BANK OF ENGLAND

Speech

Investing in capital markets

Speech given by

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At the Association of Corporate Treasurers Corporate Funding Conference, London

28 October 2015

With thanks in particular to David Elliott as well as Ronnie Driver, Andrew Harley, Tom Henderson and Tim Taylor for their input into these remarks.

It is a pleasure to be here today at this ACT conference on Corporate Funding.

The theme of my remarks is investing in capital markets.

The corporate funding landscape that has emerged from the rubble of the financial crisis is very different to that which preceded it. Capital markets are a much more important financing source for many firms. This change is creating new opportunities and should support the resilience of corporate funding.

But, it also suggests new requirements for corporate treasurers. This includes the need to invest time in understanding the drivers of a now more diverse set of financing options, so that you can have effective plans for what remains an uncertain world. And it strengthens the case for investing energy to influence the on-going reform programme to enhance the infrastructure of those markets.

So, after describing some of the key trends in corporate funding since the crisis, I will offer some thoughts on each of these two areas, using examples to illuminate the broader point I am making. I will focus on possible factors affecting the future supply of bond financing, given this remains the second most important source of debt finance after bank credit. And, I will focus on two specific reforms to capital market infrastructure – benchmark rate reform and standards and codes guiding foreign exchange market activity – which the Bank is involved in and which will directly affect a number of corporates.

Changes in the corporate funding landscape

Bank lending to corporates has fallen since the crisis

The most notable change in funding patterns since the crisis has been the reduction in bank lending (**Chart 1**). Between 2000 and 2007, average net lending by banks to UK non-financial corporates was £38 billion per year. Since 2009, net lending has been minus £17 billion per year.

Initially, much of the reduction in borrowing from banks was reflected in falling corporate leverage. Indeed, non-financial UK corporates were significant net issuers of equity in particular in 2009. But it has also been associated with increased usage of other sources of debt. And different firms have turned to different markets for non-bank financing.

Public and private bond issuance has increased

Large firms have increased bond issuance, particularly in international bond markets. Annual net issuance by UK private non-financial corporates averaged £13 billion between 2000 and 2007. Since 2009 it has averaged £30 billion.

And the stock of outstanding bonds issued by UK private non-financial corporates has increased from around £140 billion in 2007 to over £400 billion today. Much of this issuance has been in euro and dollar, to take advantage of the larger markets these currencies offer – and has so involved greater use of the foreign exchange markets by corporates.

UK corporates have not been alone in increasing bond issuance: over the same period, the global private non-financial corporate bond market has nearly tripled to £6.6 trillion.

It is not just total issuance that has increased. Bond market access has become available for a larger number of firms (**Chart 2**). Between 2000 and 2007, there were on average six first-time UK non-financial corporate bond issuers per year. Since 2009, there have been twenty-six per year. 2014 saw a record thirty-six first-time issuers coming to market.

Large and medium-sized European firms have also made greater use of private placement markets. This has included both the well-established US private placement and German Schuldschein markets, but also the growth of new markets such as the French Euro Private Placement market.

Moreover, while data on private bond issuers are limited, it appears that the size barrier to corporate bond issuance is now lower. Bank staff estimates suggest that the size of the median corporate bond issuer has fallen by half since the crisis.[1]

Other sources of market-based finance are growing

But there have also been interesting innovations in the funding markets for mid-sized and smaller companies – those firms to which the bond markets remain out of reach.

Several asset managers have raised billions to lend directly to medium-sized European companies.

And smaller firms have started to benefit from the growth of alternative financing sources such as peer-to-peer lending, invoice trading and equity crowd-funding (**Chart 3**). Alternative financing of this sort remains small. Only 1% of SMEs currently use alternative financing, and estimates suggest that it makes up less than 1% of the stock of SMEs' outstanding bank loans. But it is growing rapidly from its small base, having increased ten-fold since 2012.

SMEs have also been increasing their usage of a much more traditional funding source – supply chain finance, such as invoice discounting.

[1] Specifically, the median UK corporate issuer since 2009 was half the size, measured by annual turnover in real terms, than in the period between 2000 and 2007.

The picture will not look the same for every firm. Some have had it easier than others. But one conclusion is clear – there has been a material shift from a reliance on bank funding to a broader range of financing sources.

Key drivers of recent developments

This move has had three key drivers.

First, the experience of the crisis gave banks and their regulators a better understanding of the risks posed by excessive leverage. This led to **retrenchment by banks** – a reduced supply of credit through the traditional banking channel. This in turn prompted corporates to diversify their funding strategies as the risks of reliance on one funding source were highlighted, increasing their demand for non-bank finance.

Second, this diversification has been supported by **structural change** flowing from several sources. For example, technological innovation has facilitated new forms of intermediation such as peer-to-peer lending. And the official sector has played a role, for example by encouraging direct non-bank lending through the UK Government's Business Finance Partnership.

Third, **stimulative monetary policy** by central banks has contributed to a decline in long-term government bond yields, encouraging investors to seek yield elsewhere, including in the corporate bond market.

How might these three factors evolve in coming years?

On the last of the three, I am afraid I may disappoint you, since it is not my job to talk about the outlook for monetary policy. That will depend as always on the outlook for the economy. Instead in the next section I will consider what impact future changes in monetary policy might have on corporate financing conditions.

I can more freely make predictions about structural change, which will of course continue apace. Technology will be used in new ways to overcome information barriers. Crowd-funding and peer-to-peer lending platforms look set to continue growing. Initiatives to develop a pan-European private placement market could fuel further growth in that market. And the liberalisation of key emerging market economies may provide new markets for corporate debt.

But the first of the three factors – retrenchment by banks – appears to be easing. In every quarter from 2009 Q1 to 2014 Q2, we saw negative net lending by banks to non-financial corporates. But this year bank net lending has turned positive.

Our contacts tell us that banks are increasingly competing with bond markets to fund the best credits. Most large firms now face little difficulty in raising the cash that they need from banks. Some smaller companies are still finding it difficult to get the loans that they want. But even for small firms, conditions have improved over the last year, and are expected to improve further. In the Bank's Credit Conditions Survey, UK lenders reported that the availability of credit to small businesses increased in the most recent two quarters, with a further rise expected in Q4. The Federation of Small Businesses also reported an improvement in credit conditions facing small firms. Increased competition, including by challenger banks, seems to have helped here.

But while retrenchment may be easing, and banks' own funding situation normalising, we do not expect it to reverse. There looks to have been a permanent shift towards market-based finance. Estimates suggest that bank lending made up two-thirds of the aggregate stock of UK non-financial corporations' debt in 2007. Now it makes up only half (**Chart 4**). A similar shift looks to have occurred in the US and Europe too, albeit from quite different starting points.

There are two key implications of this shift that I wish to explore in the remainder of my remarks.

First, the change in the balance of financing by corporates means that the typical treasurer needs to keep in mind a different set of risks when planning for tomorrow. Second, as corporates become more reliant on market-based finance they have an even greater stake in the effectiveness of the infrastructure supporting relevant capital markets and a greater collective responsibility to engage in its evolution.

A different set of risks

Having a diverse set of funding sources for corporates supports financial stability. It weakens what can be a contagious link between the banking sector and the real economy. And it reduces the probability that stress in one market, or among one group of investors, makes funding unavailable for a large number of borrowers. Indeed, one of the Financial Policy Committee's medium-term priorities is to ensure diverse and resilient market-based finance.

But while diversification is undoubtedly good this is not a free lunch: bond markets, too, can be fickle. Issuers have to ensure that they understand the risks, as well as the benefits, of increased usage of market-based finance – not least those new issuers that have only experienced exceptionally supportive conditions. Let me illustrate this by reference to three factors.

First, the conjuncture may not always be as supportive as it has been in recent years – monetary policy will not be this loose forever. In most recent monetary policy tightening cycles in the UK, US and euro area, corporate bond spreads rose in the run-up to the first rate rise (Chart 5). If history repeats itself, then we might expect to see conditions in some credit markets become less accommodative as we approach 'lift off'. Indeed, our contacts attribute some of the rise in spreads during 2015 to expectations of monetary policy normalisation (particularly in the US).

That said, this monetary policy normalisation cycle will likely be different from the past – and hence corporates need to recognise that transmission of this eventual change in policy through banks and capital markets may be different.

One reason is that the MPC has said that when Bank Rate does increase, it is likely to rise more gradually and to a lower level than in recent cycles. Another is that QE-induced portfolio rebalancing has compressed term premia in a range of asset classes, including corporate debt. The reaction of term premia to signs of monetary policy normalisation is yet to be tested. This is one reason that central bankers are going to some lengths to establish clear communication strategies around their monetary policy decisions. Moreover, given significant correlations amongst long-term bond yields in the UK, US and euro area, news about global economic prospects will have an impact on our domestic bond markets. For example concerns about global growth have contributed to significant increases in credit spreads since the summer. Similarly, foreign monetary policy decisions can also be expected to have some impact. The UK's many internationally-focussed firms need to be particularly alert to the manifold factors that determine the yields their investors demand.

Second, the underlying structural demand for corporate debt is likely to be affected by different factors to bank credit, creating periods that are more or less supportive for primary market issuance. For example, defined benefit pension fund demand for long-dated bonds has grown significantly in recent years as schemes close and increasingly embrace liability-driven investment strategies aimed at hedging their long-term liabilities. By contrast, demand from the insurance sector may be changing in response to the introduction of new European regulation, and the pension freedoms announced in the April 2014 budget have reduced demand for annuities. The shifts in the demand of different investors will have implications for your debt strategies.

Third, and finally, as Deputy Governor Minouche Shafik discussed yesterday, the growth in primary market issuance has coincided with a period when liquidity in secondary markets seems to have become more fragile.[2]

[2] "Dealing with Change", speech by Minouche Shafik at the AQR Institute of Asset Management, London Business School, 27 October 2015.

Given Minouche's recent speech I will cover the issue only briefly.   A combination of factors has contributed to changes in the characteristics of liquidity in fixed income markets:

- Post-crisis regulatory reform has strengthened the core of the financial system: the dealers who underwrite debt issues and make markets. But these regulations have also increased the explicit costs of market-making – to bring them in line with the underlying risks involved.
- The experience of the financial crisis has given banks greater awareness of the risks of extending their balance sheets.
- Market-making practices have evolved to make more efficient use of inventory.
- And innovation in electronic trading has added to the data available for price discovery.

Several episodes over the past year or so have demonstrated the fragility of liquidity. Perhaps the most dramatic occurred on the 15th of October 2014 in the US Treasury market – usually the most liquid fixed income market in the world – when yields fell 29 basis points in just over an hour following the publication of not that surprising retail sales data. And on a number of occasions this year and last, our contacts have linked higher-than-usual volatility in corporate bond markets with reduced liquidity.

The risk is that this volatility could make it more difficult for corporates to issue new debt. Indeed, several times this year we have seen primary market issuance drop sharply in response to secondary market volatility.

In our view the regulatory reforms now in place should support the resilience of market-based finance though time. It is worth noting that corporates who really needed funding have generally been able to get it even in the most volatile periods in bond markets this year. And the recent pauses in issuance have lasted days or weeks rather than months – in contrast to the capital market shut-downs at times in 2008, 2009 and 2012. But the fact remains that the new market structure may be one in which seemingly benign conditions can change fast – in primary markets as well as secondary.

Higher rates, wider spreads, unforeseen shifts in demand and frequent bouts of volatility would not make for attractive – or predictable – issuance conditions. So let me clarify: my point is not capital market finance is intrinsically more prone to shocks than bank credit. Indeed the financial system is highly interlinked and separate elements of it will often be responding to common underlying shocks. But those shocks may manifest themselves different ways across the system. The more treasurers are cognisant of that, and invest in understanding how different shocks could affect the financing opportunities available to them, the better placed you will be to seize the opportunities that will lie ahead.

Evolution of market infrastructure

My second theme is the importance of investing in the infrastructure that underlies market-based financing.

As the Governor set out in his Mansion House speech, financial markets only contribute to prosperity if they are **resilient, fair and effective** and **maintain a social license**. But as you all well know, core financial markets manifestly failed to meet these standards in recent years. The underlying cause was that the key stakeholders in financial markets – authorities, intermediaries, and end-users – underinvested in the infrastructure supporting those markets.

The Bank is involved in a number of work-streams to correct these failings. But we will only succeed in this task by working cooperatively with market participants. So I want to highlight two areas that the Bank is actively working on and where corporate sector engagement will be important in coming years.

The first is benchmark reform in sterling fixed-income markets. In response to the Libor and FX benchmarks scandals, the governance and the calculation of key benchmarks has or is in the process of being enhanced. But we still face the challenge that Libor remains too prevalent. While data are not perfect, around £250 billion of corporate loans reference sterling Libor and it is the key interest rate in sterling derivatives markets, referenced by contracts with a notional value of approximately £25 trillion[3].

Yet in many of these contracts, users are looking to hedge the general level of interest rates, for which a near-risk free rate would be a more appropriate reference rate than Libor, which contains a bank credit risk component.

Recognising this, for around a year now the Bank has been working to develop and promote an alternative near risk-free reference rate. The aim of this work is to transition a significant portion of new derivatives contracts to the alternative reference rate, moving to a world where Libor is used when it is appropriate to account for bank credit risk, but not otherwise.

To succeed in this task we will need to overcome a number of substantial coordination challenges, including reaching consensus on the identity of the new risk-free benchmark and how any transition should be managed. To overcome these problems, the Bank established a Working Group of sterling swap market participants in March this year. The working group has made good progress and I expect that a concrete timetable for making a reality of this change should become clear during the course of next year.

[3] Source: DTCC. Including contracts reported to other trade repositories would likely result in a somewhat higher figure.

As users of derivatives, corporates will be affected by and have a potentially important role in actively supporting the eventual transition that will result from this work. And in any event, you will have to decide whether and how to adapt your own use of reference rates once the transition is underway. For that reason it will be important to engage with the Bank and the Working Group in coming months as and when firmer proposals emerge. The working group has already had initial discussions with the ACT but that dialogue will need to intensify.

The FX scandal highlighted weaknesses in the construction of key FX benchmarks. But it also highlighted a lack of harmonisation as well as inadequacies in the effectiveness of codes of conduct in guiding behaviour in those markets here and overseas. Earlier this year, major central banks launched an initiative to develop a new, improved, single code of conduct standards and principles to be applied across wholesale FX markets globally. The aim is to replace the existing patchwork of national codes with a single code and to develop mechanisms to increase adherence. The code will apply to all participants in global wholesale FX markets, including buy-side, sell-side and infrastructure providers. That will include large corporates accessing FX markets directly.

The work is being taken forward by central banks working with a group of market participants drawn from across the globe and representing all different types of business, including the corporate sector. This will be complemented by engagement with regional foreign exchange committees, including the Joint Standing Committee in London which I chair. The ACT sits on this committee and that provides an avenue through which the corporate sector can engage with the process. And it will be important to do so: the new global code will set out good practices in relation to market practices that matter to corporates such as information sharing and client order handling by the banks which undertake wholesale FX market transactions on their behalf. And it will also create obligations on corporate users of those markets.

The intention is to publish the new Code in May 2017, with interim guidance provided next May.

Looking beyond these specific examples, the forthcoming Open Forum will focus on the role of financial markets in society more broadly. This is an event that the Bank will be hosting on 11th November, bringing together every type of stakeholder in financial markets to discuss the progress of reform so far, and a map for the future. Colin Tyler of the ACT will be attending on behalf of corporate treasurers.

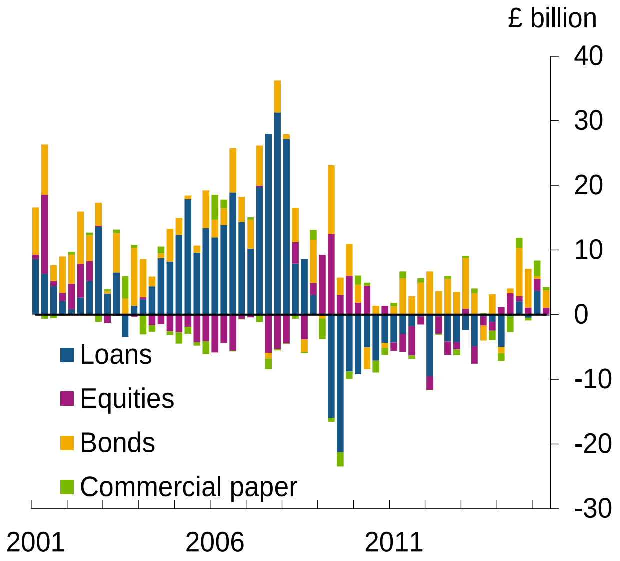
But that forum will be just one step in an ongoing process by which end-users should engage in the evolution of market infrastructure. There will be further opportunities for corporates to contribute to the development of initiatives to support the development of effective markets – including those such as the Capital Markets Union and the work of the new FICC Markets Standard Board that I have not discussed today. On a continuing basis, therefore, we will be calling on all end-users to participate in the effort to improve the effectiveness of markets and to help them maintain a social license.

I should summarise before I use up all your time and energy. The change in financing patterns since the financial crisis is welcome; and is consistent with the development of more diverse and resilient market-based finance, an FPC objective. But the changes we have seen require corporates to invest: in understanding the determinants of new funding sources and in ensuring that the infrastructure supporting these markets is robust and works in their interests as end users of these markets.

Thank you.

Charts

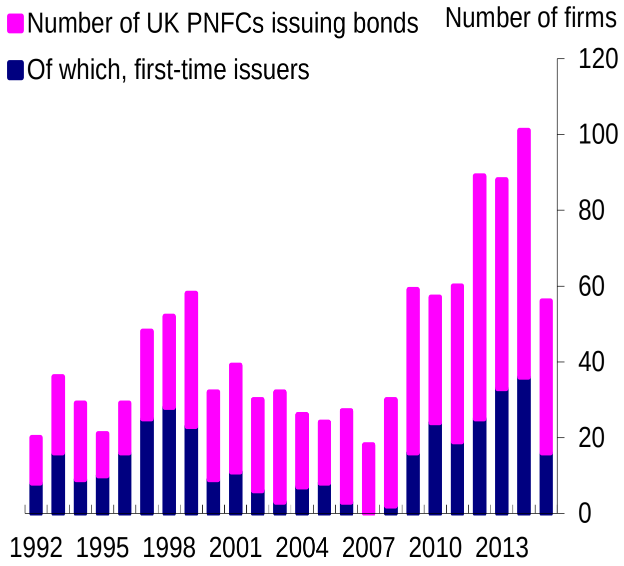
Chart 1: UK PNFCs' quarterly net external finance raised



Sources: Bank of England and ONS.

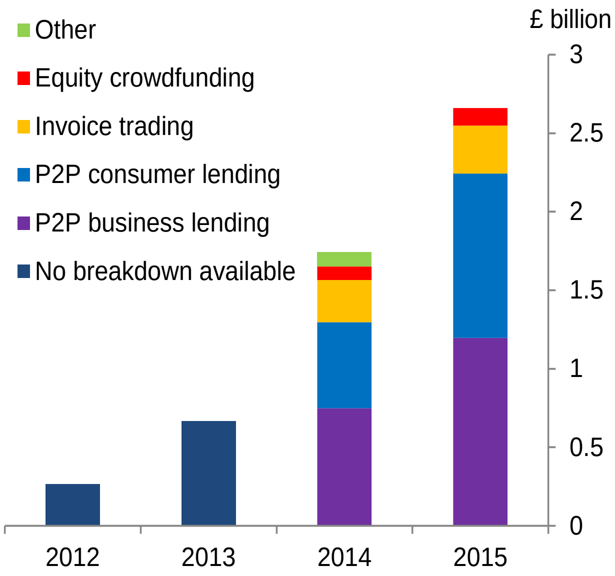
Finance raised by PNFCs from monetary financial institutions and capital markets. Includes sterling and foreign currency issuance. Bonds includes stand alone and programme bonds. Non seasonally adjusted.

Chart 2: Estimate of the number of UK PNFCs issuing bonds



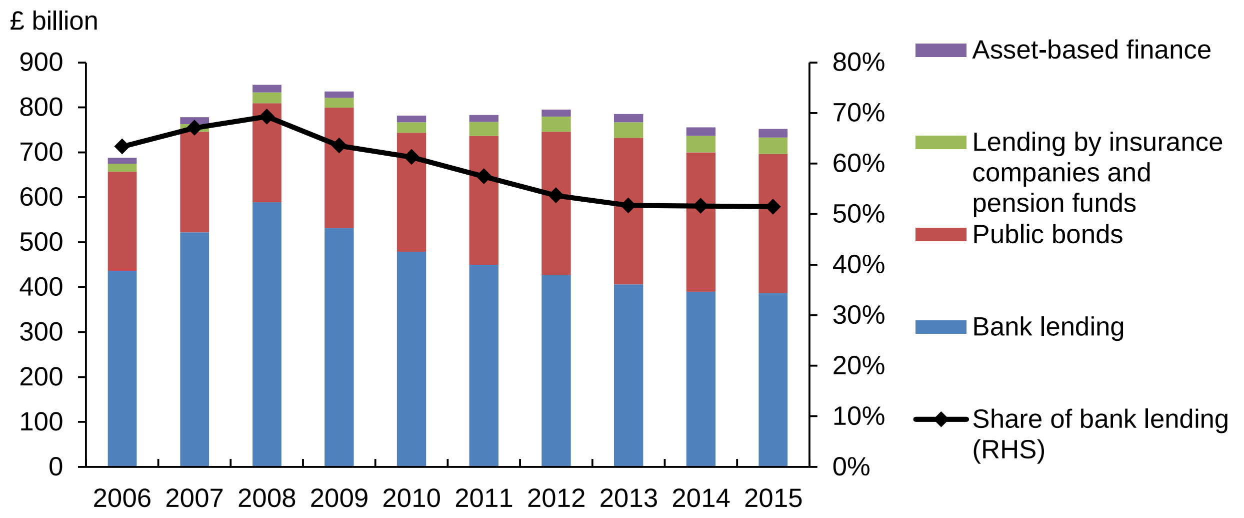
Sources: Dealogic and Bank calculations.

Chart 3: Gross flows of alternative finance



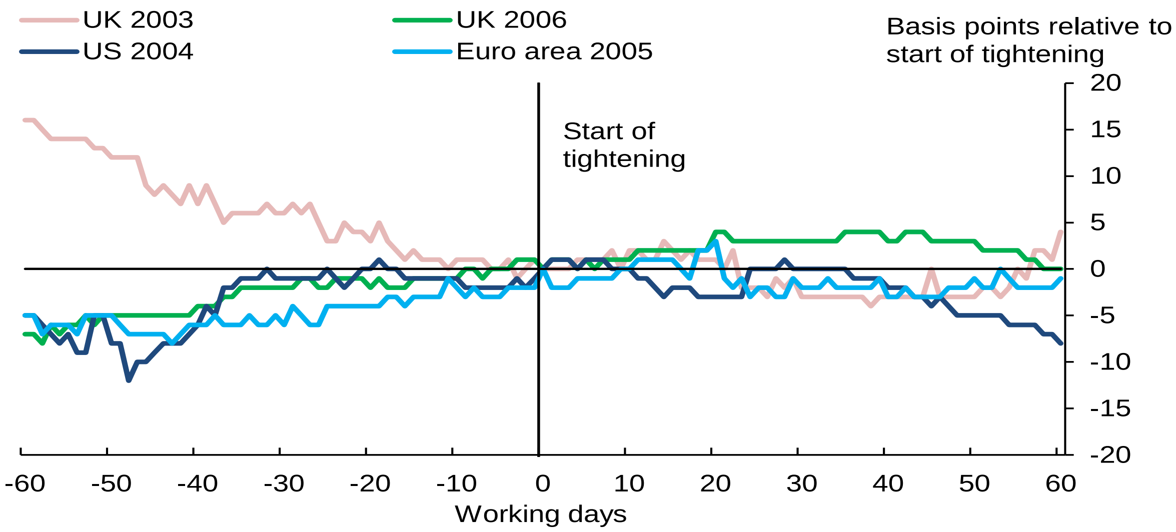
Sources: NESTA for 2012-2014, AltFi Liberum Volume Index UK for 2015 (data to 22 October, annualised).

Chart 4: UK PNFCs' stock of external debt



Sources: Bank of England, ONS, Asset Based Finance Association and Bank calculations.

Chart 5: IG corporate bond spreads around the start of recent monetary policy tightening cycles



Sources: Bank of America Merrill Lynch and Bank calculations.