Markets for Swedish non-financial corporations' loan-based financing

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This study aims to describe the Swedish non-financial corporations' debt-financing markets and discusses the future development of them. Numerous media reports and articles from financial analysts in the last couple of years have argued that structural changes are taking place. Corporations in Europe are said to be moving away from taking bank loans towards issuing corporate bonds, a development which started during the recent financial crisis.

This trend has not been clearly seen in available statistics for the Swedish debt markets following the crisis. However, Swedish banks and financial institutions have started preparing for a growing demand for Swedish corporate bonds. At the same time, many Swedish corporations have shown interest in expanding into the corporate bond market. However, numerous issuers, investors and intermediaries state that the Swedish corporate bond market is underdeveloped. They argue that transparency and liquidity in the market is poor. Also they argue that the available statistics for corporate bonds and loans are insufficient.

The new Basel III banking regulations are expected to increase the price for bank loans to corporations and to decrease the supply. Due to these changes, the Swedish corporate bond market may become more important for Swedish corporations' financing. Steps to develop the market may thus now be relevant. A more efficient corporate bond market may be a positive development for the Swedish financial markets. It could improve the efficiency of financial intermediation, better determine the price of credit risk in different maturities and increase the diversification options for Swedish corporations' financing. Further work is however needed to be able to develop an efficient Swedish corporate bond market.

1 We would like to thank Anders Nordberg, Daniel Sachs, David Forsman, David Kjellberg, Lars Nyberg, Lena Strömberg, Mia Holmfeldt and Sofia Kåhre for their useful comments, as well as the Swedish debt market participants that we have interviewed.

Changing markets

The majority of Swedish non-financial corporations' debt financing comes from bank loans. Apart from bank loans, Swedish corporations also use the money and bond markets locally and globally to obtain funding. The debt financing situation for Swedish non-financial corporations is therefore affected by the development of the credit markets. During the recent financial crisis, banks around the world became less willing to lend to corporations (Chui et al., 2010). Due to that fact, issuance activity in the global corporate bond markets increased substantially during the crisis. It increased especially in 2009 as corporations looked for alternative financing for bank loans (Fitch, 2010). Swedish corporations, for example, issued large amounts of corporate bonds in the euro market in 2009. Banks' lending to corporations has now recovered from the crisis.[2] On the other hand, new regulations may affect the loan market again in the near future. This will affect Swedish corporations and may lead to some structural changes in their debt financing.

Corporations are important for a country's economic prosperity and their access to financing is crucial for their operations. Efficient financial markets are therefore important for a country's economy, corporations' risk management, market efficiency and even the financial stability of the country. As an example, the absence of an efficient local debt market may force corporations to depend on borrowing from foreign lenders. This would imply a higher degree of currency risk since earnings and investments would not be denominated in the same currency as borrowing. Alternatively, companies may only have access to more short-term loans in the local currency, causing a higher degree of interest rate and refinancing risk for them (BIS, 2007).

Structural changes expected in Swedish non-financial corporations' debt financing will impact the Swedish financial markets. Therefore it is important to follow these changes.[3] With the above as a background, we wanted to investigate further the Swedish corporations' debt financing markets and obtain a better picture of the market situation.

In the first section, we map the markets for Swedish corporations' debt financing. This includes a description of instruments and an overview of statistics for the Swedish debt markets, i.e. bank loans and fixed-income instruments. In the second section, we analyse the debt markets. Issues discussed are new regulations that may impact Swedish corporations' debt financing, possible structural changes to debt financing, and market actors' views of debt financing and future developments. The analysis is mainly built on interviews with market participants and a survey which was sent out to corporations

2 Although, the growth of lending has not returned to pre-crisis levels yet.
3 Hereafter, we refer to Swedish non-financial corporations when we say Swedish corporations.

in March 2011.[4] Finally, we discuss how the Swedish corporate bond market can be developed.

Mapping the debt markets

SWEDISH NON-FINANCIAL CORPORATIONS' DEBT FINANCING

When discussing Swedish non-financial corporations' debt financing, we are referring to bank loans, corporate bonds and commercial paper. In this section, we give a basic description of these instruments, including a cost comparison of bank loans and corporate bonds.

Bank loans

A bilateral loan is provided to a borrower by one lender. Smaller corporations usually use bilateral loans as their main debt-financing source. According to the market participants, these are often called relationship loans. This is due to the fact that the lending banks have built customer relationships with the corporations over the years. The corporations then often feel secure in obtaining funding from their bank, based on their past relationship.

A syndicated loan is provided to a borrower by more than one lender. This enables large corporations to get credit in excess of a single bank's loan limit. Syndicated loans are traded on the secondary market and therefore have some resemblance to corporate bonds (Altunbas et al., 2009).

In addition to traditional term loans, corporations often have credit facilities in place, which are loan programmes that are drawn on by request. Some of the credit facilities are only meant to be used in cases of emergency, while others are used as overdraft facilities.

Fixed income securities

A corporate bond is a debt instrument issued to investors in the bond market, with a maturity of a year or more. There is a minimum size limit for issuing in the bond market (often 250 to 500 million kronor on the Swedish market). Issuing corporate bonds is thus more attractive to larger and medium-sized corporations. Usually, when a Swedish corporation issues a large bond, this is a syndicated bond, with two to five banks participating in the issuance.[5]

4 As the purpose of this study was to obtain a broader picture of the Swedish markets for bank loans and corporate bonds, we met with several market participants to help form our views. We interviewed banks, corporations and investors. We met with NASDAQ OMX Stockholm, where corporate bonds are registered. We met with representatives for the initiative to develop the Swedish corporate bond market, and with Svenskt Näringsliv (Confederation of Swedish Enterprise), which is to participate in developing the corporate bond market. We also attended seminars at which the bank loan and corporate bond markets were discussed by market participants and regulators. In addition, we sent out a survey in March 2011 to a number of Swedish corporations to get a better understanding of the markets. The survey results were published separately on the Riksbank's homepage in September 2011 (Sveriges Riksbank, 2011).

5 According to interviews with the Swedish banks.

A commercial paper is a short-term debt instrument issued in the money market, with a maturity of less than a year. It is thus similar to a corporate bond but with shorter maturity.

Cost of taking bank loans versus issuing bonds

The Swedish non-financial corporations mainly look at the cost of financing when deciding on a financing source. On the other hand, for various reasons, it is generally difficult to compare the cost of taking bank loans or issuing bonds. For example, there is not much public information available on the prices that individual Swedish corporations pay for their debt financing.

The interest rate cost of a corporate bond is a market price, but the interest rate cost of a bank loan usually differs depending on the corporation's business relationship with the lending bank. If the company also does other business with the bank, such as foreign exchange deals, swaps, deposits etc., the bank often takes this into account when pricing a loan. If the corporation does a lot of business with the bank, it can get a very good price. Larger, well rated, Swedish corporations can, for example, often get a lower price for their bank loans than the lending bank can obtain for its own funding on the market.[6]

With a bond, you pay the same interest rate over the lifetime of the bond, which is negotiated at the beginning, fixed or floating rate plus issuance fees. For a bank loan, on the other hand, the interest rate cost plus other costs can be variable, depending on when you take the loan and how much of the loan programme or credit facility the corporation uses.

Another factor that lenders usually look at when determining the price of a loan or a bond is the credit quality of the corporation. Credit rating agencies give corporations, and sometimes the debt, an official credit rating. This is usually preferred by bond investors – however, it is costly to attain for corporations.[7] With bank loans the lending bank itself estimates an internal credit rating for the corporation. These two ratings can differ. Banks may take other things into consideration compared with the rating agencies, such as the size of the corporation and the relationship history the bank has with it.

The administrative costs are more extensive when issuing bonds, compared to taking bank loans. As an example the documentation requirements are higher.[8] The cost of listing

6 According to interviews with the Swedish banks and corporations.

7 The yearly cost of having a credit rating from one rating agency is about 2 million Swedish kronor. In addition, someone needs to take care of the dialogue with the rating institution, which is an additional cost (according to interviews with market participants).

8 When taking a bank loan, the corporation has to sign a loan document. Banks do not charge for loan documentation, but the documentation cost is associated with having an external lawyer examine the contract. To issue a bond, the corporation needs to have a bond programme in place. One can, for example, have a European medium term note (EMTN) programme for the euro market or a domestic programme for the Swedish market. Having an EMTN programme costs about 1 million Swedish kronor a year, while having a Swedish programme costs up to 100 thousand Swedish kronor a year. The corporation then needs to have a prospectus for the bond programme and to issue a form of pricing supplement when issuing. The prospectus needs to be updated once a year. The cost of this is about half a million Swedish kronor a year. When issuing a bond, the corporation usually has to undertake a road show to introduce the company to investors. Road shows are usually included in the total price for the lead bank. On the other hand, it takes time and effort for the corporation to do the road show (according to interviews with market participants).

bonds on exchange is however not high, but one has to comply with IFRS standards to be able to list the bonds. About 95 per cent of the Swedish corporate bonds are listed on an exchange, which is often a requirement from investors.[9]

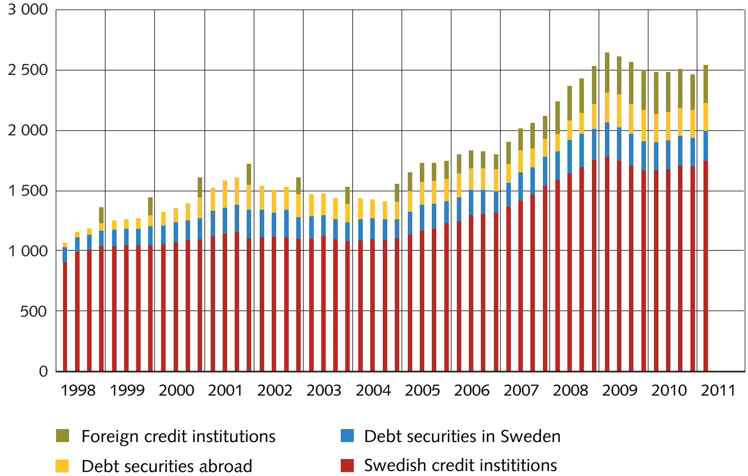
According to market participants, bank loans have generally been less costly for Swedish corporations in recent years, compared to issuing corporate bonds. This may explain why bank loans are a more popular debt financing source for corporations.

THE DEVELOPMENT OF SWEDISH CORPORATIONS' DEBT FINANCING

In this section, we focus on statistics available for Swedish corporations' debt financing.

Strong tradition and favourable prices have led to bank loans being the major debt-financing source of Swedish corporations. This is shown in the statistics from Statistics Sweden where bank loans count for about 80 per cent of the corporations' debt financing (see Chart 1). According to Statistics Sweden, Swedish credit institutions are the major lender to Swedish corporations as shown by the red columns in Chart 1. On the other hand, it is noticeable that, from 2008, outstanding market financing has increased (as represented by the yellow and blue columns in Chart 1), while outstanding bank loans decreased in 2009.

Chart 1. Outstanding debt financing of Swedish corporations
SEK billions



Source: Statistics Sweden.

According to Statistics Sweden, Swedish corporations are defined as non-financial corporations operating in Sweden. The statistics in Chart 1 include the total debt financing of the corporations, both Swedish parent companies and foreign companies' affiliates and subsidiaries operating in Sweden. Foreign affiliates and subsidiaries of Swedish corporations are therefore excluded.

9 Listing is not needed for private placement bonds (according to interviews with market participants).

Chart 1 does not include all loan-based funding as it does not show trade credits and so-called foreign direct investment loans (FDI).[10] Many Swedish corporations are part of international groups. Their borrowing within their own groups is referred to as FDI loans. These loans stand for an increasing part of the Swedish non-financial corporate sector's total financing[11], which means that their financing from abroad has been increasing. The chart therefore underestimates the foreign financing part.[12]

Statistics from Statistics Sweden do not always correspond with the information we have received from the Swedish banks and other secondary sources regarding the debt markets. The biggest disagreement seems to be on how much of the loan market is made up of syndicated loans and bilateral loans, and how much of the lending that comes from foreign banks.

In 2011 the Riksbank received the Swedish Parliament's approval to collect the data it requires directly from all market participants, even if these do not fall under the supervision of Finansinspektionen (the Financial Supervisory Authority).[13] This should improve the quality of the statistics for corporate debt in the near future.[14]

Swedish corporations' bank loans

The outstanding amount of bank loans to Swedish corporations amounted to 2001 billion Swedish kronor at the end of 2010.[15] Of this, 85 per cent of loans are given by Swedish credit institutions, according to Statistics Sweden. The majority of these loans are in Swedish kronor and euros.

There was a large increase in loans to corporations during the years 2003 to 2007, both in Sweden and in other Nordic countries, due to favourable conditions on the markets.[16] These loans will mature in the near future, particularly in the years 2011-2013, as can be seen in Chart 2.

10 Trade credits are the non-financial companies' foreign accounts receivable and accounts payable and they constitute a small share of the total financing.

11 According to estimations made by Sveriges Riksbank, FDI loans amount to about a quarter of total corporate financing.

12 According to Sveriges Riksbank.

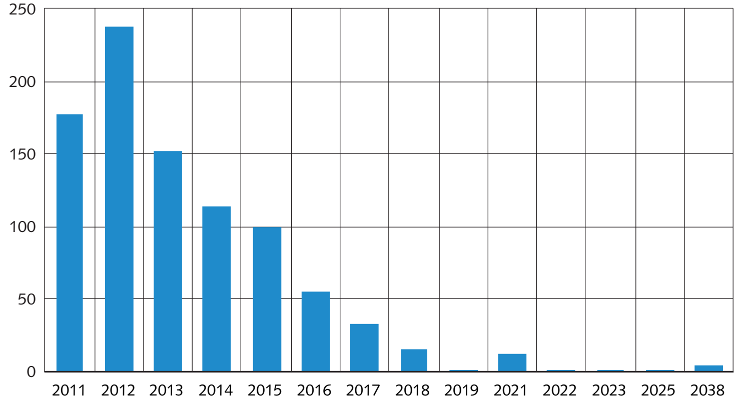
13 www.riksdagen.se. Sveriges Riksbank Act (1988:1385), amended as of 1 July 2011.

14 We have compared statistics from Statistics Sweden, Bloomberg, Dealogic and the Swedish banks. These data sources do not match each other, as these institutions may not have the same access to data or may use different definitions for Swedish corporations. Statistics Sweden, for example, obtains statistics from the Swedish banks on their lending to Swedish corporations, but does not have complete information on foreign bank lending to Swedish corporations (only a sample). Swedish corporations are not required to report their borrowing to any data source.

15 According to Nordea, 75 per cent of loans in the Nordic market are syndicated, while 25 per cent are bilateral. Statistics Sweden does not agree with this, stating that bilateral loans form the majority of loan financing for Swedish corporations (90 per cent of Swedish financial institutions' lending). On the other hand, no information is available from Statistics Sweden on the proportion of syndicated loans held by foreign financial institutions. Results from the corporate financing survey in March 2011 indicate that syndicated loans account for 38 per cent and bilateral loans for 62 per cent of the total Swedish loan market, based on a sample (Sveriges Riksbank, 2011).

16 According to interviews and reports from the Swedish banks.

Chart 2. Maturities of syndicated loans of Swedish corporations and their subsidiaries
SEK billions[17]



Source: Dealogic.

Swedish corporations' fixed-income financing

The Swedish kronor corporate bond market is small in an international comparison and is mostly dominated by large corporations. Those corporations are well known in the market and have no problem getting the financing they need, even in foreign currency markets. Outstanding amounts issued by Swedish non-financial corporations only account for about 6 per cent of the total Swedish kronor bond market.[18]

Outstanding commercial paper issued by Swedish non-financial corporations amounted to 61 billion kronor at the end of December 2010.[19] Nearly all of the issued commercial paper was issued in Swedish kronor. This market is important for corporations' short-term financing, but we do not focus especially on that market in this study. We, instead, focus on more long-term financing, which constitutes a much larger share of corporations' financing. In addition, there is not much data available on the corporate commercial paper market.

The largest and most developed market for corporate bonds in the world is the US market, where there is a strong tradition that corporations issue bonds rather than depend mainly on bank loans.[20] The euro market is not as well-developed as the dollar market and the tradition of taking bank loans rather than issuing bonds in the market is strong, as it is in Sweden (ECB, 2007). The euro market, on the other hand, has a size advantage over the

17 It is important to note that Dealogic does not cover all loans in the market since no one is required to report to them. It also does not cover small loans; therefore bilateral loans are not many in Dealogic. Chart 2 is therefore just an indication of the maturity profile of Swedish corporations. Swedish corporations will also need to renew their credit facilities which are not included in Chart 2.

18 According to Statistics Sweden.

19 According to Statistics Sweden.

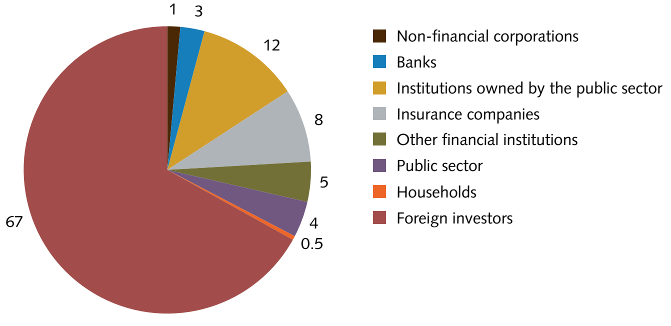
20 In the US, a largely low transparent secondary market in corporate bonds has been converted with careful regulatory and industry oversight, into a largely transparent one in the last few years. The TRACE system has been developed where individual trade information is published. Dealers have an obligation to report corporate bond deals to TRACE under a SEC-approved set of rules. This system may help the fact the US corporate debt financing is 70 per cent bond market financing against 30 per cent in bank loans. The US corporate bond market also has a strong investor base through its well-developed large money market fund market (González-Páramo, 2007).

Swedish corporate bond market, with a greater investor base, which often makes it a more liquid market than the Swedish kronor market.

The outstanding amount of bonds issued by Swedish corporations was 376 billion Swedish kronor at the end of December 2010. The majority of Swedish corporate bonds is issued in foreign currency, around 60 per cent of the outstanding total amount. The rest is issued in Swedish kronor.[21] The largest Swedish corporate bond issuers, issuing in both foreign currency and Swedish kronor, are Vattenfall, TeliaSonera, Volvo, Vasakronan and Atlas Copco. They account for more than half of the bond issuance. In total, there are about 70 Swedish corporate bond issuers.[22] Hence, it is evident that bond issuance by Swedish corporations is dominated by very large, often global corporations. Many major bond issuers have also ties to the Swedish government. They may therefore get a better credit rating, which enables them to get a better price and to have access to more investors in the markets.[23] The majority of the Swedish corporate bond issuers, on the other hand, do not have a credit rating.

The largest investor group in Swedish corporate bonds is foreign investors. They count for 67 per cent of holdings at the beginning of 2011, as can be seen in Chart 3.[24] Institutions owned by the public sector and insurance companies are the next largest investor groups in Swedish kronor corporate bonds. Retail investors (households) are not a large investor group, as the tradition in Sweden has been that private investors take credit risk in the equity market rather than in the bond market. In addition, it often requires larger amounts to be able to invest in corporate bonds.

Chart 3. Investors in Swedish corporate bonds at the beginning of 2011
Per cent



Source: Statistics Sweden.

21 According to Statistics Sweden. According to Bloomberg, 50 per cent is issued in euros, 33 per cent in Swedish kronor and 17 per cent in other currencies.

22 According to Bloomberg.

23 The ten largest Swedish corporate bond issuers according to Bloomberg are: Vattenfall 22 per cent (government owned), TeliaSonera 12 per cent (partly government owned), Volvo 11 per cent, Vasakronan 5 per cent (bought from the government in 2008, now owned by the Swedish pension funds AP fonderna), Atlas Copco 5 per cent, Investor AB 4 per cent, Ericsson 4 per cent, Sandvik 3 per cent, SCA finans 3 per cent, Akademiska hus 3 per cent (government owned).

24 According to Statistics Sweden.

The possibility for investors to invest in Swedish corporate bonds through funds has increased in recent years. Although, many institutions only offer those funds to larger investors. As an example, in Nordea's Institutionella Företagsobligationsfond, one has to invest at least one million Swedish kronor to be able to buy into the fund. Other fund companies, such as SEB Funds, Swedbank Robur, Öhman's and Case, offer corporate bond funds to retail investors, with minimum investing amount varying from 1 to 1 000 kronor.[25] Although there have been improvements, the market needs to develop further in order to make it available to more investors.

About 100 corporate bonds were listed on the NASDAQ OMX Stockholm (both issued by Swedish and foreign corporations) in 2010.[26] Listing has usually only been done to fulfil requirements of investors. There is not much trading on the exchange and the transparency of the market is poor. Trading of Swedish corporate bonds is mostly over the counter trading (OTC).[27]

Recent development of Swedish corporations' bonds

2009 was a record issuance year for Swedish corporate bonds, particularly in terms of bonds issued in foreign currency. In 2009, the euro market was very attractive to corporations in terms of pricing, and investor demand for corporate securities was good. The Swedish kronor market did not take off to the same extent as the euro market. Increased funding assistance by Svensk Exportkredit during the crisis may have impacted this (SEB, 2009) (Nordea, 2009-2011).

In 2010, the investment activity of corporations was low in Sweden and Europe. Swedish corporations had, in general, good capital bases. Many of them had for example prefunded the large bond maturities in 2010 and had positive earnings. Therefore the financing need of Swedish corporations was low, and issuance volumes were lower in 2010 compared to 2009, looking both at Swedish kronor and foreign currency financing of Swedish corporations (SEB, 2010). Swedish corporations' capital bases are still strong, although the level of issuances this year is already higher than in 2010, according to Bloomberg.

Although the issuance volumes of Swedish corporations decreased in 2010, some corporations issued bonds for the first time, such as Corem Property, Sagax, Kungsleden (real estate companies), Bonnier (media) and Mjölby-Svartådalen Energi (energy).[28] Some of these newcomers are so-called high-yield issuers.[29] According to market participants, high-yield issuance in Swedish kronor has increased substantially since 2008. Before there were no high-yield issues at all. The Swedish high-yield market is still very small, but it is

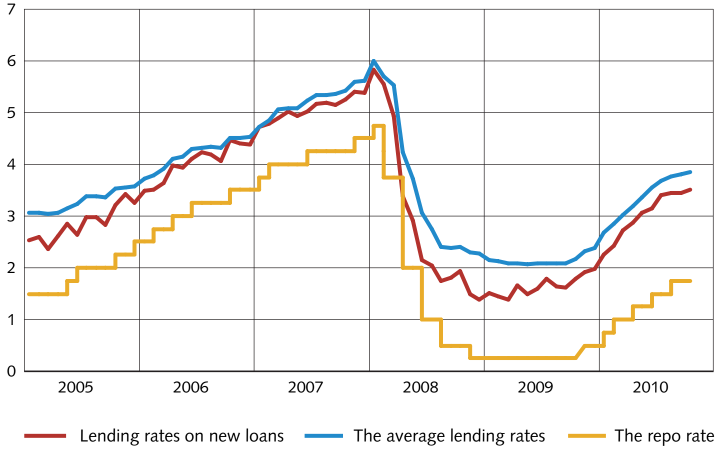
25 www.e24.se, "Företagsobligationsfonder endast för den insatta." June 2009.
26 According to NASDAQ OMX Stockholm.
27 Over the counter (OTC) trading means that the bonds are traded directly between a buyer and a seller instead of via organised exchange.
28 According to Bloomberg.
29 High-yield bonds are bonds rated below investment grade (rated BBB- or higher by credit institutions). High-yield bonds have a higher risk of default but, typically, they pay higher yields than higher-quality bonds in order to make them attractive to investors.

developing. In 2010 these amounted to 17.4 billion kronor.[30] As a comparison, the high-yield markets in the euro area and in Norway have been established for many years, as there has been more investor interest in high-yield bonds in these regions.

One reason for the increased issuance of high-yield bonds is that corporations with low ratings argue that the prices for their bank loans have increased and they are therefore seeking financing alternatives by issuing bonds.[31] To support this, Chart 4 shows that the increased average lending rates to Swedish corporations cannot only be explained by the recent increases to the Riksbank's repo rate.

The high-yield market has been expected to keep expanding during 2011, as investors search for yield in the low interest-rate environment. However, the increased financial turmoil during the summer has impacted this development, as investors prefer safe investments with low risks in uncertain times. In addition, in a longer perspective the demand for high-yield bonds may decrease if major central banks start hiking rates to a greater extent.

Chart 4. Swedish banks' lending rates to Swedish corporations
Per cent

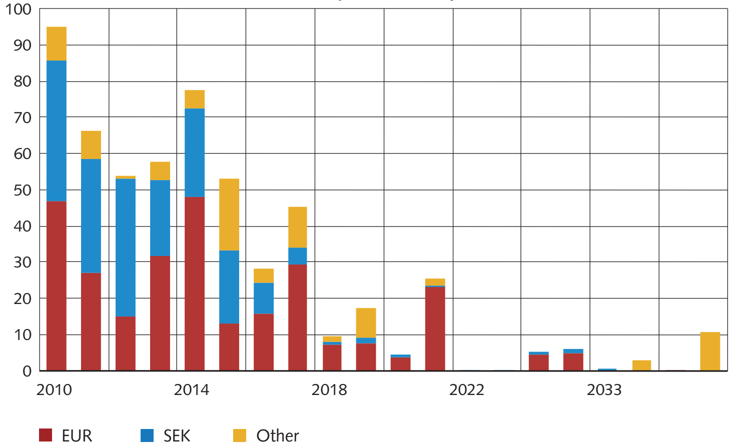


Source: Statistics Sweden.

Looking at Bloomberg's statistics in Chart 5, we see that there are relatively large bond maturities for Swedish corporations in the coming years, especially in 2014. On the other hand, the maturities in 2010 were the largest in a long time. However, it did not cause problems in the market, as many corporations had, as previously mentioned, prefunded the upcoming maturities during 2009.

30 Dagens Industri, February 2011.
31 According to news reports and Sveriges Riksbank (Sveriges Riksbank, 2011).

Chart 5. Maturities of bonds issued by Swedish corporations



Source: Bloomberg.

Alternative debt-financing sources for Swedish corporations

In addition to traditional bank loans and fixed income securities, Swedish corporations have had access to alternative financing sources or assistance. This support comes, for example, from Svensk Exportkredit (SEK), Exportkreditnämnden (EKN) and Proventus Capital Partners.

SEK's mission is to secure access to financial solutions for export companies. SEK's services include export credits, lending, structured financing, project financing and leasing, as an example. SEK has been of assistance to Swedish corporations, especially during the crisis, when it increased its lending to Swedish corporations substantially. According to SEK, its outstanding loans to Swedish corporations amounted to 49.6 billion kronor, while its loans to Swedish corporations' subsidiaries amounted to 17.6 billion kronor at the end of September 2010.[32] In addition, SEK lends to foreign corporations that buy Swedish exports, which further helps Swedish corporations' operations.[33]

EKN is commissioned by the Swedish government to promote Swedish exports and the internationalisation of Swedish companies. It does so by insuring export companies and banks against the risk of non-payment in export transactions, thereby enabling them to conduct more secure export transactions. EKN, for example, provides guarantees for export payments. During the crisis, it is also guaranteed credit/loans to corporations often issued by SEK, with which it works closely. EKN takes 75 per cent of the risk in such loans.[34] EKN has been criticised by the banks, who claim that it takes "normal" business away from the market by offering these guarantees, as it provides corporations with lower interest rates than are available on the market.[35]

32 These are both direct loans and loans via buying bonds issued by these companies.
33 www.sek.se and Svensk Exportkredit's quarterly reports.
34 As an example, Ericsson obtained a loan in 2009 from SEK with a guarantee from EKN for 4.6 billion kronor (625 million dollar).
35 Svenska Dagbladet, "Statliga EKN får från kritik", 28 July 2010.

Proventus Capital Partners has been active in the corporate market from 2005 and announced in May 2011 that they were launching a new structure. Proventus will be lending 5.3 billion Swedish kronor to medium-sized Nordic corporations that need financing, for example for acquisitions and restructuring. Institutions such as Fjärde AP-fonden, Folksam and Länsförsäkringar are co-investors with Proventus Capital Partners.

Analysis of the debt markets

NEW REGULATIONS AFFECTING SWEDISH CORPORATE DEBT FINANCING

Basel III

The Basel III banking regulations will require banks to hold more capital of better quality and at the same time improve liquidity. The regulations will be introduced step by step over the coming years, starting in 2013. However, due to market pressure, the banks may be forced to comply with the rules earlier. It is difficult to estimate the effects of the regulations, as they impact different parts of the banks' operations and also due to the long implementation period from 2013-2019. According to the Riksbank, the four major Swedish banks already have sufficient capital to fulfil the new capital requirements.

However, analysing the effects of the new liquidity rules is more challenging. The banks have to improve their Net Stable Funding Ratios[36]. This can be done in many ways, for example by changing the conditions for deposit accounts, by reducing commitments and assets requiring stable funding, and by extending short-term funding to long-term funding. With greater liquidity buffers, banks will generate a lower return than they would if they had kept other assets instead. Also, by increasing the maturity of their funding, banks usually have to pay higher interest rates for their borrowing. The banks can pass on the increased costs to their customers, for example by increasing lending spreads or charging higher fees for their services. The Swedish banks may also choose to decrease the lending or try to lower the maturities on the loans they provide and to decrease the size of credit lines.

Depending on how the banks will act, the new regulations may impact corporations directly with lower corporate loan supplies, higher borrowing rates and increased refinancing risk. Alternatively, the banks' shareholders may accept a profitability that corresponds to the lower risk. That implies that the banks do not have to pass on the new costs fully to the customers.

36 The Net Stable Funding Ratio (NSFR) requires a bank's stable funding to be greater than the bank's need for stable funding. The NSFR specifies the percentage of different types of debt that are considered to be stable and the percentage of the various assets that are considered to need stable funding. For example, securities issued with a maturity of more than one year and deposits with a maturity of more than one year are classified as 100 per cent stable funding, while loans from financial firms maturing in less than one year are not considered to provide any stable funding (Sveriges Riksbank, 2010).

Solvency II

Through their significant holdings of financial assets, insurance companies, particularly life insurance companies, form an important part of the financial system. The Solvency II regulations will likely enter into force in the spring of 2014. These regulations may significantly change the investment strategies of insurance companies. They may, in turn, impact financial markets (Sveriges Riksbank, 2010).

The current solvency capital requirement of life insurance companies is mainly based on the size of the companies' commitments. Under the new Solvency II regulations, the capital requirement will be based on the insurance risk existing in the insurance companies' operations and on the risks arising when these companies invest in financial assets. It is presently unclear how large the solvency capital requirement will be for the insurance companies under Solvency II. If their capital base is less than the new solvency capital requirement, they will have to reduce their risk. They can do that by increasing investments in financial assets with the lowest capital requirement, which are government bonds and covered bonds. At the same time, they can reduce their holdings of other financial assets. According to a Bank of International Settlements (BIS) report, Solvency II will make it more difficult for insurance companies to play their traditional role as global providers of long-term risk capital. The proposed changes will, for example, tend to make it more expensive for them to hold low-rated corporate bonds (BIS, 2011).

At present, the Swedish insurance companies hold about 8 per cent of bonds issued by Swedish corporations, corresponding about 25 per cent of outstanding Swedish kronor bonds. There is still uncertainty regarding Solvency II but at present, the rules do not encourage insurance companies to invest larger amounts in corporate bonds. At the same time, many say increased investment by insurance companies is crucial for the further development of the Swedish corporate bond market. In addition, according to the proposed regulations, it may be better for some corporations not to have a credit rating. This is because it will be more advantageous for insurance companies to invest in non-rated companies than in corporations with lower ratings than BBB, i.e. companies with high-yield bonds.[37]

Markets in Financial Instruments Directive (MiFID)

The European Commission has proposed to increase the transparency of the corporate bond market within the framework of MiFID. According to the proposal, the key rationale for transparency is to provide investors with access to information about current trading opportunities, to facilitate price formation and to assist firms in providing the best execution for their clients. It will provide information that enables users to compare trading

37 Danske Markets, June 2011. Companies can then, for example, have the rating institutions give them a secret rating, just to know at what level they would be rated. If this level is not satisfying, they can choose not to be rated publicly.

opportunities and results across trading venues. Post-trade transparency is also used for portfolio valuation purposes (European Commission, 2010).

MiFID is set to be adopted in Sweden in the next few years. Post-trade transparency is to be increased by making the International Securities Identification Number (ISIN) codes, coupons, maturities, ratings, issuers, currencies, prices, volumes and so on of all trades public. Although, some exceptions to the rules may be made. By implementing the MiFID regulations, the hope is that more issuers and investors will be interested in the Swedish corporate bond market, resulting in increased liquidity.

However, not everybody agrees that increasing transparency will only be a positive development. In a small market like the Swedish corporate bond market, it may, instead, be inhibiting. This is because the number of issuers and investors and the size of the bonds are small. So, with these regulations, it may be possible to figure out more information than is needed for the market to function well according to some. This is an argument mostly made by banks. They are worried that the increased transparency might reveal market makers' positions. This may result in unfavourable prices for the market makers, who may become unwilling to take on some positions. Today, market makers often have a head start when it comes to see what happens in the market. If all have access to market information and volumes at the same time, the risks for those who buy and sell on their own behalf increases (Nyberg et al. 2006). This may, in turn, lead to fewer being interested in being market-makers, which could decrease liquidity in the market.

There are therefore different views on how the proposed MiFID regulation will affect the Swedish corporate bond market.

STRUCTURAL CHANGES TO THE SWEDISH CORPORATIONS' DEBT FINANCING?

Based on the above overview of Swedish non-financial corporations' debt financing, it is clear that some structural changes may be forthcoming in the near future. The Swedish corporations will be facing large maturities on both the loan and the bond markets. And with the Swedish economy recovering, they may want to invest more. This implies that the corporations probably will have large financing needs in the nearest future, even though their capital base now is strong. At the same time, the supply of loans to corporations may become more limited or at least more expensive under the Basel III regulations. A new period of global financial turmoil may also cause banks to hold back on lending to corporations.

The Swedish banks are well-capitalised. They should therefore not need to decrease the loan supply to Swedish corporations to a large extent in order to comply with the Basel III regulations, although they may want to decrease the maturities of the loans.[38] However, the price for the loans may increase with the new regulations.

38 Swedish banks have stated that they should not have problems in extending the loans given to corporations when they mature.

Nevertheless, it needs to be kept in mind that foreign banks also stand for a certain share of Swedish corporations' bank loans.[39] On average, foreign banks' capital positions may not be as strong as those of the Swedish banks (Peters, 2011). There is therefore a risk that the foreign banks may not be able to continue lending as much as previously to corporations outside of their country, according to the Swedish banks. If foreign banks, on the other hand, renew the loans, they will, at least, be likely to demand a higher price for the loans due to the new regulations and because Swedish corporations often do not do any other business with them. If lending from foreign banks decreases or becomes too expensive, Swedish corporations will likely turn to the Swedish banks instead. There will then be a risk that demand will exceed the Swedish banks' ability to lend to the corporations. The corporations may therefore need to seek other financing sources.

When bank loans became limited during the crisis, corporations started issuing corporate bonds to a greater extent as an alternative financing source to bank loans (European Commission, 2010). Under the upcoming regulations, the change from loans to bonds for corporations may thus become more permanent with less supply of and increased prices for the loans (unless some other financing source, such as equity, is more attractive).[40] We believe bank loans will, on the other hand, remain the number one debt-financing source of corporations, especially credit facilities.[41]

No clear trend has yet been seen in statistics for suggesting that Swedish corporations are moving from taking bank loans to issuing bonds, even though there has been some increased interest in high-yield Swedish corporate bonds. There have, however, been numerous news reports discussing this trend in the last couple of years. Swedish banks and financial institutions have, on the other hand, started preparing for a growing demand for Swedish corporate bonds as the implementation of the Basel III regulations gets closer. For example, during the spring, some of the major Swedish banks have expanded their departments responsible for managing corporate bond issuance. In addition, a few smaller financial institutions have developed departments focusing on the corporate bond market.[42]

39 Nordea, SEB and Statistics Sweden disagree on how large the share held by foreign banks is, as they disagree on how large the syndicated loan market is. As an example, Nordea says syndicated loans form 75 per cent of the total Nordic loan market, while Statistics Sweden indicates that they form no more than around 23.5 per cent of the total Swedish market with the rest being bilateral loans. Nordea and SEB say that foreign banks stand for about 50 per cent of the syndicated lending (or about 37.5 per cent of total lending), while Statistics Sweden says this is only 15 per cent of total lending (excluding FDI loans). Dealogic's statistics indicate that foreign banks stand for a share closer to 50 per cent of syndicated loans.

40 Corporations may see an advantage in issuing corporate bonds over equity, for example to keep control over their company as equity holders, or, get voting rights for their shares (Veckans affärer, "Hotet mot Börsen," June 2011).

41 According to interviews with the Swedish banks and corporations.

42 According to interviews with the Swedish banks. Smaller financial institutions, such as ABG Sundahl Holding, Carnegie, Catella, and Proventus, have also developed their departments focusing on corporate bonds (Bloomberg and Affärsvärlden, February 2011).

MARKET PARTICIPANTS' VIEW OF SWEDISH CORPORATIONS' DEBT FINANCING AND ITS FUTURE DEVELOPMENT

In this section, we present the views of Swedish corporations, banks and investors on the current debt-financing situation of the corporations and on its future development. We will focus particularly on the development of the Swedish kronor corporate bond market. That market is more accessible than foreign markets to Swedish corporations of all sizes but, of course, corporations can also choose to issue bonds in foreign bond markets.

Swedish corporations' view of bank loans and bonds

Based on interviews with a number of corporations in 2010 and 2011, we have drawn the conclusion that their view on debt-financing sources and the financing situation depends on their size. This is also in line with the results we obtained in the Riksbank's corporations' financing survey (Sveriges Riksbank, 2011).

During the financial crisis, medium-sized and smaller corporations found it more difficult to obtain debt financing.[43] Many of those say it is still more challenging to get funding than before the crisis, especially when it comes to getting longer-term funding. Some even say that they have seen the price of bank loans rising recently.

Consequently, a few medium-sized corporations have issued bonds for the first time recently or are planning to expand into the market to attain a more diversified financing structure and due to the increasing prices. Smaller corporations have less knowledge of the upcoming regulatory changes to the financial markets and the Swedish corporate bond market. Therefore, they show less interest in this area.

On the contrary, very large corporations state that the price offered for bank loans today is very good and that the banks have not yet adjusted to the new Basel III regulations. They say that they have no problems in obtaining funding at present. It is important to note, however, that the largest corporations have full access to both the loan and bond markets in Sweden and internationally, which smaller corporations may not have.

In the Riksbank's financing survey (Sveriges Riksbank, 2011), a number of corporations said that increased prices for bank loans could push them to search for alternative financing sources, such as the issuance of corporate bonds. Due to the cost issues mentioned above, medium-sized corporations may now have the greatest incentive to expand into the corporate bond market. The larger corporations already often have access to this market, while the smaller companies may consider it is too costly to participate in. However, corporations of all sizes generally believe that financing through bank loans will always remain as the main debt-financing source. It is very important for them to have credit facilities in place to have access to secure funding when needed.

43 According to Statistics Sweden, small companies have fewer employees than 50. Medium sized companies have employees from 50 to 250 and large companies have 250 employees or more. Other estimates could also be used to categorize companies such as the size of the company's balance sheet.

Many of the companies that, in the survey, said they have interest in expanding into the corporate bond market also mentioned that they see some limitations to the Swedish market. Examples of such limitations are low transparency, limited volumes, low liquidity and vulnerable market. Corporate bond contracts in Sweden are also difficult to understand as there are no standardised contracts available.

All of the corporations we interviewed were positive towards taking steps to develop the Swedish corporate bond market.[44] They believe that the initiative to develop the market has to come from all market participants: issuers, investors and intermediaries. They see increased transparency in the corporate bond market as an improvement. They suggest that credit analysis could be done just like equity analysis to attract more investors. They think a well-functioning Swedish corporate bond market could, for example, be important to decrease corporations' currency risk, as the foreign exchange swap market often does not function that well. In addition, medium-sized and smaller corporations often do not have access to foreign bond markets, so a well-functioning Swedish market would be a good financing alternative for them. The overall view is that now would be a good time to start up the Swedish corporate bond market with the upcoming banking regulations. Some corporations, for example, are worried about being too dependent on bank loans.

A few of the corporations we interviewed or which participated in the survey stated that they believe that banks are negative towards developing the corporate bond market, due to how profitable corporate loans have been for them in the past. They believe the banks are an important factor in pushing ahead with this development since they have central functions when issuing bonds.

Swedish banks' views of bank loans and corporate bonds

We met with some of the Swedish banks and discussed the Swedish corporate debt-financing situation and asked if they believe corporations will start using the corporate bond market more for their financing.

The banks' views vary, but all of them said that, at present, it is generally less expensive for corporations to borrow from banks than to issue corporate bonds. That is the main reason why corporations continue to prefer bank loans over corporate bonds. A lot of work also comes with issuing in the bond market, which the corporations may want to avoid (bond programmes, road shows, getting a credit rating, etc.). Economies of scale also matter as, proportionally, it is more expensive to issue a smaller-sized bond than a larger-sized bond. Consequently, issuing in the market may not be attractive for smaller corporations.

It needs to be kept in mind that, over the years, banks have earned well from providing bank loans to corporations, and may want to hold on to that business for as long as they can. This may affect their view regarding this trend. The banks may, nevertheless, become more interested in the market if it develops and liquidity increases. The banks will

44 Note that all of the corporations we interviewed are already participants on the bond market.

then see some profit prospect in the market through bid ask spreads and more corporate clients. In addition, they may be able to profit from taking care of the issuance of bonds for corporations, at the same time as they decrease the risk on their balance sheets by providing fewer loans to corporations. The reason for this is that corporate bonds have no balance sheet impact for banks.

However, the banks do point out the fact that the price situation for corporations may change after the new Basel III regulations have been implemented. At this point, the banks will have to preserve more capital per loan, the available liquidity pool for bank lending will decrease, and funding costs for corporations will increase (Nordea, 2010). Consequently, the difference in the cost of taking bank loans and issuing bonds may get smaller for corporations in the near future, which may make them evaluate their financing options. As mentioned earlier, the banks have already started preparing for this change by enhancing their units that focus on corporate bonds.

Investors' views of the Swedish corporate bond market

Many investors see an opportunity to invest in Swedish corporate bonds, as this is associated with less risk than the equity market, but a decent return can still be had. Some Swedish insurance companies may be interested in buying more corporate bonds instead of investing in equity. However, in some cases, their investment policy needs to be changed for that to be possible.[45] The new Solvency II regulations for insurance companies will, on the other hand, likely restrict this development. At present, there is, on the other hand, a lot of uncertainty over how the regulations will affect insurance companies' investment decisions.

Retail investors could also become more interested in investing in corporate bonds if there were more corporate bond funds available for them to invest in. However, for more investors to be interested in the Swedish corporate bond market, the market would need to become more transparent and liquid, and the supply in the market would need to be higher.[46] Investors should follow the development of the financial markets and follow new opportunities for investment when new asset classes appear and evaluate the risk that they are taking on both in bonds and equity investments (Nordea, 2010).

DEVELOPING THE SWEDISH CORPORATE BOND MARKET

This section will mainly focus on the development of the Swedish kronor corporate bond market, of which both Swedish and foreign issuers are a part of (although foreign issuers are a minority).

45 From discussions with a number of insurance companies.
46 Corporate finance conference, IVA, 7 September 2010.

Increased interest in the market

As stated above, the Swedish corporate bond market is underdeveloped. Statistics are not complete and transparency regarding price and turnover is poor,[47] liquidity is low, investors mainly buy and hold the securities, there is no trustee function to protect the rights of both issuers and investors in corporate bonds,[48] and there are very diverse terms between bonds

In the past, there has not been much incentive to develop the market as corporations, banks and investors have been very set in their ways. Developing the market has, on the other hand, been a topic in Sweden for more than a decade. An article in Affärsvärlden from 1999, for example, discussed how corporations should start to consider using market financing to a greater extent, as international banks were decreasing the supply of loans. Increased corporate bond issuance in Sweden was also discussed in the Riksbank's second Financial Stability Report from 1999, stating that this diversification of corporations' financing is a positive development.

Based on the Riksbank's survey and our interviews, there now seems to be increased interest from investors, issuers and even banks in further developing the Swedish corporate bond market as the implementation of the new Basel III regulations approaches. The MiFID regulations will then increase the transparency of the market, which may increase investor interest in it. But the problems in the market will not be solved on their own. There needs to be a joint push by all market actors, including corporations, investors, financial institutions and even regulators, to start up the market. If more corporations, for example, ask to issue in the market, this will help the developing process. History, on the other hand, shows that developing the market can be a long process.

A better-functioning corporate bond market in Sweden could improve the efficiency of financial intermediation in Sweden. It would provide more financing alternatives and diversification for the Swedish corporations that mostly need Swedish kronor financing (and perhaps decrease the foreign exchange risk and currency mismatch of corporations). Corporations may also receive more long-term financing from the market, which would provide a more stable working environment for them and less refinancing risk, especially at a time when the banks may try to decrease the maturities of their loans to corporations due to new regulations.

47 Turnover statistics are missing. Euroclear sees the turnover flows but, legally, it cannot publish the data. Market makers can then only see price and turnover for their own bonds.

48 A bond trustee is an independent third party who can play a critical role in acting as a bridge between the borrower and holders of its debt securities during the life of a loan capital issue. The Bond Trustee shall exercise the discretions provided in the Loan Agreement. About 95 per cent of the issues for example on the Norwegian bond market have a Bond Trustee. Benefits for borrowers of having a bond trustee are that they can relate to only one single legal entity as creditor, and discuss any necessary confidential matters and disclose price sensitive information to the Bond Trustee. The Bond Trustee also protects the borrower from bondholders making arbitrary proceedings as an example. The benefits for the investors of having a Bond Trustee are that they then have professional monitoring of the terms and conditions of an issue to protect their interest. Legal action can be taken by the Bond Trustee as a class action on behalf of all bondholders. In a default situation the Bond Trustee will be able to take possession of assets and negotiate on behalf of all bondholders (Norsk Tillitsmann, 2006).

With a larger, more efficient market, a better price for credit risk can be determined from actual bonds available on the market. That, in turn, could lead to a more efficient pricing of derivatives in Sweden. Foreign issuers and investors may then also become more interested in the Swedish market, which could increase the investor base for Swedish corporate bonds. In addition, with increased market financing of corporations, credit losses of banks may be reduced since corporate bonds have no balance sheet impact for banks. The banks may also benefit from a greater number of credit opinions regarding the borrowers on their books, as investors will need information about what they are investing in (Fitch, 2010).

On the other hand, it needs to be taken into account that markets may often suffer from irrational behaviour, especially in times of crisis. Smaller and less liquid markets such as the Swedish corporate bond market may be more vulnerable than larger markets in such times. It can therefore be argued that pushing corporations into such a market is not necessarily a positive thing. However, if companies expand their options and gain access to both bank loans and the corporate bond market, they should not be worse off than they would be if they only had access to one source of debt funding.

Initiatives taken to develop the Swedish corporate bond market

In the last couple of years, an initiative from market participants has been taken to develop the Swedish corporate bond market.[49] The initiative suggested five steps that can be taken to improve the Swedish corporate bond market:

1. *Increase transparency*: At present, the pricing of portfolios is impaired by the lack of *available* prices in the market. To improve this, the initiative suggests that a certain level of post-trade transparency is introduced, which will lead to better market statistics, improve the possibilities to launch a Swedish corporate bond index and improve liquidity over time. One argument is also that MiFID is likely to lead to increased transparency being forced in any event.
2. *Improve corporate governance through self-regulation:* The corporate bond market is in need of common structure and standardisation.
3. *Establish a trustee function*: The trustee would, for example, manage corporate restructuring cases for the investors (see footnote 48).
4. *Modernise and adapt investment policies*: Today's investment policies, for example for life insurance companies, often limit investment in corporate bonds.
5. *Open up the corporate bond market for more issuers/investors*: For more corporations to be able to issue in the market, the minimum amount for issuance needs to be decreased. The minimum amount for trading also needs to be

49 Daniel Sachs (CEO of Proventus Capital Partners) and Erik Thedéen (former head of NASDAQ OMX Stockholm) started the initiative to develop the corporate bond market in Sweden (Upprop: Fem steg till en bättre obligationsmarknad).

decreased.[50] More banks and fund companies then need to offer these investments to retail investors on exchanges, as is done in the equity market.

As a consequence of the above market initiative, the Confederation of Swedish Enterprise (Svenskt Näringsliv) has decided to investigate the Swedish corporate bond market. They are to explore why the market is underdeveloped and how it can be developed.[51]

Much work remains

At present, it is clear that the Swedish corporate bond market is underdeveloped. Transparency is poor and the available statistics for both bank loans and corporate bonds are not sufficient. On the other hand, it is likely that new regulations will have an impact on corporations' financing structures in the near future. To what extent we can expect structural changes is however unclear. Due to the changing environment, the corporate bond market could become more important for Swedish corporation financing. Steps to develop the corporate bond market may therefore now be important. Developing the corporate bond market will improve the Swedish bond market, giving a clearer picture of the credit risk in the market. This will lead to the improved functioning of the financial markets, with more correct pricing of derivatives as an example. Corporations will gain better access to long-term financing in Swedish kronor and gain access to more investors, which will provide them with an opportunity to diversify their financing. The banks' credit losses may then decrease. From our study, it is, on the other hand, evident that a lot of work will be needed to improve the Swedish corporate bond market.

50 The corporation needs to issue a bond for at least 250-500 thousand Swedish kronor. Investors need 500 000 kronor to participate in a primary market auction and 10 000 to buy corporate bonds on the secondary market. (Dagens Industri, February 2011).

51 The investigation will be done by Daniel Barr, head of the Bank Support Department at the Swedish National Debt Office.

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