Enabling broader access to the UK bond markets

A Winterflood white paper

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On 29 September 2023, the FCA called for responses to a series of Engagement Papers asking for feedback on potential amendments to the UK's capital markets.

"Engagement Paper 4: non-equity securities" really grabbed our attention.

In Engagement Paper 4, the FCA outlines its ambition to make bonds more widely available to retail investors by adopting:

- *a single disclosure standard* and even;
- *an incentivisation scheme* for more seasoned issuers who elect to use retail-inclusive low denominations

Winterflood is fully supportive of the FCA's proposals.

Retail's exclusion from the UK's regulated (largely investment grade) bond market is one of those things that just doesn't stack up.

It wasn't always this way. Before the implementation of the Prospectus Directive in 2005 there was just one bond market with no bifurcation between retail and wholesale issuance.

Prior to 2005, low denomination bonds were quite normal in the UK; wholesale and retail investors co-existed. But in 2005, everything changed.

In 2005, the Prospectus Directive gave issuers the option of quick, cheap and lower-risk disclosures if bonds were sold to wholesale investors only with £50k (more recently £100k) denominations or more detailed disclosures if they wanted to include retail.

Given *that* choice, there was only ever going to be one outcome.

What are the implications of a single form of disclosure?

Regulations change behaviour.

Overnight, the implementation of the Prospectus Directive in 2005 resulted in a switch *from low denomination retail-inclusive issuance to high denomination and wholesale-only bond issuance.* See Figure 1 and Figure 2.

Our interpretation of the FCA's proposal to implement a single form of disclosure is that this is intended to underpin a return to retail-inclusive bond issuance *by making it no more difficult to include than exclude retail investors by way of the required disclosures.*

Our assessment of a single disclosure standard is this:

- if the disclosure is the same irrespective of a bond's denomination, applying a low denomination is a no-cost option for issuers
- a low denomination will enhance distribution possibilities in both the primary and secondary markets. Retail and wealth managers present a largely untapped and additive source of demand.

Incentivising issuers: what if disclosure is easier when retail is included?

We agree with the FCA that the removal of the dual standard of disclosure is one way to address the exclusion of retail investors and wealth managers from the listed bond markets.

However, issuers won't be compelled to use low denominations – and so there's no guarantee that a single disclosure standard will change much at all.

So we are a pleased to see that the FCA has proposed an *incentivisation scheme.* This scheme proposes to reduce disclosure for seasoned UK-listed corporates or similarly seasoned companies who issue bonds with retail-inclusive low denominations.

We think that this scheme will be attractive for issuers who will be able to tap into retail demand in the primary and/or secondary markets without the present disclosure-related complications.

In our view, we think that the FCA's draft requirements for inclusion in the scheme are targeted at the types of issuers whose bonds retail and wealth managers will want: investment grade bonds from well-known listed and unlisted companies.

Figure 1

Average percentage of Sterling regulated bonds[1] with denominations of less than £2k

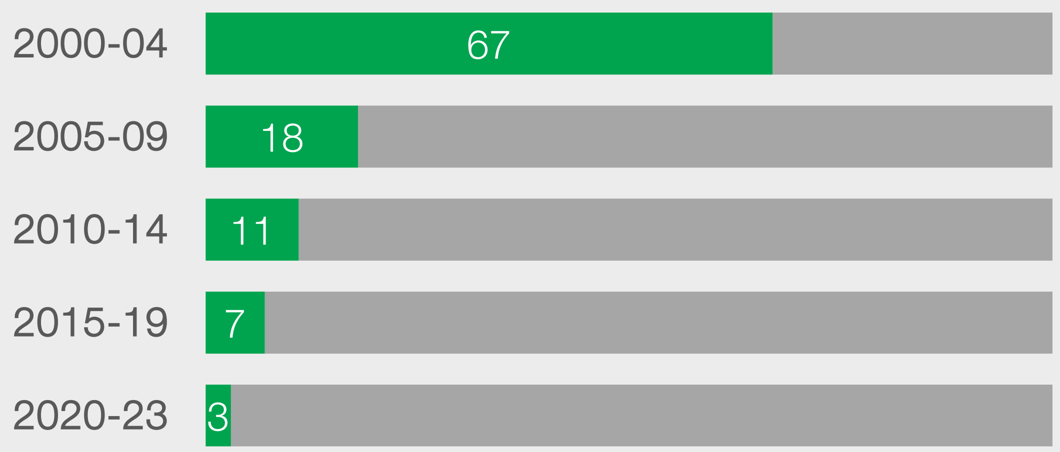
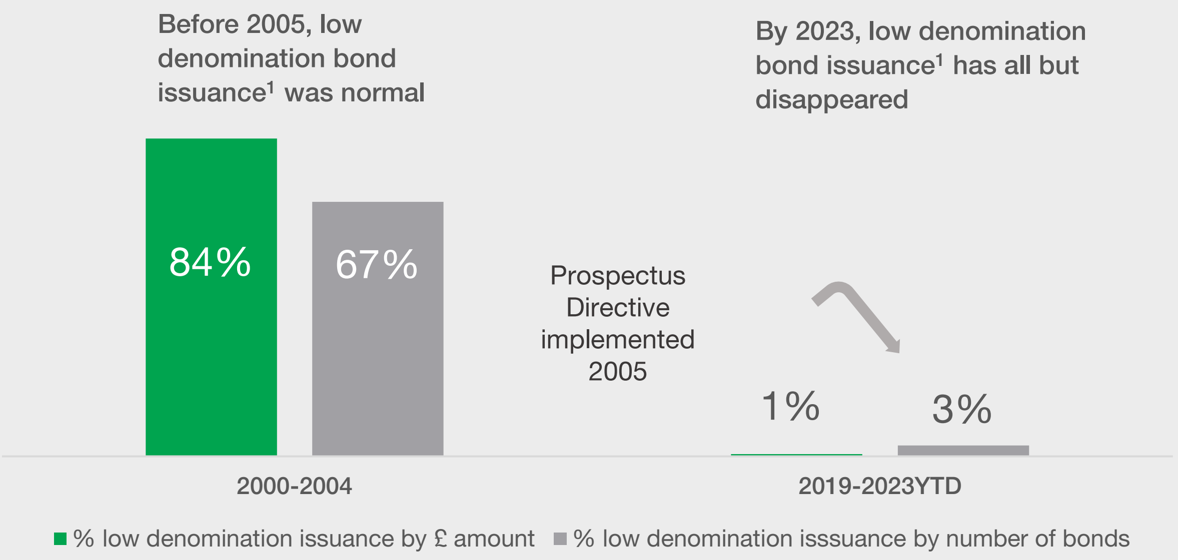


Figure 2

Low denomination bond issuance[1] and its demise since 2005



1 Source: Bloomberg, National Storage Mechanism, Winterflood Securities. The population of bonds includes regulated bonds in Sterling and excludes financial services/government agencies and supranationals

Figure 3

What retail could have had:	And here's what retail got:
£13 billion[1]	£20 million[1]
50 bonds	1 bond
94% investment grade	0% investment grade
13 industrial sectors	1 charity sector
36 issuers	1 issuer

1 The population of bonds includes regulated bonds in Sterling and excludes financial services/government agencies and supranationals

Retail in the bond markets – opening Pandora's box?

We are optimistic that the FCA's proposed amendments will make it easier for issuers to consider using low denominations.

Low denominations worked well in the past. We don't see any reason why they can't work again. We don't see any impediment to retail trading bonds in the secondary (we do this every day as a market maker in corporates and Gilts) or any insurmountable barriers to retail and wealth managers getting involved in the primary.

Undoubtedly, there will be concerns about what the FCA will be letting investors in for. But the view of the FCA (shared by us) is that the presence of institutional investors in bond transactions is a good thing and that this will lead to better outcomes for retail investors who take part.

More importantly, it's what our investors want: retail investors, their advisors and wealth managers want access to the same products as institutional investors but in low and therefore retail-inclusive denominations.

To examine what retail investors would have had access to if the FCA had enacted its plans this year, we looked at regulated Sterling bond issuance[1] to 24 September 2023. We also looked at what retail investors had access to in the new issue market. See Figure 3.

In short? As suspected, and unsurprisingly, the UK's regulated bond market is predominantly populated by plain vanilla investment grade bonds issued by well-known companies.

This year alone to 24 September and excluding a vast amount of issuance from financial companies, investors would have had access to £13 billion of issuance comprising 50 bonds from 36 issuers spread across 13 industry groupings.

Looking at this snapshot of 2023, there is a strong argument that the FCA's proposals are well targeted and if enacted, they should result in broader access to the best fixed income products *– the type retail want but can't currently access.*