the time when the issuer's RCF expires. When selecting the size and composition of the lending group, issuers seek to ensure sufficient competitive tension within their banking group by pitching banks against one another. Large corporate issuers stated they are not under an obligation to award mandates or business to any one investment bank, so that each member of the banking group is incentivised to compete for business by providing trusted advice and high-quality execution.

9. To sustain this model, large corporate issuers noted that they rarely, if ever, award mandates outside their existing lending group, except for where they have specific requirements (e.g. transactions in a regional currency). However, two issuers said that, in addition to an RCF, they also maintain bilateral loan arrangements with their banks. This allows new banks the opportunity to demonstrate their commitment and capabilities with a view to joining the issuer's RCF in the future.

Fees

10. Large corporate issuers characterised the pricing for committed facilities as being 'aggressive'. They recognised that banks' returns on credit lines extended to them (particularly in respect of committed facilities) were likely to be commercially justifiable only on the basis of revenues subsequently generated as a result of transactional service mandates or ancillary business. However, they felt that it was in their commercial interest to take advantage of attractive credit terms made available to them.

11. With regard to fees for capital market transactions, large corporate issuers stated that fees, particularly for DCM transactions, are typically determined by the issuer based on previous market benchmarks (unless the form or currency of the transaction is specialised). They said that there is generally little or no further fee negotiation. For example, one large corporate issuer stated that it requests quotes for DCM fees from lending banks at the start of each year. Based on these quotes, the issuer's treasury produces a fee schedule with which banks are remunerated on all subsequent transactions.

12. Three issuers noted that, while they could in principle seek to negotiate lower fees, this may negatively affect their banking relationships by reducing the incentives for their investment banks to provide high-quality advice and execution. Such an approach may also discourage existing banks from renewing their RCFs. In addition, other banks might be unwilling to engage with issuers where they are perceived to generate low overall returns to the bank on a client relationship basis. Two other issuers stated that fees in absolute terms were 'high and difficult to justify'. One

treasurer noted that, at current levels of liquidity, his firm's bonds 'sell themselves' and he did not consider that fees were reflective of this.

13. With regard to fees incurred in other jurisdictions, large corporate issuers highlighted that fees for US on-shore transactions are significantly higher than in Europe and that banks in the US are less responsive to fee negotiation. Issuers thought that the reason for these differences is that in the US there are fewer providers with comprehensive capital markets capabilities. One issuer noted that given fees in the US are publicly disclosed in the associated transaction documentation this reduces banks' incentives to accept lower fees, on the basis that may set unhelpful precedents in respect of future transactions. We discuss fees in further detail in Chapter 8 and Annex 7.

Choice of lending and syndicate banks

14. There are a number of factors that issuers assess when selecting which banks to appoint to a lending group. These factors include execution capabilities, sector expertise and knowledge of the company, geographic footprint as well as secondary market capabilities. For large corporate issuers, less importance is placed on banks' league table position when choosing a bank for each transaction. This is to some extent because banks that possess the capabilities to serve large and frequent corporate issuers are likely to be near the top of league tables in any event. Issuers noted that in banks' pitches they often define league table parameters (for example, geography, time frame and product type) in the manner that generates the most favourable ranking. Issuers also commented that when undertaking a pitch process, it is common for multiple banks to assert that they are 'number one'. We discuss league tables in further detail in Chapter 6.

15. Large corporate issuers also discussed how they determine which lending banks will be included in a DCM transaction syndicate. They said that the composition of the syndicate is not delegated to the lead manager but rather is determined by the issuer. Issuers look to select banks that possess the necessary capabilities to successfully execute the transaction; these are often driven by the characteristics of the transaction (e.g. some banks in the RCF might have greater expertise than others in a particular currency or debt structure). In addition, issuers reward banks that have provided high-quality advice, conveyed useful market insights and been responsive to the issuers' needs.

16. Large corporate issuers said that their DCM syndicates typically encompass three to four book-runners, although this may vary depending on the type of the issuance and the issuer's objectives. Two issuers stated they award junior roles to smaller banks that are developing their DCM franchise but have provided value-added service or advice. Other large issuers noted that banks in junior (or passive) syndicate roles provide very little material input into a transaction.

17. Treasurers and finance directors noted that managing relationships with lending banks is generally time consuming, as it requires a balance between rewarding past advice/support and encouraging continued high-quality coverage while ensuring good execution and value for money in terms of fees. Issuers adopt a variety of measures for managing the banking relationships. Some have a preference to rotate though the lending group in a systematic manner. Other issuers said that they require lending banks to pitch for each transaction they propose to undertake. Some also stated that they distribute mandates and roles in a manner that ensures the share of annual transaction fees is proportionate to the amount committed to the RCF.

Transparency

18. Large corporate issuers, as frequent users of investment banking services, felt that they had a strong understanding of 'what good looks like'. The most immediate measure by which they establish how well a bank has executed a transaction is to compare the pricing and secondary market performance of a new bond against the issuer's past bonds or against deals of comparable maturity, risk rating and type. Qualitative feedback that investor relations departments gather from investors is also useful in assessing banks' performance. Moreover, because large corporate issuers' transactions are visible, banks that mis-manage a transaction would suffer from reputational damage (as well as losing the opportunity to be appointed on a future transaction).

19. With regard to the allocation decision-making process, issuers' involvement in the process varied. While all issuers expressed preference for long-term, buy-and-hold investors, some issuers said that they adopt a passive approach, expecting banks to deliver a book of demand reflecting the agreed allocation objectives. Conversely, other issuers said that they adopt a more proactive approach to the book-building process and allocation decisions. In either case, issuers did not feel that banks limit their involvement in the allocation process, and that the final allocation decision is always that of the issuer.

Additional concerns raised

20. Large corporate issuers expressed some concerns with regard to liquidity in secondary markets, which they perceive to have fallen, as banks have cut back trading activities. Some issuers expressed competition concerns in other markets. However, both of these aspects are outside the scope of this market study.

Small & medium-sized corporate issuers

21. We received views from 21 small and medium-sized corporate issuers, through bilateral discussions and written submissions. We canvassed views from firms across the market cap spectrum. This included firms listed on the LSE Main Market (excluding FTSE 100 firms, whose feedback is discussed in the section above), the AIM market and the ICAP Securities & Derivatives Exchange (ISDX), as well as a privately owned company. Firms provided their insights in relation to specific transactions (IPOs, M&A deals, recently signed RCFs and debt issuance) as well as discussing their ongoing relationships with banks.

Degree of choice

22. Many small and medium-sized corporate issuers stated they had a sufficient number of banks and advisers from whom to procure services. For services that firms typically tender (e.g. IPO mandates and RCFs), they indicated that they had sufficient choice of suppliers. For other services (e.g. corporate broking and M&A ideas) they noted that a number of market participants regularly approach them to pitch ideas. In addition, two smaller corporate issuers stated that they are able to satisfy their funding requirements though bilateral loans and noted that the willingness of banks to provide loans to smaller companies had improved over the past two years.

23. Three smaller corporate issuers noted that they face less choice of banks and advisers than they would have liked. They said that their limitations in choice were affected by their size, niche, or circumstance rather than by structural issues in the market:

- One issuer with a high leverage ratio said that it struggled to source a bank that was willing to provide it with day-to-day banking services. Ultimately, several banks agreed to work with the company.
- A listed small firm stated that there were only three to four medum-sized advisers that could act as the firm's corporate broker. It said that this was due to its small market capitalisation and specialised niche.
- A medium-sized firm commented that few advisers (be it corporate finance advisers, M&A boutiques or accounting firms) research and pitch M&A ideas in their market size range because firms in its industry sector tend to be much larger. However, the firm said that it receives 10-12 pitches per year from banks, advisory arms of accountancy firms and M&A boutiques.

Drivers of choice

24. Firms discussed the selection criteria they apply when assessing banks and advisers for different investment banking services. We set out in detail our analysis of issuers' selection criteria by product in Annex 4. However, the main features are:

- **Trust and relationships**. Firms place great importance on trust and confidence in their banks and advisers. Many firms highlighted the desire to build relationships with banks and advisers over time in order to secure their support throughout the business cycle.
- **Capabilities and track record.** For 'transformative' transactions (IPOs, debut DCM issues and M&A deals) firms look for execution capabilities, such as investor reach, sales and distribution strengths, and the ability to manage the legal/documentation aspects. A track record in deals similar in size and/or in related industries is also an important selection criterion.
- **Value for money.** Firms noted that value for money is important across all banking services they procure, but more so in 'commoditised' services such as lending and transaction banking. Fees are less important in transformative transactions than the certainty of execution and the quality of advice provided.

Views on different investment banking services

25. Firms noted that some investment banking services are awarded via a competitive tender, while other services are awarded on the basis of established relationships. Firms described how different services are procured, and provided their views on fees and quality of the service received.

IPOs and debut bond issuances

Selection of syndicate banks

26. The majority of firms we engaged with selected their IPO syndicate through a formal 'beauty parade', where a number of banks were invited to demonstrate their expertise in the firm's sector, discuss their distribution capabilities, share their views on possible valuation, and outline fee levels. Based on this process, firms selected the size and composition of the syndicate. Two firms said they undertook a similar process for their debut bond issuances.

27. Firms expressed differing views in relation to the importance of league tables. While they were aware that banks can enhance their league table ranking by constructing parameters that produce a favourable view of their position, some firms said league tables represent a useful comparison tool. For others, the ability to evidence experience on recent comparable transactions was more important than aggregate statistics.

28. For some firms, an existing lending relationship was an important consideration when awarding an IPO mandate. While no firm indicated that any of its banks had 'leaned' on them to be awarded an IPO mandate, firms recognised that banks with whom they had a previous lending relationship had demonstrated commitment and support to the firm and generally had a better understanding of their needs. One firm stated that it adopted a forward-looking approach to lending, by requiring all banks that wished to join its IPO syndicate to make a lending commitment to the firm post-transaction.

29. Overall, issuers stated they had full control of the selection and composition of their IPO syndicate. We did not receive evidence that suggests that banks were able to insist on the appointment of their peers to the syndicate. Similarly, firms that had engaged a corporate finance adviser to assist them in the selection process noted that the appointment of members of the syndicate was taken by them in concert with the adviser and not delegated to the global co-ordinator.

Fees

30. Some issuers commented that fee levels for IPOs were high. They also remarked that the level of fees quoted by different banks during 'beauty parades' were often very similar. To justify fee levels, banks make reference to fees paid by comparable companies in previous transactions. Firms that used corporate finance advisers stated that they felt well-placed to challenge fees quoted by banks.

31. Nevertheless, issuers stated that banks are willing to negotiate on fees. Many of these firms agreed a discretionary fee element, which is subjectively determined based on the quality of service received. Issuers expressed a preference for this form of fee structure as it better aligns the objectives of the banks and the issuer.

Allocation

32. Issuers' preferences are for stable, long-term holders to be prioritised in allocation of shares. They are aware that banks must manage potential conflicts of interests in relation to the allocation process. To address this potential issue, some issuers hire corporate finance advisers that have knowledge of the investor base and are better able to anticipate the holding patterns of different investors. Other issuers rely on internal expertise to challenge banks' allocation suggestions. Most issuers were closely involved in the allocation process, although a minority said that they opted for a more passive approach delegating the allocation decision-making process to its banks. For example, the chief finance officer of a firm recently listed on the London Stock Exchange (LSE) stated that its allocation book included more than 500 investors. While the chief financial officer was very familiar with the top 50 proposed investors in the allocation (who received the majority of the shares) he was less knowledgeable of the balance of the proposed investor base. He estimated that 5% of the allocation book was 'friends and family' but he did not consider this to have a material impact on the IPO.

33. Overall, issuers considered that banks' recommendations in relation to allocations to the core investor base were sound and that adjustments to the proposed allocations

took place at the fringes. However, the allocations typically reflected a focus on rewarding investors who were active in road shows or demonstrated price leadership. Issuers did not report any instances in which banks did not accommodate changes in the allocation they had requested.

Lending

34. Unlike large issuers, only a few small and medium-sized firms had issued debt in public capital markets. However, seven firms that had recently re-financed their RCFs shared their views on the relationship between lending and other banking services.

35. These issuers noted that the process of selecting banks for the RCF was competitive. Both existing and new lenders are typically eager to join a firm's RCF, allowing the issuer to choose the size and composition of the lending group based on the capabilities and the attractiveness of the terms on offer.

36. Issuers felt that rates of RCFs were currently favourable. They were aware that banks may be 'making a loss' from the provision of RCFs and that banks had an expectation that the RCF would act as a conduit for additional revenue in the form of subsequent transactional banking services (e.g. forex, deposits, international payments, credit cards etc.). For those firms that had issued bonds, the pre-existing lending relationship facilitated these DCM mandates.

37. Issuers were supportive of awarding transactional banking business to members of their lending group. They perceived this as an important means by which to keep banks interested in their relationship and to reduce the risk that a bank would not renew its commitment when the term of an RCF comes to an end. One issuer that had lost some banks in a recent renewal of its credit facility stated that going forward it wished 'to avoid having banks in the lending group that had nothing to lose from pulling away from the relationship'.

38. Despite issuers' willingness to award ancillary business to their existing lending banks, the majority noted that they did so conditionally on receiving competitive pricing. Only one issuer said that it was knowingly paying higher fees for payments services to a bank in its lending group. This issuer said that although local banks could provide the service at a better rate, it felt that using an international bank helped reduce the risk of fraud at a country operating level.

Corporate broking

39. The majority of firms that had recently listed on the LSE stated they retained one or two members of the IPO syndicate as their corporate brokers. Issuers said that selecting a corporate broker from that group was a natural choice as during the IPO process these advisers develop a thorough understanding of the issuer's business, its financial needs and its investor base. The selection and appointment of a bank as a corporate broker will depend upon the advice and support that a bank provides during the IPO process, as well as the relationship of trust that forms between the issuer's management and individual advisers.

40. Most issuers recognised that the retainer fees paid for ongoing corporate broking services were unlikely to cover the cost incurred by the broker in providing the service. In addition, a number of larger firms confirmed they are not charged a fee for the provision of corporate broking services. Issuers considered that this was, in

part, offset by the trading commissions that brokers earned from being market makers for their stock. However, issuers acknowledged an awareness that brokers' business models depend on fees being generated from subsequent equity transactions on which brokers had an expectation of being mandated.

41. Issuers' approaches towards this expectation varied. Many issuers stated that they would consider their broker(s) ahead of others in future ECM or ECM-linked transitions. Others adopted a more opportunistic approach, noting that the decision for whom to award a mandate is assessed on a transaction-by-transaction basis. Other issuers stated that, as they did not anticipate undertaking an equity issue or M&A transaction in the foreseeable future, they were content to receive corporate broking advice knowing that the relationship was unlikely to be profitable for the corporate broker.

42. Generally, issuers stated they were committed to their corporate broking relationship, but not bound by it. They considered that corporate brokers were naturally best placed to lead future ECM transactions given their knowledge of the issuer and of its investor base. However, they did not feel obligated to use their corporate brokers should the relationship deteriorate or if the brokers' expertise and capabilities were unsuitable for any particular transaction.

43. Most issuers commented that, while corporate brokers are better placed to secure mandates in respect of equity-related transactions, there is relatively little link between corporate broking and other investment banking services (e.g. debt-related deals). There were three exceptions to this:

- One issuer that had recently re-financed its RCF, invited its corporate brokers to join the RCF as a condition for continuing the broking relationship. The issuer reasoned that joining the RCF was an important test of brokers' commitment to the client relationship.
- One issuer noted that one of its lending banks repeatedly attempted to discuss replacing one of the issuer's incumbent brokers. The issuer declined on each occasion as the bank's research department did not provide coverage of the firm.
- One issuer noted that it had awarded its foreign exchange business to one of its two corporate brokers. The issuer stated that it had awarded the mandate competitively and that the broker provided good value for money.

44. Issuers stated that despite recent consolidation among medium-sized corporate brokers the market was competitive and that they regularly received approaches from brokers pitching ideas with a view to replacing or complementing their existing adviser(s). Some issuers that had been listed over a long-term term period noted that they review their broking relationships regularly. When assessing whether to replace an existing corporate broker, issuers consider:

- **Research coverage** – advisers whose research department does not provide coverage of the issuer are unlikely to be selected as a corporate broker.
- **Secondary trading** – an issuer assesses the extent to which a broker trades the issuer's stock to determine how well the prospective broker understands the investor base.
- **Investor feedback -** through their Investor Relations departments, issuers solicit feedback from investors on the performance of the prospective broker.

45. Trust and confidence in individual advisers is an important precondition when initiating a new broking relationship. A number of issuers noted that if a trusted

individual were to leave their corporate broker, they would re-assess their relationship with that broker.

46. When considering the UK corporate broking model in the round, no issuer expressed dissatisfaction with it. Some issuers commented that for small firms with limited investor relations budgets, corporate brokers are an invaluable extension of their investor relations teams. Issuers liked the fact that they only paid substantial fees when they needed to use the broker's platform.

47. Issuers stated that a joint broking model helped create competitive tension on subsequent ECM transactions. The threat of awarding mandates outside of an existing corporate broking relationship can in some cases act as an incentive for brokers to provide excellence in execution and competitive fees.

M&A

48. Issuers that had recently undertaken an M&A transaction or were contemplating undertaking a transaction stated that in the majority of cases, corporate brokers or other relationship banks are unsuitable for originating M&A transactions (albeit they do advise on financing). For smaller transactions, it is typically intermediaries with specific industry knowledge and contacts, or the issuers themselves, that identify potential M&A opportunities.

49. Two issuers had recently undertaken M&A transactions of a sufficient size to engage investment banks for financing and advice:

- In one transaction, the corporate broker had originated the transaction and acted as adviser. The company noted the need for confidentiality and speed meant that it would have been impractical for it to use an adviser other than its corporate broker. Nevertheless, the firm requested a different bank to quote based on generic/hypothetical information. The corporate broker quoted the same fee, which the firm proceeded to negotiate down and to split into a base and a discretionary element. The firm did not pay the discretionary part in full.
- In another transaction, a firm had awarded an M&A advisory mandate to its corporate brokers. The firm had in-house experience in M&A that enabled it to negotiate the fees downwards. With regard to ensuring value for money when awarding M&A mandates to corporate brokers, the company noted that their brokers were "terrified" by the potential reputational damage associated with not winning a mandate it would otherwise have been suitable for. The company felt that this had gave it negotiating power.

Additional concerns raised

50. Three issuers raised specific areas of concern:

- One issuer client expressed concerns in relation to potential conflicts of interest. It had recently ceased the relationship with one of its banks because its relationship manager had begun advising a competitor of the firm.
- Another issuer client noted that for firms in the FTSE 250 and below, issuing debt in public capital markets is expensive with high regulatory costs. Firms resort to using the US private placements market instead.
- One company noted that banks had significantly increased the financial covenants for their credit lines in the period following the financial crisis. This meant that should a firm experience short-term funding challenges, the covenants are likely

to be broken, meaning that the bank can withdraw its credit line when it is most needed. The client noted that covenants are most restrictive for 5-year credit lines, while for 3-year lines covenants are more reasonable.

- The same company also commented that some banks are very insistent on selling hedging products, sometimes with little consideration as to whether they would be suitable for the client.

Private equity firms

51. We sought the views of five private equity firms (PE firms) that have been highly active in UK IPOs. The PE firms with whom we spoke owned a stake in companies that had raised over $20bn on equity capital markets in 2015.[3] These firms provided feedback in relation to specific transactions, as well as discussing their relationship with banks more generally.

52. PE firms are sophisticated buyers of investment banking services and many of these firms have dedicated teams that managed their relationships with investment banks. Unlike individual corporates, who typically list on the stock exchange once, large PE firms will seek to realise their investments though IPOs or trade sales on a regular basis.

53. The services that PE firms procure from investment banks and advisers relate to the acquisition of new portfolio companies (M&A advice and acquisition financing) as well as the disposal of businesses and assets though IPOs and trade sales. We sought the views of firms in respect of both of these areas.

M&A

54. Large PE firms stated that investment banks do not typically provide them with M&A ideas but rather arrange financing in order to fund acquisitions originated by PE firms' internal investment teams. Having determined to acquire a company, PE firms approach a number of investment banks with the proposed terms of the transaction with a view to receiving fee quotes and advice in respect of the structuring of the transaction. This typically consists of a 'bridging' loan to complete the acquisition, followed by a bond issuance and associated loan re-financing. With regard to acquisition loans, a bank may provide funding from its own balance sheet. Alternatively, the loan may be syndicated and investors may buy a share of it (PE firms noted that the number of specialised funds investing in acquisition financing has grown). PE firms did not express any concerns about of a lack of choice for suppliers of M&A financing.

IPOs

55. When a PE firm wishes to realise its investment in a portfolio company, it may do so by disposing of it via a private sale or by listing the firm on a stock exchange. PE firms often pursue the two options in tandem (referred to as a 'dual track' process), electing to pursue the optimal form of exit once they have explored valuation and potential execution risk.

56. When selecting investment banks to manage an IPO, PE firms primarily value strong research and distribution capabilities, country or sector expertise, and a bank's previous track-record in respect of similar transactions. A PE firm's past experience

[3] FCA analysis of Dealogic data for each PE firm.

of working with a particular bank or team is also an important factor. PE firms stated that they did not consider league tables to be a major driver of choice. This was in part because they expect banks they worked with to be at the 'top of their trade' and in part due to an awareness that league tables may not be representative of a bank's experience and capabilities.

57. PE firms often appoint corporate finance advisers on a transaction to provide assistance in respect of the selection of syndicate banks, negotiation of fees and input into the allocation process. PE firms also gave other reasons why they use corporate financial advisers:

- One firm noted that using corporate finance advisers was helpful when it had a gap in its knowledge of the IPO process.
- Another firm commented that advisers can assist in managing the IPO process when multiple PE firms own a share of the portfolio company being listed.

58. With regard to fees incurred in relation to IPOs, PE firms expressed differing views:

- Some PE firms did not raise concerns in relation to the amount of fees they paid, noting that – as a percentage of funds raised – fee levels were appropriate and reflective of the value of the service received.
- Conversely, one PE firm stated that banks' fees are very high. In relation to a recent IPO, it noted that it had shortlisted a number of banks to pitch for the transaction, where each bank quoted almost identical fees. However, supported by a corporate finance adviser, the firm negotiated a discretionary element for the fee, which it did not subsequently pay out in full.

59. PE firms with international listing experience stated that IPO fees were, on average, lower in Europe than in the US. One firm attributed this to a lack of competition between US investment banks. Another firm commented that there are 8-9 banks in Europe who are capable of managing a large scale IPO, whereas in the US that number is only 5-6. PE firms also stated that fees in the US are higher in relation to debt issuances, but the difference was less striking compared with equity.

60. With regard to the composition of the syndicate, PE firms said that they are always responsible for appointing banks to the IPO syndicate. PE firms also shared their insights on junior roles. They said that generally advisers and smaller banks focusing on medium-sized clients can add value to a syndicate through their research capabilities and by reaching investor niches that larger banks do not serve. One firm said that the appointment of investment banks to junior roles may occur for relationship reasons. For example, in one recent IPO a number of banks were awarded junior titles because those banks had agreed to extend a credit facility to the firm after the IPO. Similarly, a bank that has provided a useful service or insight in the past may be given a junior position in an IPO.

61. PE firms did not raise concerns in relation to the allocation process. Larger PE firms highlighted that, during the IPO process, obtaining the highest valuation is not their overriding objective. Pursuing aggressive pricing during the IPO may adversely affect the firm's share price in the long term. PE firms stated that investors are perceived to be less keen to invest in future IPOs undertaken by a PE firm if its previous portfolio firms that have been floated consistently underperform.

Additional concerns raised

62. A number of firms raised other specific individual concerns:

- One firm stated that syndicated loans generally require interest rate hedging. The firm said that in the sector in which it is active banks insisted on distributing hedging contracts among syndicate banks on a pro-rata basis, which the firm considered dampened competition. The same firm also commented that the pricing of derivatives lacked transparency.
- With regard to the difference between the IPO process in the US and Europe, one firm stated that the difficulty experienced in making an adjustment to the price range in European IPOs is unhelpful.

Sovereign, Supra-national and Agency (SSA) issuers

63. SSA issuers include sovereign governments (e.g. the UK Government through the Debt Management Office or the US Treasury), supra-national institutions (such as the World Bank or the European Investment Bank) and agencies (such as the German development bank KfW). SSAs represent a significant proportion of debt issuance and their debt is typically highly rated[4]. The total value of DCM this group of stakeholders undertook in 2015 was $549bn.[5] We sought views across a range of SSA institutions from large and frequent issuers through to those smaller and more less frequent debt issuers.

Degree and drivers of choice

64. SSAs stated that given the volume of debt they issue they benefit from a wide choice of banks with whom to mandate. For example, one large SSA issuer commented that it had awarded lead manager roles to many different banks over the course of the previous year. The same SSA issuer said that withdrawal of some banks from SSA business (in respect of both underwriting and swaps) had until recently been a concern but had now stabilised.

65. SSAs commented that the key criteria for selecting a bank for a book-built transaction is the bank's historic performance record in the secondary market.[6] In addition, given SSAs typically convert fixed rate coupons to payments linked to interest rates, swap capabilities are an important consideration. SSA issuers usually seek to mandate a bank with a low counterparty risk and a strong balance sheet. SSAs also place value on more qualitative factors, such as feedback banks had provided on investor sentiment, the quality of research and whether banks had introduced new investors.

66. An additional issue raised by two large SSAs was the ability of banks' treasury departments to invest in the debt that these SSAs issue. As a result of the Basel III regulations banks have an increased appetite for holding high-quality liquid assets.

[4] Governments issue debt to fund spending deficits. Their debt is typically considered of lower risk than corporate debt, because governments can raise taxes and/or reduce spending to meet their funding costs. Supra-nationals and agencies, on the other hand, use debt capital markets to raise funds for investment and lending as required by their mandate. They enjoy the implicit or explicit backing of governments that founded them, meaning that their debt is considered of comparable risk to the debt of the governments that back them.

[5] FCA analysis of Dealogic data for each issuer.

[6] This serves as proxy for gauging how many buyers of SSA the bank has relationships with and – by extension –how effectively it could sell a primary issue.

SSAs on occasion issue debt through 'bought deals', where syndicate banks commit to purchase a proportion of the issued securities through their own treasury investment funds. These transactions are advantageous for the issuer, because of reduced execution risk. SSAs noted that, in increasingly volatile bond markets, bought deals are useful.

67. In 'bought deals', banks that are unable to purchase securities that an SSA issues are less likely to be awarded a mandate. We sought SSAs' views on the extent to which (if any) this represents an impediment for banks unable to leverage their treasury investment funds in the same way. SSAs stated that, in the wider context of their issuance programmes, the ability of banks to buy their debt does not override the importance of high-quality advice and execution. Banks unable to place their securities in this way are unlikely to be placed at a disadvantage in the market. Conversely, banks that are developing their DCM offering to SSAs would not be able to "buy their way in" through leveraging their treasuries' capabilities to win mandates.

Syndicate size

68. SSAs stated that they typically use syndicates on large benchmark deals. However, many of the transactions undertaken, for example, debt issued on the basis of a 'reverse enquiry' do not involve a book-building process and consequently there is no need to appoint a syndicate.

69. On benchmark transactions, SSAs noted that they typically appoint three to four banks in lead-manager roles. One SSA issuer said that slightly larger syndicate sizes (with more lead manager roles) had assisted it in securing wider distribution in the face of increased market volatility.

70. Some SSAs also commented that their benchmark transactions encompassed a number of co-lead managers, who may not have the capabilities to execute a transaction in a lead-manager role but provide insights or services the SSA wishes to reward via a junior mandate. Co-lead managers may bring smaller or niche investor orders to the allocation book. Some SSAs noted that a number of Canadian and Japanese banks had "graduated" from junior roles into lead manager roles over time.

Fees

71. Given the size of their issuance and the frequency with which they access capital markets, SSAs said they are able to exert fee pressure. For benchmark transactions in major currencies, SSAs typically set the fee, with little or no negotiation with banks (negotiation does occur on more specialised transactions, e.g. for debt issued in a regional currency). While value for money is important to SSAs, rewarding high-quality advice and encouraging excellence in execution is more important than driving down the level of fees. SSAs stated they have a good understanding of the 'going rate' (with some issuers referring to it as "market standard") for the transactions they undertake.

Allocations

72. SSAs did not have concerns with regard to the transparency of the allocation process and noted that they are closely involved in allocation decisions. As with corporate issuers, SSAs have a preference for long-term holders of securities, rather than

trading accounts. Investors generally comprise central banks, pension funds and other ‘buy-and-hold’ institutions. However, some SSAs noted that it can no longer be assumed that certain investors groups, for example, central banks, will hold bonds to maturity. Understanding the behaviour of investors in the secondary market is important to SSAs and represents a key aspect of the advice they seek from banks.

73. SSAs made two observations on the transparency and possible conflicts of interest in the allocation process:

- **Oversubscription**. Given frequent and large transactions, it is uncommon for a SSA bond to reach a level of oversubscription that is characteristic of corporate bonds. As a consequence, there is less discretion over which investors will be allocated their full demand versus those who will receive less than their order. Unlike corporate issuers, SSAs may (and often do) increase the size of the issuance if the order book is oversubscribed. Order inflation is therefore a less common occurrence in an SSA issuance because there is a risk to an investor who submits an inflated order that it may receive its requested allocation in full.
- **First-trading day return**. SSAs issue bonds which are not typically characterised by significant first-day trading price increases. As a result, there would be little advantage to a bank in allocating securities to preferred investors, as the preferred investors are unlikely to profit significantly from any first-day uplift in price.

Additional concerns raised

74. One large SSA raised two specific issues:

- Banks’ stricter enforcement of Chinese walls is a welcome development but it means that SSAs (and issuers in general) can access less granular information about the performance of their bonds in the secondary market. This means it can be more difficult to distinguish long term investors from speculative buyers.
- As a consequence of increased capital requirements, banks are shrinking their trading activities thereby reducing liquidity in secondary bond markets. This may affect an issuer’s ability to issue securities in primary markets if investors are unwilling to purchase these securities because they lack confidence in their ability to subsequently trade them in the secondary market. The SSA noted that, while this development was a concern for them, it had not affected their primary market issuance to date.

Financial institutions as issuers

75. Financial institutions (a group which includes banks, insurers and other types of deposit-takers) represent a sizable proportion of DCM issuances. New capital adequacy requirements introduced by Basel III regulations have increased the need for this client group to issue debt, equity and hybrid products though capital markets.

76. We engaged with the treasury departments of three banks about their use of debt capital markets and their relationship with their investment banking capital division, particularly in the context of reciprocity.

Choice

77. Treasurers we engaged with did not raise concerns in respect of the choice of suppliers available to them. Two treasurers stated that more than ten credible banks provide them with research coverage, and there is sufficient choice in relation to potential book-runners for DCM transactions.

78. Treasurers stated that they apply a variety of criteria when appointing banks to a book-built transaction. One bank said that secondary trading volume is an effective means by which to gauge a bank's ability to execute a transaction. Others adopt more qualitative considerations such as the quality of market intelligence and advice provided, ratings support, expertise in a particular type of DCM issuance (e.g. convertibles) and whether the provider's research is well-respected.

Self-issue and reciprocity

79. The extent to which treasurers relied on their bank's own investment banking arm for DCM transactions varied across respondents. Similarly, treasurers also had differing views and approaches towards the practice of reciprocity.

80. One issuer stated it looks to award mandates on the merits and other banks are mandated where they offer a superior execution and value proposition. The treasurer said that reciprocity was not a consideration in the treasury department's decision to mandate other banks.

81. Another issuer commented that the treasury department would generally seek to include its own DCM desk in transactions, either as sole bookrunner or, for benchmark transactions, along with other banks. In respect of reciprocity, the treasurer did not seek advice from the DCM part of the business when choosing leads for a transaction but the treasury department refrains from using certain providers if another part of the business has relationship concerns. The bank stated it had a committee in place to manage any potential conflicts.

82. Another bank noted that it looks to include its DCM desk in all debt issuance undertaken. The treasurer felt that this was important for the DCM unit's credibility and its ability to win business elsewhere. In relation to the practice of reciprocity, the treasurer noted that the bank has included banks in junior roles on deals at the request of the investment banking division. Banks appointed in this way play passive roles and it is the investment banking arm that pays the associated fees.

Fees

83. Issuers noted that fees are not a major driver of choice. One bank stated that it had never awarded a mandate purely because of a lower fee quote. The same bank said that if proposed fees were too low compared to the market average, this would raise questions about the quality of execution.

84. Treasurers indicated that fees tend to be relatively standardised. All three financial issuers stated that they seek to negotiate quoted fees and are able to agree reductions to varying degrees. One bank noted that because of its smaller issuance programme it has little scope for negotiating discounts. Another bank remarked that fees are most difficult to negotiate when the issuer raises subordinated or hybrid debt. Conversely, one bank noted that in securitised transactions, it could negotiate significant fee reductions.

85. All three treasurers stated that fees for US-dollar-denominated issuances were higher than comparable Europe-based transactions. One issuer attributed this to the smaller number of banks that are able to undertake US-dollar-denominated transactions. Another issuer commented that, because fees are disclosed in the US transaction documentation, banks are reluctant to agree to fees which are lower than the published "market rate".

Allocation

86. Issuer banks stressed their preference for long-term holders over speculative investors. Treasurers stated that they are very much involved in the allocation process for benchmark transactions, reviewing draft allocation books proposed by the syndicate and making adjustments to reflect road-show feedback or price leadership. Treasurers did not feel that inflated orders were an issue they struggled to manage.

Additional concerns raised

87. One bank raised concerns that retail investors may be being sold unsuitable investments in the UK retail bond market.

Housing associations

88. Housing associations (HAs) issue debt to fund the development of new or existing housing stock. Prior to the financial crisis, it was typically banks that provided long term financing to housing associations in the form of bilateral loans. As banks have retrenched from long-term financing, debt capital markets have become an attractive alternative for housing associations wishing to refinance or issue additional debt.

Choice

89. While HAs stated that banks' appetite for offering long-dated bilateral loans has reduced in the period following the financial crisis, they said that they have sufficient choice of banking service providers.

90. HAs noted that lending banks are often the starting point for associations wishing to issue debt in capital markets but associations may, and often do, use providers other than their lending banks. However, for certain[7] housing associations, covenants in respect of existing loans prevent them from issuing further debt without lending banks' consent. While we did not hear that this has the effect of forcing housing associations to award mandates to lending banks[8], HAs often elect to do so in return for lending banks relaxing other covenants (e.g. restrictions with regards to mergers with other HAs) contained in existing loans.

91. The ability of banks to secure suitable investors is crucial to HAs' choice of bank. Housing association bond transactions are typically small in size, meaning that their bonds do not qualify for indexes. In addition, obtaining a credit agency rating is often expensive relative to the amount issued. This prevents institutions whose investment

[7] This is particularly the case for housing associations created by transferring council housing stock. These HAs had to invest heavily in upgrading the estates they took over from councils and these re-developments were funded through long-term bank loans with restrictive covenants to reflect their riskiness.

[8] In principle, a HA can circumvent any veto imposed by lending banks by refinancing the entirety of its debt.

mandate is limited to listed and/or rated debt from buying HA securities. The long-dated nature of HA debt may further restrict the scope of potential investors.

92. HAs noted that there were a number of advisers that specialise in housing association debt issuance. Two HAs shared differing opinions on their potential effectiveness:

- One issuer had received advice from its retained treasury adviser. It said that the advice had been helpful but the adviser did not have requisite DCM expertise and so it had since switched adviser.
- A second issuer stated that the fees charged by advisers were unjustifiably high. The issuer also questioned whether the advice could be regarded as 'independent' given fees are calculated as a percentage of the amount issued. The issuer felt that advisers were often hired on debut transactions to provide a 'comfort blanket' to housing associations' boards with regard to the decision-making process.

Fees

93. All three HAs stated that fee quotes received from banks were similar although banks were generally willing to negotiate. One issuer said that the fee quotes it received from five banks were very similar to each other and that banks had an awareness of what their competitors were quoting. The same HA also raised concerns that fees are determined as a percentage of deal value and not on the basis of an hourly rate. However, overall, HAs said fees were not the main driver of choice.

Allocation

94. HAs had different experiences with regard to the allocation process, although overall did not raise material concerns:

- One issuer noted that it had delegated the allocation decision-making process entirely to the bank managing the transaction. Given that HA debt primarily appeals to long-term investors (pension funds and insurance firms) the issuer did not have concerns about securities being allocated to trading accounts.
- Another issuer commented that, prior to its transaction, the investment bank had introduced it to up to 10 potential investors, who provided valuable feedback in relation to their interest and pricing.
- Another issuer stated that its organisation played a proactive role in the allocation decisions, favouring buy-and-hold institutions and investors who had provided feedback and early interest during the road show.

Additional concerns raised

95. Housing associations raised a number of other specific issues:

- One issuer stated that book-runners were incentivised to get the deal done, rather than getting the best price for the issuer.
- One issuer felt that advisers did not provide value for money, and fee structures were biased towards advising clients to issue debt on capital markets, which may not always be in HAs' best interest.

Financial Conduct Authority

25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk