UNIVERSITY OF GOTHENBURG
SCHOOL OF BUSINESS, ECONOMICS AND LAW

A SHIFT IN THE BALANCE OF POWER

THE TRANSFORMATION FROM BANK LOANS TO CORPORATE BONDS

ERIK JOSEFSSON AND DAVID LEANDER

UNIVERSITY OF GOTHENBURG - SCHOOL OF BUSINESS, ECONOMICS AND LAW

MASTER THESIS IN BUSINESS ADMINISTRATION - INDUSTRIAL AND FINANCIAL MANAGEMENT - SPRING 2012

COURSE SUPERVISOR: STEFAN SJÖGREN

ACKNOWLEDGEMENTS

A debt of gratitude is owed to many people for this thesis. Respondents have helped us understand the corporate bond market and have provided us with advice and encouragement. We would like to express our sincere thankfulness to Elof Hansson and especially Fredrik Block and Mikael Ehrenborg at the treasury department. We also want to thank our supervisor Stefan Sjögren as well as the School of Business, Economics and Law at University of Gothenburg.

ABSTRACT

Since the financial crisis in 2008, there has been an ongoing discussion in media concerning the need for alternative funding sources. Corporate bonds are the primary alternative to bank loans and many corporations currently consider entering the Swedish market. Therefore, this study aims to assess the possibilities for these firms to issue bonds. The report is based on interview answers of 43 respondents and assessed from three perspectives. The structure of the corporate bond market is firstly described. Secondly, the new conditions in the market are evaluated and finally the requirements from a corporate perspective are analyzed. The study concludes that the structure of the bond market is made for large firms and limits the possibilities for smaller corporations. However, for the first time all market players show interest in developing the market and the conditions for new firms will therefore be improved. Due to the awakened interest we predict a slow transformation where more corporations will issue bonds in the future.

TABLE OF CONTENTS

1. INTRODUCTION

Swedish firms have a long tradition of relying on bank loans, which represent approximately 80 percent of the total debt financing. Gunnarsdottir & Lindh (2011) state that the Swedish corporate bond market is small in size and dominated by a few large and well-established blue-chip firms (such as Vattenfall, TeliaSonera, Volvo, Vasakronan and Atlas Copco) that rarely have any problems to obtain the capital they desire. There is an indication that more firms move away from regular bank loans, pass the banks and go directly to the corporate bond market for financing. The market for non-financial firms has grown by 45 percent to SEK 190 billion since 2007 (Statistics Sweden, 2012). To meet this demand SEB, Öhman, ABG Sundal Collier, Carnegie and Catella have all rushed to set up new corporate finance departments for corporate bonds (Affärsvärlden, 2011).

There are many factors behind the growing attractiveness of corporate bonds but the strongest is believed to be the new regulations in the financial sector. According to Louis Landeman, Head of Credit Analysis at Danske Markets, the BASEL III regulations will likely lead to higher borrowing rates and more firms will issue corporate bonds in the future. The prospected increase of market-based debt has also attracted medium-sized corporations to evaluate a potential entrance of the corporate bond market. Elof Hansson, a trading house in Gothenburg, is now considering raising a significant amount of debt: “We see all time high spreads and borrowing rates that most likely will rise. Therefore, we want to be prepared for the future and consider issuing corporate bonds as an alternative to bank loans” (Mikael Ehrenborg, Group Treasurer at Elof Hansson).

There is an on-going discussion of what impact changes in the financial industry will have upon non-financial firms and this is an area that needs to be researched further. Since all firms with external debt will be affected by the new market conditions to a certain extent, it is likely that many other firms think along the same lines as Elof Hansson. This thesis will analyze the potential transformation toward a more active corporate bond market in Sweden.

2. PROBLEM DISCUSSION

In the United States, debt instruments like corporate bonds are common, while in Sweden bank loans have been the historically preferred tool in the external funding for corporations. Erik Blomberg, Head of Pricing Principles & Capital at Nordea Markets says that this can exemplify an 80-20 rule. In the United States, nearly 80 percent of the debt financing is represented by public debt (i.e. Bonds or Commercial papers) and only approximately 20 percent is private debt (i.e. traditional bank loans). However, the situation in Europe has been said to be roughly the opposite, with nearly 80 percent private and only 20 percent public debt (Hässel, Norman & Andersson 2001). The so-called blue-chip companies have dominated the Swedish corporate bond market for several years while medium-sized enterprises have been represented to a limited extent (Gunnardottir & Lind, 2011). The corporate bond market can be divided into two subgroups depending on the credit-worthiness of the companies. The corporate bond market for firms with investment grade rating (BBB or higher) works well, where the companies can raise significant amounts and the bonds are traded in the secondary market (Gunnarsdottir & Lindh, 2011). The corporate bond market for firms with high-yield credit rating[1] (BB or lower) has been used to a very small extent. Additional factors apart from credit rating such as high fixed costs and other requirements might have limited corporations to use bonds (Affärsvärlden, 2011).

The recent financial crisis in 2008 has led to a vast concern about corporations' debt financing and a thorough discussion regarding re-regulation in the financial industry in order to prevent market volatility and new crises (Jaffe & Walden, 2010). Members of the Basel Committee on Banking Supervision agreed on the Basel III regulation of bank capital adequacy, stress testing and market liquidity risk (FI, 2001). Solvency II is applied to insurance companies within the European Union and concerns the amount of capital firms must hold in order to reduce the insolvency risk (ECB, 2007). In addition, the European Commission has implemented the Markets in Financial Instruments Directive (MiFID) in order to raise the transparency and protect the investors (European Commission, 2011). The new regulations are expected to affect the corporations' debt financing but it is uncertain to what extent (The Riksbank, 2011). Apart from the regulations we will also study if there are other factors behind the increased interest in corporate bonds.

The secondary effect on the corporations' debt financing due to the new regulations is a hot topic today. The majority of the previous research about the Swedish corporate bond market is outdated and new studies based on the new conditions are demanded. We therefore decided to thoroughly investigate the market, analyze the new market conditions and define the problems for new issuers to use bonds. The reason behind our focus on the issuers is that the Swedish corporate bond market is still under development and we believe that it is in the corporations' interest to develop the market. It is also believed that new market regulations are expected to reduce the credit supply for these firms, which make them further interested in alternatives to

[1] Also called non-investment grade bonds, speculative grade bonds and junk bonds

bank financing. We circumscribe the corporations as non-financial and thereby ignore the bond market for housing credit institutions, banks and insurance companies. The reason behind our interest in the bond market for non-financial firms is that the firms in Europe are said to be moving away from taking bank loans towards issuing bonds in the aftermath of the recent financial crisis and similar development might take place in Sweden.

2.1 Research Questions

1. How is the Swedish corporate bond market structured and what is needed in order to improve it?
2. How will new market conditions affect issuers of corporate bonds?
3. What should new emitters consider when structuring the bonds?

2.2 Purpose

The main objective of this thesis is to assess the possibilities for corporations to enter the Swedish corporate bond market.

This thesis will firstly describe the development of the Swedish corporate bond market. Secondly, evaluate the new conditions in the financial market and finally analyze the requirements from a corporate perspective.

3. RESEARCH METHOD

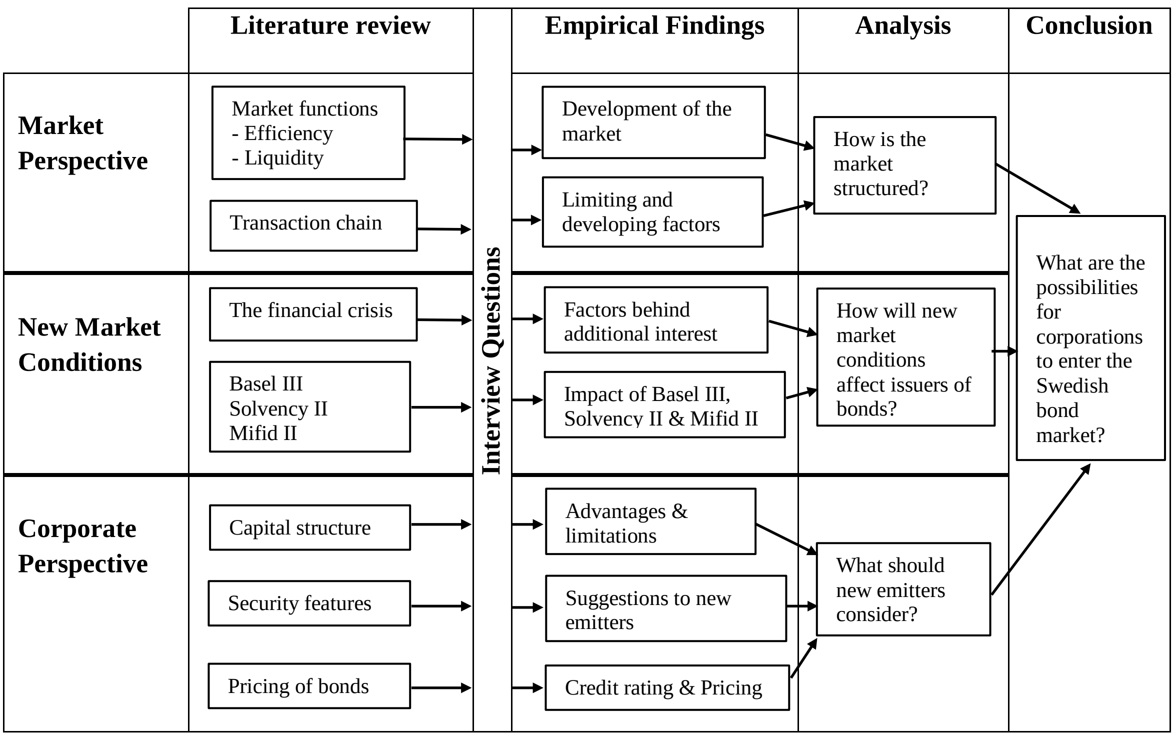
Paulsson (1999) states that the purpose of scientific research is to add further knowledge based upon previous research. Our approach is not to develop or evaluate a theory, but instead to increase the understanding and knowledge of an already existing market. We have collected opinions, thoughts and literature concerning the development as well as the future potential. Based on the answers of our selected respondents, we have tried to draw conclusions and generalize about the market as a whole. Our methodology is therefore based on inductive reasoning (Blumberg et al., 2008).

Bryman (2002) states that qualitative studies focus on words rather than quantification and data analysis. Our intention is to do a qualitative study since we have gathered attitudes and knowledge from the selected sources. The fact that the market is currently experiencing a transformation makes it hard to crystalize pure answers and our empirical study is more or less based on market predictions. Furthermore, the regulations will have a secondary effect on the Swedish corporate bond market and it is difficult to calculate how much it will increase the corporations' debt financing in the future. We are therefore confident that a qualitative study based on discussions and predictions will fit this purpose the best.

3.1 RESEARCH DESIGN

A THREE-STEP APPROACH

Figure 3.1 Thesis disposition "Three-step-approach"



The structure of the thesis is divided into the three perspectives Market Perspective, New Market Conditions and Corporate Perspective. This step-by-step approach will follow as a common thread throughout the whole report. We start from a macro perspective by exploring the corporate bond market and the implications of the new market conditions and then narrow it down to an issuer's perspective of corporate bonds. All three steps elucidate different views on corporate bonds and help us finalize if the current market changes have made it lucrative for firms to enter the corporate bond market.

The first step, Market Perspective, shape a picture of how developed the market is and what obstacles can be found in the literature and empirics. It is vital to understand the market and its development before finalize if it is time for new firms to enter this market. The market perspective helps to answer the first research question: "How is the Swedish corporate bond market structured and what is needed in order to improve it?". Developing the corporate bond market has been a topic in Sweden for more than a decade. Based on the current situation as well as the recent financial crisis resulting in new regulations, there seems to be incentives and increased interests to further develop the Swedish corporate bond market. The additional interest has attracted smaller firms to evaluate corporate bonds as a financing alternative and it is important to examine the underlying factors behind this "hype". This represents the second perspective, New Market Conditions, which finalize the second research question: "How will new market conditions affect issuers of corporate bonds?" After evaluating the condition of the market and changes of the market conditions it is natural to question the practical requirements for medium-sized firms to issue corporate bonds. This represents the last view, the Corporate Perspective, which aims to respond the third research question: "What should new emitters consider when structuring the bonds?". These three analyses on different levels will help to finalize the possibility for firms to use bonds.

LITERATURE REVIEW

The literature review is based on secondary data and forms the foundation for the empirical study and is made to generate understanding of what factors have shaped the market until today. Furthermore, it is made to help the reader make logical sense of the relationship between the present literature and our stated interview questions. The literature review will map the secondary data such as scientific articles and government publications available within the subject. These articles are often based on empirical data. The literature review was mainly done by searching on specific key words but also by using references found in other sources. The data was collected and the main findings were put together in our review. The literature review culminates in our interview questions used in the empirical part and secondary data in the literature review forms therefore the foundation for our interview questions.

EMPIRICAL FINDINGS

The empirical part uses qualitative methodology, which focuses on interpretation and understanding and has its origin in hermeneutical science. It aims on how understanding can be reached from how people perceive themselves and their context (Skärvad, 1999). The empirical part is based on primary data and relies heavily on qualitative information, which is represented by interviews with key players in the market. All interviews are conducted by the use of a focused semi-structured interview technique (Lindlof & Taylor, 2002). By using this method, we set up a situation that allows the respondent the time and scope to talk about their opinions on a particular subject. It uses open-ended questions, some suggested by the researcher and some arising naturally during the interview. A focused semi-structured technique is the most advantageous method due to our broad perspective where we do not want to limit the respondents. This means that we have a standardized interview guide but we were able to ask follow-up questions and the respondents were able to talk even outside of the asked question. The semi-structured technique means that our results consist of a broader spectrum of answers than otherwise could have been achieved. The majority of the interviews where so called "face-to-face" interviews. We visited the respondent in their natural environment and conducted the interviews. This strategy helped to create a situation that benefited follow-up questions and personal encounters limited the risk for misunderstandings. We also conducted a few telephone interviews to complement and to verify the replies of our respondents.

The empirical part also strives to study the phenomenon from the inside and to generate a deeper understanding and a more complete picture of the actual situation (Holme & Solvang, 1997). We did that by taking different roles depending on various situations, sometimes as represents of a potential issuing firm and in some meetings the role as university students. This is an attempt to increase the reliability of the study since the respondents tend to act differently depending on counterparty and situation. The trading house of Elof Hansson with headquarters in Gothenburg is currently investigating alternative ways of debt financing which opened up the opportunity for us to work with these issues alongside with our thesis. Through the company's perspective as a medium-sized firm, we investigated the actual impact the new market conditions will have upon the corporations' debt financing as well as the considerations that need to be made by an issuing firm. Elof Hansson is an especially interesting company for the purpose of our thesis since it is the first time that the firm will accumulate external long-term debt. They are not locked into any previous bank loan relations and therefore start from a blank sheet to evaluate the potential of the corporate bond market. Furthermore, the capital volume requirement and size of the corporation fit the medium-sized segment very well. With the help of Elof Hansson, we have had a continual dialog with their leadership and treasury department and could consequently take the unique character as an issuer. This gave us an advantageous insight into the emitting process and requirements for medium-sized companies.

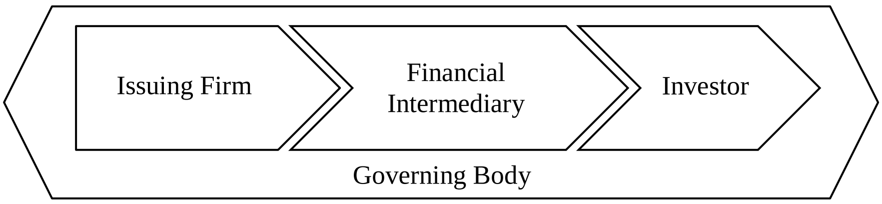
ANALYSIS

The analysis combines the literature review and the empirical findings by adding our impressions. We point out the key findings mentioned by a majority of our respondents and try to draw conclusions by analyzing similarities and dissimilarities. We try to find patterns depending on the size of the respondent as well as the role in the market and share our personal perceived image of what could be read between the lines during the interviews. The analysis is the connection between the interview questions and our stated research questions.

3.2 Sample Selection

In order to better understand the interlinkage and the complexity of the corporate bond market, we target the four key players active in the market when issuing bonds, the so called transaction chain: Issuing firms, Financial Intermediaries, Investors and the Governing body (Hässel, Norman & Andersson, 2001). All these players contribute with their unique perspective of the predicted structural change and it is vital to include all four in our study. This distinction was made in order to make sure that all market players would be represented but also so that the study would not be biased and contain a too large portion of a certain group in the market. By this separation we were also able to make a diversified sample selection, with small and large market actors as well as firms with different credit rating. To achieve a reliable substance to the analysis our limit was to achieve at least five and maximum fifteen respondents from each subgroup. We continuously strove to meet the best experts in all areas and by using the network of our respondents we achieved to meet the key players in the market, which is presented on next page.

Figure 3.2 The Transaction chain[2]



Issuing firms are corporations that are either already active in the corporate bond market in Sweden, or only issue bonds internationally or are interested in issuing bonds in the near future. The respondents in this study are also diversified with regards to the size as well as the credit rating of the firms. Respondents are representing Investment grade firms, high-yield firms as well as unrated firms. *Financial Intermediaries* are represented by the large commercial banks, agents and investment banks. They can be divided into two groups, the ones that act as intermediaries on the securities market and the ones that create financial products (Daltung, 1999). *Investors* are institutions such as investment funds, pension funds and insurance companies. *Governing body* is represented by key authorities and institutions acting as market infrastructure. They are the political decision-makers, regulators and institutions that impact on the corporate bond market.

[2] Illustration with inspiration from Hässel, Norman & Andersson (2001).

GOVERNING BODY

Ministry of Finance. **Erik Thedeén,** State Secretary.
Nasdaq OMX. **Mikael Estvall,** Head of Fixed Income.
Nasdaq OMX. **Fredrik Von Platen,** Manager Listing Service.
OECD. **Sofia Lindh**, Policy Analyst.
Swedish National Debt Office. **Daniel Barr,** Head of Bank Support Department.
Swedish Trustee. **Louise Sjödahl,** Company Secretary.
The Financial Supervisory Authority. **Jan Axelsson,** Senior Advisor.
The Financial Supervisory Authority. **Björn Bargholtz,** Head of Division Bank Analysis.
The Riksbank. **Lars Nyberg,** Former Deputy Governor.

ISSUING FIRMS

Akademiska Hus. **Åsa Elgqvist,** Deputy Treasurer.
Akademiska Hus. **Mikael Risberg,** Deputy Treasurer.
Elof Hansson. **Fredrik Block,** Treasurer.
Elof Hansson. **Mikael Ehrenborg,** Group Treasurer.
Elof Hansson. **Lennart Hedström,** CEO Elof Hansson Properties.
Elof Hansson. **Mikael Lundström,** Chairman of the board at Elof Hansson Properties.
Elof Hansson. **Stefan Hellgren,** CFO.
Getinge. **Peter Hjalmarsson,** Group Treasurer.
Getinge. **Martin Riman,** Treasurer.
Stena Finans. **Rolf Mählkvist,** Deputy Finance Director.
Volvofinans. **Jens Jirvell,** Trader.
Volvofinans. **Lars Norlander,** Group Treasurer.
Volvofinans. **Johan Oskarsson,** Treasurer.
SKF. **Magnus Ericsson**, Treasurer.

FINANCIAL INTERMEDIARIES

Carnegie. **Magnus Berggren,** Structured Finance.
Carnegie. **Niklas Ekman,** Fixed Income Origination.
Carnegie. **Peter Bergmann-Stumpp,** Director Fixed Income Origination.
Danske Markets. **Louis Landeman,** Head of Credit Analysis.
Danske Markets. **Johan Hansen,** Head of DCM Origination.
DNB. **Karl Johan Kulling,** DCM & Origination.
Handelsbanken. **Ulf Stejmar,** Head of Corporate Bonds, Debt Capital Markets.
Nordea Markets. **Erik Blomberg,** Head of Pricing Principles & Capital, FICC Sales.
Nordic Fixed Income. **Claes Bahri,** Head of Fixed Income Sales.
Nordic Fixed Income. **Kristoffer Löfgren,** Head of Fixed Income Sales.
Pareto Öhman. **Stefan De Geer,** Head of Corporate Finance.
Royal Bank of Scotland. **Olof Manner,** Head of Scandinavian Rate Sales.
SEB. **Hans Beyer,** Head of Fixed Income.

INVESTORS

AFA Försäkring. **Andreas Nordvall Lagerås,** PhD Mathematical Statistics.
Alecta. **Tony Persson,** Head of Income and Strategy.
Amf. **Magnus Röstlund,** Portfolio Manager.
Carnegie. **Peter Werleus,** Portfolio Manager.
Proventus. **Daniel Sachs,** CEO.
Simplicity. **Henrik Tingstorp,** CFO and Fund Manager.
SKF. **Richard Magnusson,** Manager Pension fund.

3.3 DATA COLLECTION

The data collection started by a thorough literature research. A database of sources related to the corporate bond market was constructed. As a first step of the empirical data collection, interviews were conducted with key authorities to get a picture of the structure of the market. The visit was followed by another period of readings and secondary data collection alongside interviews with representatives of issuing firms to get a view of how the different conditions affect funding choice of each unique firm.

The first meetings combined with a comprehensive literature review led to a continuous improvement of our interview guideline and the questions are presented in Appendix 1. In the second round of interviews in Stockholm fifteen interviews were conducted with investors and intermediaries. 85 percent of the empirical data was after that point collected and all answers were written down and categorize depending on subject. The collected data were analyzed to find areas for improvement. The last 15 percent of our interviews were made by phone in order to fill in parts that previously were inadequate. In total 43 respondents took part in this study.

3.4 RELIABILITY DISCUSSION

In a study with a high level of reliability the measures are to a very little extent affected by random errors. It is important to use a technique suited to the unique situation and since we used interviews as our main method of collecting primary data, we are very dependent on how open-minded the respondents are at the specific time. Another disadvantage of using interviews is the risk of misunderstanding and since it is held under social circumstances there is a risk that one person's opinion might affect the counterpart in a discussion. The probability of misunderstanding will partly be eliminated by letting the respondents read the notes before publishing. We have used a semi-structured interview technique, which means that another researcher could experience problems with finding the same results as we did. This is due to the fact that we have been flexible with regards to the individual interview as well the appeared situation. To minimize the risk we have used standardized interview guides as basis for our meetings. Another research using our interview guide should thus generate similar results.

There is always a risk of misinterpretations when conducting interviews. To minimize this risk we have recorded most of the interviews alongside taking notes. The recorder has increased the objectivity of our research and provided a chance to re-listen if there were any ambiguities. Esaiasson et al (2004) argue that a problem that might arise when conducting the interviews is the risk of interviewer effects as well as the probability of affecting the answers provided by the respondent. This risk of unwanted effects in the interplay between the respondent and the interviewer is higher in personal, face-to-face interviews. However, this problem is somewhat counteracted by its strengths in the form of a greater control of the answer situation. The fact that both researchers have been present at all interviews has also increased the level of reliability. It is however believed that the result of this study would have been different if it was performed by other researchers since the authors always have a personal impact on the work to some degree. The fact that we had the chance to meet the respondents sometimes as students and at times as company representatives increases the reliability since it is likely that the respondents would have answered differently to these two parties.

The objective was to achieve as many interviews as possible on each level to increase the validity and generalizability. Respondents asked to be anonymous and we therefore took the decision to implement anonymity among our respondents' answers in the empirical part. For the reader to still understand what type of respondent that have been quoted, each paragraph shows which part of the transaction chain that is represented and a number of the respondent. This number is randomly given and independently of other respondents. Only a few quotations verified by selected respondents are used in the study. All respondents agreed to publish their names in the reference list to increase the reliability of the report.

Since the empirical part relies on answers of 43 respondents, we have collected a significant amount of information. To be able to keep a common thread and overview of the report, all our empirical findings were collected and categorized depending on the subject of the data. This means that we could not present all our results due to the high number of interviews and amount of data. This can be seen as a first step of an analysis since we put the advantages and disadvantages of an argument against one another. This limitation meant that a prioritization had to be made and only the most important findings were presented. The prioritization was based on our perception and this might limit the credibility of our report.

4. LITERATURE REVIEW

The literature review culminates in our interview questions in Appendix 1.

4.1 MARKET PERSPECTIVE

Corporations play an important role in the welfare of a nation and supply of funds is vital to their existence. Therefore, well-functioning financial markets are crucial for investments and development of companies and the whole nation's gross domestic product as well as the financial stability of a country. Governments' and corporations' funding is the reason behind the existence of a debt market (Choudry, 2004). Corporate bonds are debt security instrument that are used by companies to accumulate public debt.

Niemeyer (2000) explains that the market is divided into a primary market and a secondary market. The main characteristic of the primary market is that the bonds have not previously been traded on organized markets. There is a need to issue a relatively large volume to quickly create conditions for an active secondary market (Niemeyer, 2000). In the secondary market the securities are traded among the investors. Bonds are commonly traded Over-the-Counter (OTC) via a dealer network as opposed to a centralized exchange. This means that debt instruments are often traded by investment banks that are acting as market-makers for specific issues (Niemeyer, 2000). An investor that wants to buy or sell a bond must call the market-maker in order to ask for quotes. The market-maker accepts the risk of holding a certain number of securities in order to facilitate the trading (Bessembinder & Maxwell 2008). The market-maker's incentive to offer large trading volumes increases in direct relation to the spread of the security since the bid and ask spread serves a large part of the agent's profit (Niemeyer, 2000).

4.1.1 MARKET TRANSPARENCY AND LIQUIDITY

The level of transparency and liquidity is vital to investors in the corporate bond market (Hässel, Norman & Andesson, 2001). Fama (1970) defines an *information-efficient* market as "a market in which prices always "fully reflect" available information". Niemeyer (2000) discusses the term transparency as the amount and type of information provided to the investor, and thus the available decision support. The author states that there are two types of transparency where the first is the company-specific information about how the financial position and future prospects look like as well as information about major shareholders and decision makers. Niemeyer's second type of transparency concerns the trading activity. This gives information about who are trading, at what prices and at what amount. According to Bessembinder & Maxwell (2008) trading activity can be divided into pre- and post-trade transparency. "Pre-trade transparency" refers to the dissemination of quotations or other indications of trading interest, while "post-trade transparency" refers to dissemination of information such as price and volume for completed trades.

Feldman & Stephenson (1988) state that a market with high level of transparency is characterized by easily accessed information compared to a market with low transparency where there are information gaps. These gaps are due to the fact that the major players have a better position and can read the market by analyzing the trade they are conducting. These large players can gain a better sense of a fair price and future development compared to small players in the financial markets. It is clear that the degree of trade transparency affects the market players' opportunities to make the best decisions about financial transactions. Many therefore believe that a market must have the highest trade transparency as possible (Niemeyer, 2000).

The lemon law by Akerlof (1970) concludes that some markets might be susceptible to asymmetric information, which therefore might suffer from decrease in price since the buyers demand a deep discount as they possess a lot less information than the seller. However, Niemeyer (2000) says that it is possible to argue that a less transparent market is better, from e.g. a pricing point of view. The authors explains that the London stock exchange has used the lack of transparency as a selling point as it enables larger volumes traded by the dealers, which attracts significant transactions to the exchange. By moving these transactions to London, the pricing quality increases. According to the author several market players also conclude that the lack of transparency is an important reason why the Swedish fixed income market has been one of the most liquid (deep) fixed income markets in the world (Niemeyer, 2000).

O' Hara (1995) writes: "Liquidity is easily recognized but not so easily defined." Harris (1990) propose a classification of liquidity in to four different types; width, depth, immediacy and resiliency. The first dimension, *width*, refers to the bid-ask spread for a given number of securities. The bid-ask spread is the amount by which the ask price exceeds the bid. This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it. It can be interpreted as the cost of a round-trip trade (i.e., of an instantaneous buy and sell transaction). The second dimension, *depth*, is the corresponding volume or number of securities that can be traded at the given ask or bid price, which according to Niemeyer (2000) characterizes the Swedish corporate bond market. The third dimension stated by Harris (1990) is *immediacy* that refers to the time period needed to accomplish a transaction of a given size at a given cost. The last dimension, *resiliency*, measures how fast prices revert to prior levels after having changed due to large transactions that were initiated by uninformed traders and that have no impact on the value of the underlying asset (Harris, 1990).

4.1.2 Corporate Bonds in an International Perspective

Nyberg, Viotti & Wissén (2006) state that as late as in the early 1980s, Sweden had no bond market. There were however bonds outstanding, but the investors were only represented by institutions, which were obligated to buy the bonds. Additionally, it existed no market-determined interest rates. The European market for corporate bonds has increased remarkably since the introduction of the Euro in 1999. However, the market in the United States is larger and more diversified with respect to the creditworthiness of the companies. Hässel, Norman & Andersson (2001) state that the companies within the Euro area used bank loans as 80 percent of the external financing and only 20 percent of the debt was financed by corporate bonds. In the United States numbers were the opposite with corporate bonds as the dominant funding source. Choudry (2004) states that in the United States there are more corporate bond issues on the New York Stock Exchange (NYSE) than there are equities, and the dollar value of daily bond trading is at least as high as it is in equities. The trade is dominated by OTC transactions since only a small amount of the bond trading does take place on the exchange itself (Choudry, 2004). The rise of the large OTC trade was due to the growth of institutional bond trading dominated by pension funds, mutual funds and endowments, which are stated to be better off in an OTC market (Green & Biais, 2007).

As a result of the introduction of the Euro, the corporate bond market has had increased importance for the European companies. To be able to manage the new competitive environment companies have strived to increase their market share by European expansion. This has to a large extent been made through capital-intensive mergers and acquisitions which have increased the demand for funding. This demand has mainly been supplied by external financing, and as a result the supply of corporate bonds has increased. (Hässel, Norman & Andersson, 2001).

DIFFERENCES IN BANK STRUCTURE

According to Hässel, Norman & Andersson (2001), the reason behind the dissimilarity in external debt structure is believed to be the difference in governmental involvement between the banking systems. In the United States the involvement of the state is limited to monitor and implement laws. In Europe the governments have historically been more actively involved in the banks' business operations, where different types of central government guarantees have been frequently used. State-owned banks and implicit government supports to banks based on the "too big to fail" argument as a result the cost of debt in e.g. Sweden and Germany is sometimes lower compared to banks in countries without these characteristics. This capital is lent to corporations at a lower interest rate than the companies could achieve from a funding from the corporate bond market (Hässel, Norman & Andersson, 2001). De Fiore & Uhlig (2011) confirm this by stating that the average risk premium on bank loans in the United States is higher relative to the European.

DIFFERENCES IN LEGAL STRUCTURE

Other literature states that the corporate finance differences are explained by the legal systems (La Porta et al., 1997). Countries such as the United States and the United Kingdom are using common law, which is said to be more effective to protect shareholders and creditors compared to the civil law used in countries like Sweden and Germany. This means a larger role of market finance relative to intermediated finance and easier access to equity finance for firms in the United States than in Sweden. Another factor that has affected the corporate bond markets is the relatively lower availability of public information about firms' creditworthiness (De Fiore & Uhlig, 2011).

4.2 NEW MARKET CONDITIONS

4.2.1 THE FINANCIAL CRISIS

The financial crisis has had detrimental consequences for banks' and corporations' debt financing (Richelson & Richelson, 2011). When the first signs of financial turbulence emerged in mid-2007 the global credit conditions worsened substantially and peaked in tightening credit standards in early 2009. According to the European Commission (2010) this was the starting signal for several European enterprises to turn to the bond market for external financing. The issuance of bonds by the non-financial sector reached record high levels (354 billion EUR), which is twice the amount registered in 2008 according to European Commission statistics (2010). Large firms mainly represented the increase. The funding of small and medium-sized enterprises (SME) remained mostly bank-financed. European Commission nevertheless states that the redirection of larger firms towards corporate bonds freed up banks' lending capacity to meet SMEs funding needs. However, in the very critical phase in late 2008 the corporate bond market dried up and all firms sought financing from banks, which resulted in bigger firms crowding out the SMEs' pool of financing and instead hurting the SMEs badly. The increased demand in market based financing in Europe was confirmed by Fitch's EMA and Asia-Pacific Treasury Policy Survey (2010), where 40% of the respondents stated that they were increasing their funding allocation to capital market debt.

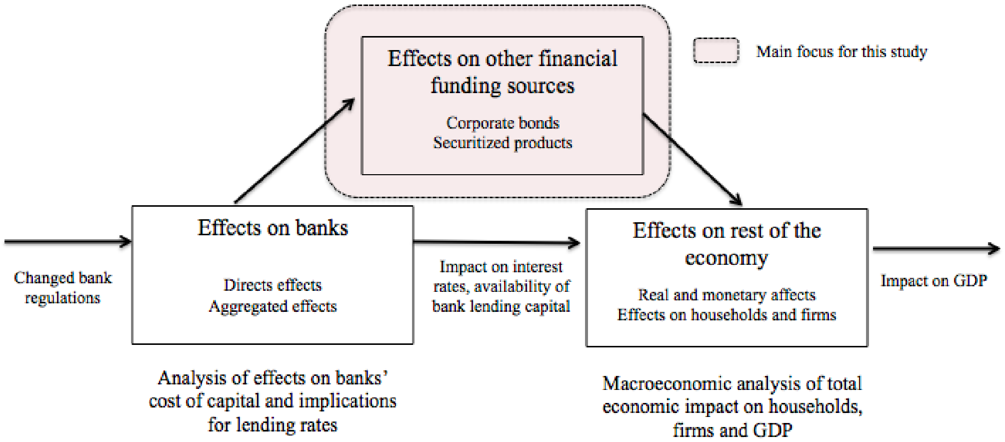
According to Richelson & Richelson (2011), the financial crisis is said to have created a greater investor demand for corporate bonds. Since 1950, there has been a clear tendency toward larger investments in equities, the so called "equity cult". Nevertheless, Citygroup Global Markets (2010) published an article entitled "The End of a Cult", where stocks are severely questioned since bonds has shown to outperform equities from 2000 to 2009, annual performance of 0.3 percent of equities and 6.9 percent for bonds. Richelson & Richelson (2011) states that investors now seek less risky investments as a result of the two stock market crashes in 2000 and 2009.

4.2.2 NEW REGULATIONS

Di Giorgio, Di Noia & Piatti (2000) state that a primary objective of financial market regulation is to increase the macroeconomic and microeconomic stability. Monitoring the stability of the system translates into macrocontrols over the financial exchanges, clearing houses and settlement systems. Another objective stated by the authors is investor protection and transparency in the market and a third objective is the protection and promotion of competition in the financial intermediation sector.

The collapse of international bank finance during the crisis has led to more stringent and redefined regulations in the financial sector. The new regulations in the aftermath of the crisis; Basel III, Solvency II and MiFID II are said to affect Swedish non-financial corporations' debt financing according to Gunnarsdottir & Lindh (2011). The authors state that the structural change in Europe may also be taking place in Sweden as a result of stricter regulations. These regulations will primary effect banks, institutions and investors and secondly the financial funding sources for corporations as illustrated in figure 4.1 below (Jaffe & Walden, 2010).

Figure 4.1 Secondary effects on corporate bond market due to regulations[3]



4.2.3 Basel III

As a result of the recent financial crisis and to prevent future crises the Basel Committee on Banking Supervision (BCBS) submitted a proposed Basel III, a follow-up of the old regulatory framework of Basel II and aims to improve the banking system's ability to absorb risks arising from financial distress and improve banks' risk management (BCBS, 2009). The *capital adequacy rules* are the major priority in the new proposal and bank capital is divided into Tier 1 and Tier 2 capital where Tier 1 capital is the highest quality (BCBS, 2009). According to FI (2011), Swedish banks have an extra core Tier 1 capital add-on that means that the core Tier 1 capital requirement for the four large commercial banks[4] will reach ten percent from 1 January 2013 and 12 percent from 1 January 2015. In total Swedish banks will face a capital requirement that is five percentage points higher compared to other European banks. Sweden, along with United Kingdom and Switzerland, which also have large banking sectors and consequently high bank risks have chosen to impose stricter rules on Basel III (FI, 2011).

The Riksbank (2010) concludes that the financial crisis showed the shortcomings in bank's liquidity management. To address this problem BCBS (2009) suggest that two new quantitative requirements as *liquidity rules* within Basel III. The *Liquidity Coverage Ratio (LCR)* refers to the bank's asset side and regulates the buffer level of liquid assets that banks must hold. The aim is that the ratio will cover payments for the upcoming 30-day period in case of a rise of a possible stressful situation. *Net stable funding ratio (NSFR)* encourages an increased long-term funding of bank assets. The introduction of this ratio increases the pressure on bank to improve the balance of the maturity structure between assets and liabilities (BCBS, 2009).

[3] Illustation with inspiration from Jaffe & Walden, 2010
[4] SEB, Swedbank, Handelsbanken and Nordea

Jaffe & Walden (2010) states that on a short-term basis, Basel III is expected to decrease the credit volumes and that the banks will have to increase their interest margins. In general, this will lead to higher borrowing cost for companies and especially small firms are expected to experience trouble in getting funding from banks. The Riksbank (2010) says that the effect on Swedish banks will be as high as or slightly lower than the rest of the European banks. This is due to the fact that Swedish banks are well capitalized compared to international banks and they have already started the adjustment to stricter requirements. Jaffe & Walden (2010) conclude along with most analyses that banks will satisfy higher Basel III capital requirements by doing an equity-for-debt swap in their capital structure. Nevertheless, the authors state that it is uncertain how much the new capital requirements will impact the long-term median lending spread. BCBS (2010) predict an increase of 13 basis points and also provides an alternative estimate of 16 basis points after 4 years of transition. Jaffe & Walden (2010) state that if Swedish banks pass on increased costs to their customers, these corporations will seek alternative markets and suppliers to obtain their financial services. Jaffe & Walden see alternative funding sources as a positive side effect of the new regulations, and suggest that the government, central bank and regulator endorse the expansion of the Swedish corporate bond market and other debt markets.

4.2.4 Solvency II

The European Commission has proposed a revision and plans to implement a new solvency framework to all insurers in the European Union (ECB, 2007). According to Gatzert and Martin (2012) Solvency II is likely to be enforced from 2014. The regulation will set the framework for a new risk-based solvency requirement by placing greater emphasis on an economic approach to the valuation (ECB, 2007). In Solvency I, the solvency capital requirement is based on insurers having to hold a fixed margin based solely on the size of the companies' commitments to cover all risks. Under Solvency II, on the other hand, a risk-sensitive measure is implemented for the first time for many countries. Moreover, assets and liabilities are intended to move from fixed-value to market-consistent valuation (Gatzert and Martin, 2012).

It is presently unclear how large the solvency capital requirement will be under Solvency II (Jaffee & Walden, 2010). According to Piozot et al. (2011) a study identified that the regulation can fundamentally change how insurance companies consider asset risk. The negative impact of Solvency II is predicted to be felt all across the bond market (Piozot et al. 2011). Fitch Rating Special Report (2011) states that solvency II will lead to higher cost for the risk for insurers to hold long-term bonds and it is likely that the demand for long-term corporate bonds will drop.

According to the Riksbank's financial stability report (2010), the Swedish insurance companies hold over SEK 2,800 billion of financial assets and life insurance companies stand for almost 85 percent. Gunnarsdottir & Lindh (2011) therefore conclude that the new regulations might significantly transform the Swedish insurance companies' investment strategies and secondly affect the demand of Swedish corporate bonds. The two authors agree with Piozot et al. (2011) that Solvency II will make it tougher for insurance companies to play their traditional role as a provider of long-term risk capital. Additionally lower rated bonds also carry heavy capital charges under Solvency II, which might hinder investments in high-yield bonds (Piozot et al. 2011). According to the prospected regulations it might be better for some firms to not even get a rating, since insurance companies cannot invest in bonds with lower rating than investment grade. On the other hand, insurance companies can do some investments in unrated bonds (Gunnarsdottir & Lindh (2011).

4.2.5 MIFID II

MiFID II is set to greatly improve transparency in financial markets, including commodity markets, for regulators and market participants (European Commission, 2011). MiFID II extends the former MiFID framework from equities to all asset classes and into markets in which centralized bid-offer markets and pre- and post-trade transparency have never existed. It is expected to have a huge impact on the way OTCs operate (Lambe, 2011) The corporate bond market is subject to the implementation of full post-trade transparency which will be done by publishing coupons, maturities, issuers, currencies, prices as well as volumes of all trades. The intention of the MiFID II regulations is that more issuers and investors will be interested in the Swedish corporate bond market, resulting in increased liquidity (Gunnarsdottir & Lindh, 2011).

The Committee of European Securities Regulators (CESR) has published a report stating that the decision of adopting a mandatory transparency regime for the corporate bond market should be re-considered (Imeson, 2010). This was due to that the CESR believed the regulators had reached a too high level of transparency for this type of market. Harry Eddis, Linklaters states that it is not clear that the market need or are ready for such radical changes (Lambe, 2011). Gunnarsdottir & Lind (2011) state that in a small market like the Swedish corporate bond market increased transparency would instead be prohibiting. An increased transparency may result in unfavorable prices for the market-makers, who may become unwilling to take on some positions and as a result the number of market-makers may decrease, resulting in an opposite effect with reduced liquidity in the market.

4.3 Corporate Perspective

4.3.1 The Capital Structure of a Firm

The article ”The Cost of Capital, Corporate Finance and Theory of Investment” by Modigliani & Miller (1958) provided new a perspective on the company’s capital structure through a theory stating that the capital structure has no impact upon the value of a firm in the presence of perfect capital markets with lack of both transaction cost and efficiency cost. The perfect capital market does only exist in theory, which makes it possible for companies to use existing market imperfections in order to gain value through the choice of capital structure (Modigliani & Miller, 1963). As a result of a higher focus on the return on the investments, companies have studied the relationship between debt and equity financing. To remain profitable in the eyes of the investors the companies tries to increase the return on equity, and have used bonds in order to finance the repurchase of stocks. The increased leverage creates possibilities of tax reductions, a short-term increase in the stock value of the companies’ and an increase of the earnings per share ratio (Hässel, Norman & Andersson, 2001).

4.3.2 The Security Instrument - Corporate Bonds

When corporations are unable or unwilling to use internal funds they seek to raise capital by outside investors. Broadly speaking, firms raise external debt through either transactional or relational debt and Jonathan & Parthiban (2009) distinguish between these two distinct forms of debt. Firstly, transactional debt is represented by public securities such as bonds and commercial papers. Secondly, relational debt is characterized by private loans from banks, e.g. traditional bank loans. According to Lubeck & Hagerlund (1991), corporations’ short-term market-based financing, of less than a year, is called commercial papers, typically issued to meet short-term payments. Corporate bonds, on the other hand, with time to maturity longer than a year are characterized by longer finance horizon. Private loans from financial intermediaries such as banks are often part of a long-term relationship that can provide transacting parties the opportunity to develop trust and learn how to better share information and solve problems (Boot & Marinc, 2008). Public securities such as bonds and commercial papers on the other hand are supplied by arms’ length lenders without extensive relations with the firm. These investors tend to respond with stringent requirements and quicker call for liquidation in times of financial distress (David et al., 2008).

Firms with a higher degree of information asymmetry lean towards private borrowing, while firms with lower information asymmetry prefer public debt (Myers, 1984). Diamond (1991) and Rajan (1992) state however that there exists a relationship between credit quality and debt source. The authors predict that the firms with highest credit quality issue public debt since these firms often have lower borrowing cost compared to bank loans. For firms with medium credit quality bank loans are the most preferred funding source. However, for firms with low credit quality, the costs of bank monitoring outweigh the benefits and market financing might be the only alternative.

Unlike owners of stocks, investors in corporate bonds do not have ownership rights in the corporation. However, in case of a default, the bondholders have priority on legal claims over preferred and common shareholders on both assets and income (Hässel et al, 2001). The company must first pay the interest on the bondholders before allotments are divided among shareholders. It is therefore less risky to invest in corporate bonds than corporation stocks; nevertheless there is still a risk of default, which represents the bond's credit risk. The rights of investors who buy a bond are set in a contract termed indenture. The trust indenture is printed on the bond certificate and is the legal document describing key terms of all the rights of the bondholder, the obligations and duties of the trustee, how and when the par-value will be repaid, the interest rate (coupon), collateral assets, and how to act in case of a default (Ramaswamy 2004).

4.3.3 Credit Rating

Rating analysts evaluate the risks associated with a bond and investors rely heavily on these analyses to review a bond's structure and its issuer's financial health (Richelson & Richelson, 2011). The three primary bond-rating agencies are Standard & Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch). These rating agencies have become powerful players in the corporate bond market, since their ratings are widely published and provide a recognized guide for bond purchases. Credit ratings are one of many tools that investors can use when making investment decisions about bonds and other fixed income investments. Furthermore, the ratings strongly influence how much an issuer will have to pay to borrow money (Richelson & Richelson, 2011). All things being equal, bonds with the same rating and maturity are sold with similar yields if sold at the same time.

Table 4.2 Credit rating scales[5]

S&P	Fitch	Moody's	Credit Quality	
AAA	AAA	Aaa	Prime	Investment grade
AA+	AA+	Aa1		
AA	AA	Aa2	High grade	
AA-	AA-	Aa3		
A+	A+	A1	Upper medium grade	
A	A	A2		
A-	A-	A3		
BBB+	BBB+	Baa1	Lower medium grade	
BBB	BBB	Baa2		
BBB-	BBB-	Baa3		
BB+	BB+	Ba1	Non-investment grade speculative	High-yield
BB	BB	Ba2		
BB-	BB-	Ba3		
B+	B+	B1	Highly speculative	
B	B	B2		
B-	B-	B3		
CCC+	CCC+	Caa1	Substantial risks	
CCC	CCC	Caa2	Extremely speculative	
CCC-	CCC-	Caa3	In default with little prospect for recovery	
CC	CC	Ca		
C	C	C		
D	D	/ /	In default	

Firms with credit rating of BBB-/Baa3 or higher are classified as investment grade and firms with credit rating of BB+/Ba1 or lower are or classified as high-yield. Investment grade means that the firm has a relatively low risk of default and these securities are considered to be of the highest credit quality. High-yield characterizes the companies that are considered risky and speculative and where the companies are less likely to be able to meet their payment obligations (Standard & Poor's, 2011).

[5] Illustration from Richelson & Richelson (2011)

5. Empirical Findings

The empirical findings include the answers from the interview questions (See appendix 1.) and follow-up questions of our 43 respondents. Since we used semi-structured interviews and talked to experts in all areas, the primary empirical data is comprehensive. Therefore the broad answers have been categorized and presented under suitable headlines and primary questions.

5.1 Market Perspective

"The Swedish corporate bond market is underdeveloped due to the low number of investors and lack of transparency. Nevertheless, the market works since it looks like a duck pond. It is very small with few investors knowing each other and their interests." – Lars Nyberg, Former Deputy Governor at the Riksbank

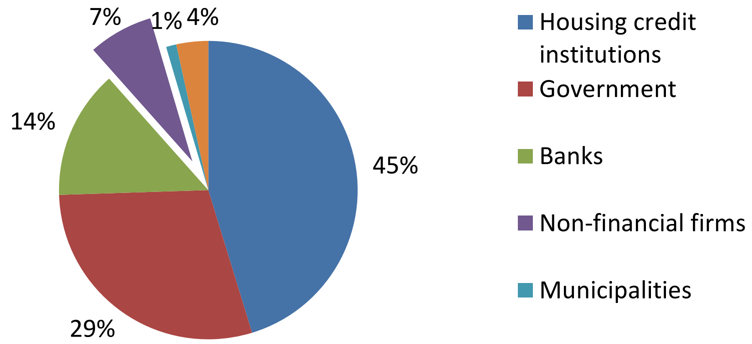
5.1.1 Characteristics of the Corporate Bond Market

Answer to **Question 3**: *"What are the characteristics of the Swedish corporate bond market?*

The Swedish bond market

Intermediary 2 states that the largest issuer of Swedish bonds[6] during the last five years (2007-2011) has been housing credit institutions which accounts for more than 40 percent of the total outstanding bonds. The credit is used to finance private housing investments. The second largest issuer is the government, where the Swedish National Debt Office is managing and refinancing the national debt (Intermediary 2). Governing body 2 stays that the Swedish government has a history of being the largest actor on the market through government bonds but as a result of declining national debt, the supply of bonds has also decreased. The third largest group of issuers is represented by the banks where the bond market has been a more important source of funding in the aftermath of the recent financial crisis (Intermediary 2).

Figure 5.1 Issuers in percentage share of total issuing in the Swedish bond market 2011[7]



[6] Including bonds issued by government, institutions, financial and non-financial firms.
[7] Illustration with inspiration from Governing body 5 and Data from Statistics Sweden, 2011

Intermediary 2 states that a fourth group of bond issuers is the non-financial firms, which issue bonds in the corporate bond market. They are to a large extent represented by industrial corporations that are mainly financing long-term investments and are using the bond market as a complement to traditional bank loans (Governing body 2). In 2011, the corporate bond market for non-financial firms stood for 190 billion SEK, which represents approximately 7 percent of the total Swedish bond market (Governing body 5).

INVESTMENT GRADE AND HIGH-YIELD

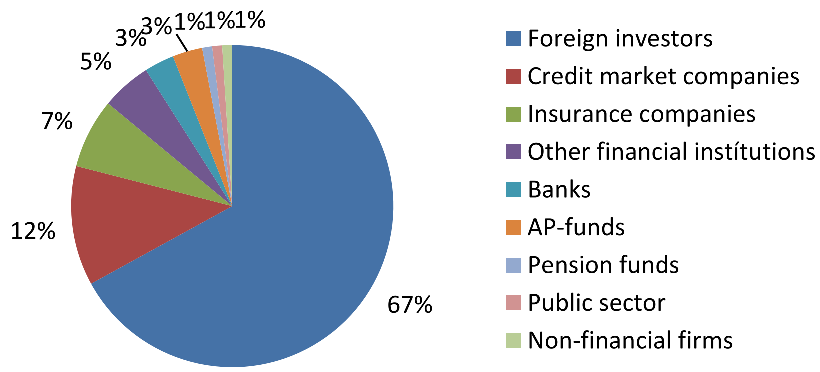
Governing body 5 states that the Swedish corporate bond market can be divided into two subgroups depending on the credit quality of the firm. The market for companies within *investment grad*e works well. The characteristics of the firms active in the market are global presence, large market capitalization and in some cases state ownership. State ownership means that the companies are put in a more favorable position in a credit rating, since the company is backed up by the government which reduces the risk of default to almost non-existent. Issuing firm 5 states that the investment grade firms are also active on the Euro market for bonds due to the fact that companies experience difficulties to issue bonds with more than 3-4 years term to maturity on the Swedish market. Many firms therefore cross the border to gain longer term to maturity profiles. Governing body 5 concludes that the investment grade market in Sweden has a developed infrastructure where the banks are responsible for the issues and the conditions are fairly standardized. The market in general does not use clauses in the same extent as bank loans, which usually limit the company's possibilities of pay dividend or to pledge. This means that the banks lend money to companies under certain conditions such as asset-backed loans, but bond investors usually do not have these terms (Governing body 5).

According to Governing body 5, the Swedish market for *high-yield and unrated companies* has struggled in its development. The banks have chosen not to cooperate with these companies and just a few corporations have issued bonds. The volumes are still rather insignificant, even though the respondent see an increase in the recent past. This is seen as an important step in the right direction (Governing body 5). It is primarily the smaller brokerage firms that have managed the transactions in this segment, such as Catella, Pareto Öhman and Carnegie, and not the large commercial banks in the first place (Intermediary 6). Governing body 5 concludes that it has been a very profitable niche for these companies, since the fees for issuing high-yield bonds can be up to ten times higher than for investment grade firms. The profitability has recently attracted interest also from the major banks, which have set up new teams working with corporate bonds and primarily high-yield (Governing body 5). The contracts in this part of the market are not as standardized and are more dependent on the unique situation that these companies are facing (Governing body 5). This leads to increased searching costs which may have reduced the number of investors (Investor 4).

INVESTORS IN THE CORPORATE BOND MARKET

According to Governing body 5, foreign investors have progressively increased their ownerships in Swedish corporate bonds and the group is now the largest of the investors accounting more than 60 percent of the total share in 2011, see figure 5.2. Other large investors are credit market companies and insurance companies. Banks guarantee the liquidity in the market by acting as market-makers (Governing body 7). The Swedish corporate bond market is young and in many ways an institutional product managed by the large commercial banks where the clients have entered the market as an alternative source of funding when the bank balance sheets are full (Governing body 6). The market is small and dominated by professional investors using buy-and-hold strategies since they do not sell off their positions frequently. This has made it suitable for a phone market (Issuing firm 3). The market participants need to document all transactions by recording the phone calls or printing the e-mails (Intermediary 5).

Figure 5.2 Investors in corporate bonds issued by Swedish firms in 2011[8]



[8] Illustration with inspiration from Governing body 5 and data from Statistics Sweden, 2011

5.1.2 CORPORATE BONDS IN AN INTERNATIONAL PERSPECTIVE

Answer to **Question 4**: *"How developed is the Swedish corporate bond market in an international perspective?"*

Investor 3 states that in the 1970s, there was no bond market in the United States. Then a change occurred, partly because of dissatisfaction with the banking system and partly due to the initiative to increase the market for mergers and acquisitions. Smaller companies started to use bonds in order to finance acquisitions of larger firms. This was an important part of the industrial transformation and the development of the corporate bond market (Investor 3). Issuing firm 5 claims that the market in the United States is now the most liquid and has almost always been open compared to the European market, which has been closed during certain periods. A reason behind this is according to the respondent that the market in the United States has emerged during a longer period of time. The European market seems underdeveloped in comparison to the market in the United States, but it is still more developed than the Swedish market (Issuing firm 5). Governing body 4 underline that it is important to bear in mind that there are several reasons why markets in some countries are not fully developed. The legal systems in the United States and the United Kingdom are built up in a different way compared to the Swedish. The Nordic countries are much more similar since they have been developed from the same basis.

Most of our respondents compare the Swedish market to the Norwegian. Governing body 5 concludes that Swedish companies use bonds for financing to a similar degree as the Norwegian corporations. However, the respondent means that the corporate bond market in Norway has taken a different path and is more focused on companies within the high-yield segment, compared to the Swedish market, which is concentrated to investment grade companies. Intermediary 3 says that the presence of a high-yield market in Norway is related to the large exposure to the capital-intensive shipping and offshore business. These industries are cyclical and involve a high degree of risk. The corporate bond market has also increased since a major part of the assets in these industries can be pledged. The respondent concludes that these factors have facilitated the evolvement of a market focused on companies with lower credit rating. Norwegian corporates are in general very good at trading these securities also to foreign investors (Intermediary 3).

Intermediary 2 claims that when comparing the Swedish and Norwegian markets, it is important to bear in mind that the markets have entirely different conditions. Norway has no national debt, which means that the corporate bonds have had less competition in the debt market. In Sweden, government bonds have had a "crowding out effect" on corporate bonds (Intermediary 2). Investor 4 declares that Sweden also has a large level of private equity funds that are investing a lot of money, which is something that is not very common in Norway. Intermediary 2 states that the differences between these two markets are too deep-rooted and it is hard compare the Norwegian market to anything else.

5.1.3 FACTORS THAT HAVE PREVENTED THE DEVELOPMENT OF THE MARKET

Answers to **Question 5** and **Question 6**: *"What factors have limited the development of the market?"* and *"How efficient is the market with regards to transparency and liquidity?"*

A majority of the respondents mentioned the lack of interest have limited the development of the market. The reasons behind the lack of interest were mentioned to be the tradition of relationship banking, lack of transparency, stock investing tradition and complexity of the instrument.

"The only limiting factor for a developed Swedish corporate bond market is the preceding weak interest from the market participants. If the interest increases the market will most probably develop." - Lars Nyberg, Former Deputy Governor at the Riksbank

STRONG RELATIONSHIP BANKING

Governing body 5 concludes that the historically favorable priced bank loans have limited the market. The Swedish government has guaranteed the existence of the banks, which has led to low cost financing. Since banks have low input cost, it has enabled cheap lending to corporations (Investor 4). The focus has been on relationship banking where the banks have accepted minor margins on bank loans in exchange of higher margins on other services. Low interest rates on bank loans can also be explained by the existence of a symbiosis between investors, government and banks (Governing body 5). Intermediary 2 claims that the fact that many of the large companies have the same owners as the banks might also have increased the degree of relationship banking where the same people are members of the board in both the bank and major corporations in Sweden. Intermediary 1 states that all else being equal, companies tend to prefer borrowing from banks rather than the market and Sweden is characterized by a large banking sector that has been able to absorb large share of the debt market. Due to the strong tradition of relationship banking there have not been any incentives for smaller corporations to consider alternative debt sources and it therefore exists a knowledge gap about corporate bonds in these firms (Intermediary 1).

Governing body 4 claims that one of the reasons behind the development of the corporate bond market in the United States was the lack of trust and dissatisfaction with the banks. Unlike Unites States, the trust in the banking system in Sweden has been kept at a high level. The respondent explains that this originates from the banking crisis in the 90s when the Swedish government supported the banks. The unique Swedish model of supporting the banks is well-known internationally. It resulted in great confidence in the banking sector in Sweden compared to other countries that did not provide this support. "We have had so much confidence in the Swedish banks that there has not been a demand for alternatives to bank financing" (Governing body 4).

Lack of transparency

”It is very frustrating. The same security can be traded at completely different levels at the same time. There are no trade statistics at all. It is not acceptable that a market works like this.” – Daniel Sachs, CEO at Proventus

An issue that has been highlighted as a limiting factor by some issuing firms as well as investors is the lack of market transparency. In the stock market, the completed trades are constantly reported throughout the day, which enables market participants to follow the market continuously. In the corporate bond market, on the other hand, it is not possible to find out trading volumes or prices since the intermediaries maintain the prices by themselves (Investor 6). This non-transparent market environment has impacted the margins negatively (Governing body 5). Investor 3 states the lack of transparency implies that there are no indexes and makes market analysis and advisory problematic. The small number of issues despite a strong interest from the firms is a clear sign of inefficiency with respect to the transparency (Investor 3).

The large commercial banks in Sweden state that the lack of transparency is a prerequisite for liquidity in the corporate bond market. According to Intermediary 1, an information advantage is required from the market-maker’s perspective to be able to quote prices. Intermediary 6 would never be interested in market-maker activities if full transparency was implemented on the market. Investor 3 goes against banks’ market-maker argument. The respondent states that most transactions are brokering deals where securities are passed on from one customer to another and only very few transactions in the market are actually market-maker trades.

Governing body 5 claims that the Swedish Financial Supervisory Authority has imposed transparency regulations (FFFS 2007:17 Chapter 7 §3-4). Investment firms trading in the market are responsible for publishing the highest and lowest clearance price as well as trading volumes at latest 09.00 the following day, but this rule is not followed today. Governing body 3 argues that these regulations were drawn up with the mortgage and government bond markets in mind. However, the respondent admits that the regulations are unclear and efforts are made to improve it.

The tradition of stock investing

“Swedish investors are definitely underinvested in corporate bonds” - Peter Werleus, Portfolio Manager at Carnegie Corporate bond fund.

According to Intermediary 2, Swedish investors have a strong tradition of investing in stocks rather than bonds. This has resulted in that they in general do not have experience and knowledge of investing in bonds. The lack of Swedish interest can be traced back to the 1980s when regulations were imposed by the government to facilitate venture capital and therefore forced investors to the stock market instead of investing in debt like corporate bonds (Intermediary 2). Countries like Denmark and Italy are on the other hand very familiar with investing in the bond markets (Investor 5).

THE COMPLEXITY OF INVESTING IN CORPORATE BONDS

Another reason behind the limited interest from investors might be the low volumes issued by smaller corporations and the fact that just a few firms use bonds have hampered the possibility of portfolio diversification (Governing body 5). Multiples of 500,000 SEK or higher have also excluded many non-institutional investors to invest in corporate bonds since it hampers the diversification possibilities. In addition, Investor 4 claims that the complexity of investing in bonds is believed to have prevented the market from achieving its full potential. When investing in stocks of a certain company there might be 2-3 different stocks to invest in. The outstanding bonds of the same company might fill up 5-6 full pages of different types depending on term to maturity, fixed or floating rate, as well as if it is secured or unsecured (Investor 4).

Investor 6 argue that investors in fixed income products have had a macroeconomic focus, while equity investors rather have focused on the company specific situation and firm analysis. There is also a big difference between investing in investment grade and high-yield bonds. Bonds within the investment grade sector behave more like typical fixed income products compared to high-yield bonds, which are something in between fixed income products and equity. This means that the investors need both a macro and a micro perspective and this in-depth knowledge is something that many investors lack. As high-yield bonds are more company-specific and require more research, the complexity increases even further for this asset class (Investor 6).

5.1.4 DEVELOPING THE CORPORATE BOND MARKET

Answers to **Question 7**: *"What is needed to make the market more active and open for new firms?"*

INCREASED TRANSPARENCY AND ELECTRONIC MARKETPLACE

Investor 3 argues that if one believes that this should be a larger market with more issues, actors, investors, etc. the market has to become more transparent. It will never look like the stock market but at least it is possible to move towards the stock market with a large amount of small as well as large investors. In the current situation there are many investors that hold the bond until maturity because of poor liquidity. This buy-and-hold behavior can be traced to how the market looks like and would most probably change in a more transparent market (Investor 3). There are several ways of increasing the market transparency by implementing matching systems and post-trade information but there is uncertainty of what level would fit the market the best (Governing body 7). Investor 4 states that stricter reporting should be implemented since private investors are put in a difficult position compared to a large institutional investor when it comes to price negotiations.

Investor 6 claims that banks have an incentive to retain the OTC trading since each transaction generates a significant amount of money. In a less transparent market the market-maker can gain higher profits from the bid-ask spreads. However, Investor 3 and Investor 6 believe that the progress towards an electronic market cannot be opposed in the future. The banks' lower margins will then be compensated by higher trading volumes. Other respondents claim that an electronic market and full transparency are opposed by banks and the employees within the financial market (Governing body 7). The advantage with an electronic market is that it creates width with in the market more investors and securities while the disadvantage however is that the market might lose its depth (Intermediary 2). For large investors that trade high volumes it is important keep the depth in the market and might be better off in the current market situation.

STANDARDIZATION OF THE DOCUMENTATION AND INTRODUCTION OF A TRUSTEE

One key factor for the development of this market is said to be to attract new investors and capital by standardization of documentation (Investor 3). It is currently very time consuming and problematic for investors to familiarize with the issuing companies and prospects of hundreds of pages. Investor 3 states that a standardization of the conditions is needed to simplify the investment process. Investors leave this asset class when the searching cost and variance in documentation creates obstacles (Investor 3). Governing body 4 states that standardized documentation can be used in 75 percent of the issues and only the remaining 25 percent require individually specified contracts. This means that transaction costs can be kept at a low level and make it more viable for smaller investments (Governing body 4). Standardization along with an increasing competition between the financial intermediaries would also mean that the fixed costs of the issues decreases (Governing body 5). Governing body 4 means that higher standardization would be able to increase the number of medium-sized issuing firms.

Norway has a well-developed trustee function. According to Governing body 5, to further develop the Swedish corporate bond market and the high-yield segment, similar initiatives as need to be implemented. The Norwegian Trustee offers infrastructure, including a website that states all documentation regarding the companies' loan terms and other information needed to limit the risks for the investors. Norwegian trustee has also served as a forum for the process of standardization of the contracts. The trustee works as a neutral investor representative if any changes occur for the investors or any charges arise toward the issuer (Governing body 4). The banks have historically taken the mediatory role, but a neutral party between issuers and investors is needed since the banks also were representing themselves as lender in case of a default of the issuing firm (Governing body 5). Governing body 4 claims that a well-functioned trustee will attract more corporations to use corporate bonds. Norwegian trustee recently decided to open a branch in Sweden in collaboration with Ackordscentralen. The initiative is called Swedish trustee and will thus compete with CorpNordic, which is already active in the market.

INCREASED INVESTOR BASE THROUGH A RETAIL MARKET

The market is currently not retail-oriented and it is closed for small-scale investors since the multiples are set to 500,000 SEK or more. One way to attract new capital would be to open a retail market for private investors (Investor 3). Private investors invest in the equity of high-yield firms instead of its bonds, since the debt market is limited by high multiples requirements. An alternative to attract more capital to the corporate bond market would be to transfer private investor capital from the stock market to the bond market (Investor 5). The relation of small companies and small-scale investors is interesting and this might be a profitable niche for companies like Avanza and Nordnet who notice an increasing interest among private investors (Investor 3). There currently exists a retail bond list, but it is however not used frequently by issuing firms (Intermediary 12). Investor 3 believes that a retail segment would definitely benefit the market, but the multiples have to be lowered and an electronic market is needed for the segment to get started.

Intermediary 7 states that retail volumes suited for private investors is not a new phenomenon. Previous attempt did however not lead to any active trading. Respondents have indicated that retail customers also use buy-and-hold investment strategies, suggesting that the liquidity would not be gained by open up this market (Intermediary 7). Using a market of this type will probably result in lower interest rates but it will most likely lead to higher administrative costs. It takes a lot of effort and is very expensive in order to distribute the bonds to a vast number of investors. It also requires further documentation and more work to inform the retail investors about the risks (Investor 6). Governing body 5 does not believe in a broad market of this kind and he believes that efforts should at first be made to the institutional market.

One company that has tried to issue a bond to the retail segment is Sandvik (Intermediary 1). 1.1 billion SEK was issued in 2012 with more than 1 800 investors and the multiples were set to 10,000 SEK.[9] The bond was listed on the exchange but the trade died out after a while when nobody wanted to sell it. Intermediary 1 states that liquidity does not occur by itself and just because there are more people that want to buy there are not more people that want to sell. This is according to the respondent since many of the private investors also use buy-and-hold strategy (Intermediary 1).

MODERNIZED INSTITUTIONAL INVESTMENT RULES

The investment rules of many institutions such as pension funds are said to be obsolete and need to be modernized. The rules state that many of these market players are only allowed to invest in corporate bonds to a limited extent (Investor 5). These bond investments are restricted to high rated firms in the investment grade segment. High-yield and unrated firms are excluded in their investment regulations (Investor 2). Due to the low yield on government bonds and mortgage bonds, investors look for alternative asset types and high-yield bonds are considered attractive. This segment is a new asset class for the institutions and it is important that these investors will be allowed to invest in high-yield bonds in the future (Investor 2).

[9] According to ”Sandvik 150”January, 31, 2012

5.2 New Market Conditions

"If you are out sailing and you see birds fly towards shore, the sea becomes harder and the air gets colder. Separately these indications does not mean anything, but have you been sailing for over 30 years and you see all these things happen at the same time, you know that there will be a storm. It is exactly what the Swedish corporate bond market is currently experiencing. There are so many things going on in the market right now that I with certainty can say: 'This is going to happen!'" – Olof Manner, Head of Scandinavian Rate Sales at Royal Bank of Scotland

5.2.1 Additional Interest

Answers to **Question 10**: "*Do you experience an increased interest in corporate bonds? If yes, what do you believe are the reasons behind this?"*

20 years ago, the former deputy governor at the Riksbank Lars Nyberg began to ask the question: "Why does Sweden not have a developed market for corporate bonds?" According to Nyberg the response has continually been that there are no interests to improve this market. Investor 4 point out that banks have got their funding at low cost and consequently offered low interest credits. Therefore, according to Governing body 1, the interest to develop this market has been dead as a doornail prior the financial crisis. One participant alone has never been able to transform the market, but today there are vast interests from all directions (Governing body 1). Investor 4 states that this is the first time that the different interests are responded and numerous factors coincide.

On the other hand, Investor 5 says that everyone in the industry has heard about this predicted shift for over 10 years but not much has happened. Intermediary 1 says that it is a bit "over-hyped" since it is the primary product for some investment banks. Many market participants have now begun to promote this product intensively (Intermediary 4). Intermediary 3 however mentions that it is not only talk this time, hence if all market players promote corporate bonds, interest will rise and the corporate bond market will increase. Governing body 5 states that it will definitely not be a "quick fix", but a slow step-by-step transaction.

Intermediary 5 states that the new market environment will certainly attract more companies to issue corporate bonds and see that interest has shifted from large cap companies to small midcap companies. The high-yield segment attains supplementary attention, but it is only the largest of the medium-sized firms that might enter (Investor 4). The market will never be opened to small-sized companies (Governing body 1).

All our respondents in the transaction chain mentions that they have recognized an increased interest in corporate bonds. The majority of the respondents say new regulations and primary Basel III as the main reason for the additional interest. This is presented in 5.2.2. In addition to regulations, respondents point out five other underlying reasons; *higher cost for bank financing, corporations feel betrayed, underperforming stocks, refinancing need and favoring initiatives.*

HIGHER COST FOR BANK FINANCING

Investor 4 explains the attractiveness for corporate bonds as a result of lower cost of financing financial for corporation after the crises. The respondent began by saying that the financial crisis in 2008 led to a financial meltdown and the credit market deteriorated and corporations had problems refinancing. Since the Swedish government backed the banks, it was less risky for investors to lend to banks. The traditional cash flow business model was still working: "Investors lend to banks, which then lend to corporations". Investor 4 continues that in 2010 the crisis spread and culminated in an illiquidity crisis where investors realized that states and nations were not that stable as they had been before. Banks were very closely linked with the governments and therefore combined with high risk. Investors began to look at alternatives to banks and concluded that large corporations such as Volkswagen and Statoil actually in some cases are more stable. Suddenly, banks' financing began to cost more than the companies that they support with credits (Investor 4). This was the first time that non-financial corporations had a lower cost of financing than banks and consequently incentives to use market based financing to a greater extent (Intermediary 11). Investor 4 expresses that there is a clear indication of a shift where banks get a new role as intermediary "Investors lend directly to corporations and an intermediary assist this transaction".

CORPORATIONS FEEL BETRAYED

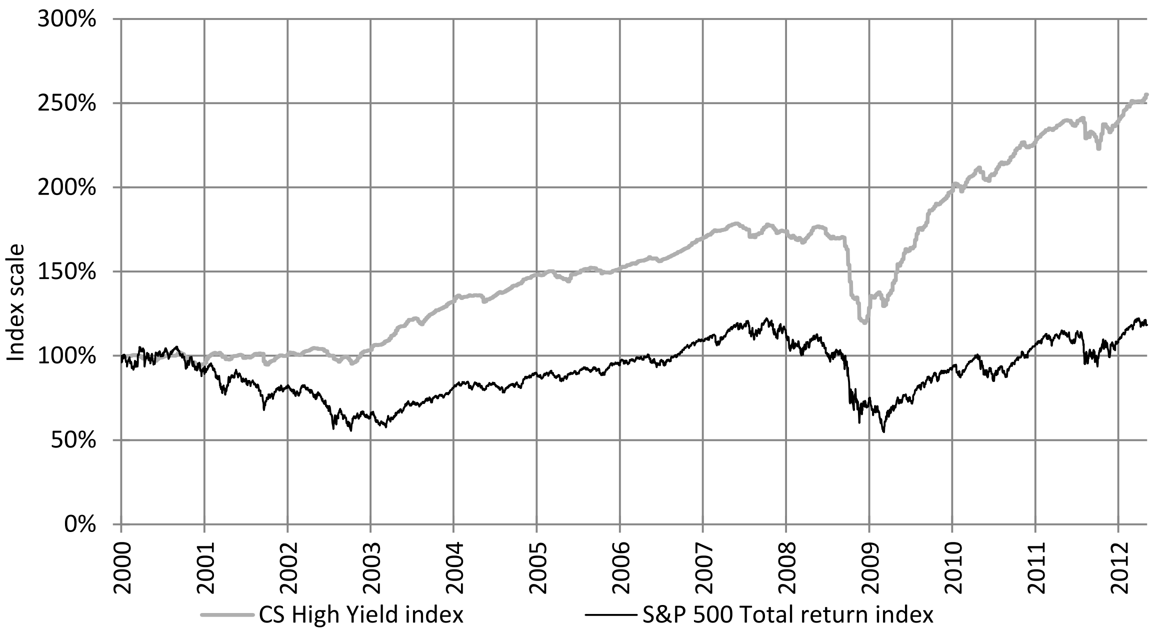
"Wise from the recent financial crisis, corporations were reminded of the importance of having diversified funding sources. Banks can always stop selling umbrellas if it starts to rain" – Peter Bergmann-Stumpp, Director Fixed Income Origination at Carnegie

Investor 4 explains that prior the financial crisis, Swedish corporations saw raising capital from banks as buying milk in a supermarket. If one store was closed it was simply to go to the next. Intermediary 5 says that the financial crisis made it clear to many corporations that the bank might not always be there for them. In 2008, the participants in the market were terrified and numerous companies were heavily beaten. Now companies have been forced to look at the opportunity to issue bonds as an alternative to bank borrowing (Intermediary 2). Intermediary 11 states that it was nearly impossible for firms to pull their credit lines, since banks lacked the liquidity to offer credits. This has created a lot of anxiety that companies will keep in mind as long as current management is at the helm (Investor 5). According to Investor 3, the confidence in banks might have been seriously hurt and the era of strong relationship banking can be over in Sweden.

STOCKS HAVE UNDERPERFORMED

The tradition of stock investments is currently questioned and many investors are tired of the stock market's poor return (Investor 1). The market has shown to be highly volatile and suffered from the dot-com crash in 2001, the financial crisis in 2008 and an illiquidity crisis in 2010. Investor 5 states that stocks have generated zero yield on average in the last 10-12 years. The respondent clarifies the performance in a graph illustrated in figure 5.3, where the CS High Yield index for high-yield corporate bonds is compared with S&P 500.

Figure 5.3 Yield S&P 500 and high-yield corporate bonds[10]



Investor 4 stays that the number of new funds willing to soak up these papers has increased substantially in the last five years. All major and smaller banks are setting up new funds to invest in corporate bonds (Investor 4). Investor 5 agreed on this indication. Only in January and February 2012, more than 600 million SEK was invested in the fund. Intermediary 12 agree that that corporate bond funds are very attractive from a diversification point of view and the investor base is dramatically larger today than before.

"It is scary that it is so extremely popular. As an investor, you are always worried about hypes and bubbles, but my fund is a symptom of the vast demand that I believe is here to stay. Bonds will gain market share relative to bank loans" - Peter Werleus, Portfolio Manager at Carnegie Corporate bond fund.

Intermediary 1 states that many small investment banks have heavily trusted their earnings from the stock market by financial advisory and wealth management. Since the stock market has underperformed many of these companies have tactically moved their positions to focus on assisting in corporate bond issues. This is, according to Intermediary 1, one underlying reason why corporate bonds have been speculated to rice to almost ludicrous levels, since these firms have to promote it to stay in business. The fixed income sector is one of few areas in the financial industry that is currently growing (Intermediary 2).

One respondent explains the attractiveness of corporate bonds with the help of a ski slope parable. The black slope is the stock market and the green slope is government bonds, while the red and blue slopes are corporate bonds. In todays' market situation, there is a clear newly awakened interest in this spectrum with less risk than stocks but higher return than government bonds.

---

[10] Illustration with inspiration from Intermediary 12. Data from Bloomberg

Refinancing need

Prior and throughout the financial crisis there were large increases in loans to corporations dominated by bank financing (Intermediary 6). Official studies claim that there is currently a gigantic refinancing need for the loans settled in 2007, 2008 and 2009 when they decay in 2012, 2013 and 2014 (Intermediary 2). During the financial crisis, banks were restrictive to commit to long-term financing, as they could not obtain long-term financing themselves. The shorter maturity profiles caused maturities earlier than planned (Intermediary 6).

According to Intermediary 6, Swedish companies in reality face a significantly higher refinancing need than shown in the statistics, since public data exclude bilateral loans as well as private portions of the syndicated loan market. The Swedish banks came out of the financial crisis in relatively good shape, but it will be very challenging and perhaps impossible to supply all upcoming refinancing (Intermediary 6). Investor 5 states that the funding landscape in Sweden has and will continue to change when banks cannot accumulate enough credits on their balance sheets.

The refinancing need is gigantic in Europe and many banks still suffer from the financial crisis (Intermediary 6). Many international banks will have to decrease their supply of bank lending in Sweden and focus on their home markets. Many companies have already experienced that international banks have changed their appetite for the Swedish market (Issuing firm 12). When international banks rethink their strategy it will lead to further refinancing need pushed on to the Swedish banks (Intermediary 1).

Favoring initiatives

According to Governing body 1 an important benefit for the corporate bond market is the development of the financial market in Europe since the Euro introduction in 1999. The respondent states that greater efficiency has led to a broadening of the investment base with a common currency and more secondary market activity. Intermediary 6 says that some of the world’s biggest institutional bond investors have currently expressed their interest in investing in small- and mid-cap corporate bonds in Europe.

In addition to the broader market collaboration there are currently initiatives to develop a Swedish trustee function and marketplace (Governing body 2). The foundation Ackordcentralen and Norwegian Trustee jointly started the corporation “Swedish Trustee” (Governing body 4). The company aim to ensure that the Swedish corporate bond market will be safer, less complicated and more liquid. The Swedish Trustee will represent the investors and develop standards to make transactions more efficient (Governing body 4). CorpNordic, a similar company is already in the market as a trustee for bonds, where they take the role as an agent for the bond investors (Intermediary 3). Additionally, a new initiative to start a trading platform “Räntetorget” for dealing with retail corporate bonds issued by smaller firms announced in February 2012 (Intermediary 2).

5.2.2 New Regulations

Intermediary 8 explains that there is a fine seedbed for corporate bonds and a majority of the respondents mention the new regulations as the cornerstones for the whole debate about the attractiveness of corporate bonds. Intermediary 10 conclude that after many years of financial deregulation and excessive credit utilization there is now greater political attention to reregulate the financial industry. The new regulatory regime from International and European initiative will require a narrower banking model where banking business and the whole financial industry will be affected to some extent (Intermediary 10). Banks have to ease their balance sheets and borrowing has already become costlier (Issuing firm 5), however other regulations such as Solvency II and MiFID II will also be imposed in the near future. Several of our respondents say that the effects of these regulations on the corporate bond market are questioned and uncertain.

5.2.3 Basel III

Answers to **Question 11**: *"What effects will Basel III have on corporations' funding and the corporate bond market?"*

*"There is no question that it will get started. It is over for banks' to pour out low-*cost money *and corporations need to find alternative ways of financing"* - Rolf Mählkvist, Deputy Finance Director at Stena AB

Investor 4 points out that Sweden has a larger banking sector in comparison to other European countries. It is dominated by the four large commercial banks Nordea, SEB, Swedbank and Handelsbanken. Investor 4 concludes that the total amount of these banks' balance sheets is 4 times larger than the Swedish GDP, an aggregate number of approximately 14,000 billion SEK. The respondent states that this is an extremely high number compared to GDP. Due to the importance of the banking sector to the real economy, this requires the Swedish state to be strong enough to support if a bank collapses. Investor 4 concludes that a collapse that was very close during the financial crisis, when Swedbank roughly speaking was bankrupt. The risks associated with governments supporting the banks and the financial crisis have accelerated the demand of new capital adequacy and liquidity rules to impose on the banking sector (Investor 4). In 2010, the members of the Basel Committee on Banking Supervision agreed on a global regulatory standard on banks, resulting in the third of the Basel Accords (Investor 3).

Governing body 1 states that there are no doubts that the regulation will lead to increased costs for banks. It is absolutely logical that higher cost of capital for banks will culminate in expensive borrowing for companies and greater interest to use alternative financing. Governing body 5 point on a shift, since the banks will be further interested in providing services for issuing corporate bonds. The revenue from intermediate a bond transaction will remain unchanged, while the cost of providing bank loans will increase (Governing body 5).

The Financial Supervisory Authority has stringent targets when it comes to Basel III. One respondent explain that the first phase of Basel III will be imposed in January 2013, which is earlier than the European time plan and the Financial Supervisory Authority also compels higher minimal capital requirements on Swedish banks. The extra core Tier 1 capital add-on will reach ten percent from January 2013 and 12 percent from January 2015 (Intermediary 9). This means that Swedish banks will face a capital requirement that is five percentage points higher compared to other European banks (Intermediary 10).

A respondent explains that banks' argument against these tougher requirements is that it has to be "level playing field", where there are the same requirements in all countries for no limitations of competition. The Financial Supervisory Authority, on the other hand, argues that they also want to create a "level playing field", but instead from the taxpayers' and the society's perspective. The respondent states that Swedish taxpayers should not carry higher risks for their national banking system compared to other European countries. Since Swedish banks are gigantic relative to the Swedish GDP, it is natural to require banks to have higher capital buffers to decrease the taxpayers' risk (Governing body 2). Governing body 1 states that this is just a gesture since all Swedish banks already meet the advised capital requirements. The respondent further says that even though the requirements make it costlier, tougher regulations might provide increased creditability for the Swedish banks internationally.

The liquidity rules are said to be the most questioned and discussed part of Basel III, since it is the first time it is imposed in Sweden and it arise difficulties to define which assets that are to be included under "liquidity" (Governing body 1). The Liquidity Coverage Ratio (LCR) requirement is said that banks have to release liquidity buffer reports quarterly and are required to hold high quality and liquid assets. These assets have to respond the bank's upcoming 30 days' liquidity demand (Governing body 2). According to Governing body 5, mortgage and corporate bonds can represent a maximum 40 percent of this "high quality assets". These assets will however be discounted by a certain value, "a haircut", to be classified as liquidity. Corporate bonds also have to have a credit rating of AA- or higher to be qualified as "high quality". Therefore, Governing body 2 concludes that it is nearly impossible for smaller companies to qualify to the liquidity reserve.

The Net Stable Funding Ratio (NSFR) requirement means that banks' stable funding have to be greater than the need (Governing body 2). Intermediary 1 says that this result that banks need long-term funding in order to supply short-term credits. This swap is costly and will further impose costs on banks and attract corporations' to use alternative debt financing (Intermediary 2).

Many of our respondents mention that banks intend to remain their return on equity under Basel III, resulting in less credit supply and increased costs for corporations' bank loans due to the capital requirement. Even though the liquidity rules argue against corporate bonds, the Basel III will clearly make the corporate bond market more attractive (Intermediary 11).

5.2.4 SOLVENCY II

Answers to **Question 12:** *"What effects will Solvency II have on corporations' funding and the corporate bond market?"*

Investor 5 explains the historical development of the law in the following paragraph. The first Solvency regulation (Solvency I) was introduced in the 1990s when European politicians studied the United States and saw a better capital market that enhanced venture capital supply. In order to improve the venture capital markets in Europe, the politicians imposed regulations on the insurance companies to force investments and thereby generate similar economic growth as in the United States. This was according to Investor 5 the start of Solvency, something that nearly everyone has forgotten. Since the 1990s, there has been a transformation of these regulations to limit insurance companies' investments instead. Investor respondents expressed frustration that the firms nearly cannot take any risk at all and that Solvency II will further reduce the risk taking for insurance companies.

Governing body 5 states that the legalization will have vast impact on insurance companies' willingness and ability to invest in corporate bonds. Nevertheless, it is unclear in what direction and insurance companies experience uncertainty how to calculate their assets (Intermediary 12).

Solvency II impose higher capital requirement on credit risk and give incentives for insurance companies to diversify their investment portfolio with less risky and short-term assets (Investor 6). According to Investor 6, the capital requirement is higher for assets with longer term to maturity and corporate bonds can be very expensive within the new regulation. Consequently it might have a negative impact on the demand side for corporate bonds. On the other hand, Governing body 5 states that there might be an increased demand for corporate bonds since Solvency II will improve maturity matching of debt and assets. Long-term liabilities need to be matched by long-term assets and insufficient matching lead to higher capital requirements (Governing body 5).

Investor 6 says that rating can be very important within the new rules. The capital costs for holding high-yield rated firms will be significant and is the segment that will be most affected by Solvency II. Long-term credits with low credit rating can be as costly as holding companies' stocks (Investor 5). If the company aims to have insurance companies as investors it is deleteriously for a corporation to get a low rating. In this situation it is better to stay unrated since unrated bonds instead will have a favorable capital requirement between BBB and BB rating (Investor 6).

5.2.5 MIFID II

Answers to **Question 13:** "*What effects will MiFID II have on corporations' funding and the corporate bond market?*"

Governing body 5 says that the financial crisis struck hard on many retail investors and the transparency within the MiFID regulations was deemed insufficient. The second initiative of MiFID is aiming for a transparency on the debt market similar as the current stock market transparency where all transactions have to be published. Nevertheless, Governing body 7 states that the new directive is currently under development and it is uncertain how the regulatory framework will look like at European as well as national level.

Governing body 3 says that transparency is beneficial, but the conditions are different for each unique market. Governing body 7 concludes that if MiFID II is fully imposed as it is written today, it will force a shift from a phone market to an electronic market for corporate bonds in Sweden. Even just an increased transparency with revised MiFID rules will result in possibility that no one is willing to take the risk as market-maker (Governing body 2). One respondents report states that MiFID venture to dry up the liquidity, increase the spreads and close the whole corporate bond market due to the small size and few transactions. Nevertheless, Governing body 1 states that there have to be better transparency to develop this market and increase the width by attracting more investors.

Sweden already has rules about a greater transparency, however this regulation is not followed and the Financial Supervision Authority has actively chosen to overlook these violations[11] (Governing body 5) The Financial Supervision Authority is currently working on how to reformulate the MiFID II in Sweden and have submitted their standpoint to the European Commission. The authority thinks that the market is too small and does not want to strangle it with regulations (Intermediary 2). Intermediary 1 states: "MiFID II is poorly thought-out and an obnoxious written text and I am confident that it will be revised". Governing body 5 suggests that the transparency in the corporate bond market can be sufficient if companies begin to follow the existing law. Then the transparency can rise to the levels of mortgage and government bonds trading.

The positive side with MiFID II is said to be that the corporate bond market will open up for smaller investors and simplify the trading process (Investor 3). Intermediary 12 means that it can lead to a more active trading area and that issuing firms need to pay less liquidity premium. On the other hand, Governing body 5 argues that MiFID II's transparency might hurt the liquidity and increase the cost for emitting firms. Investor 5 states that for large institutional investors, there are no benefits of further transparence in the market. "We have a buy-and-hold strategy and want to get as high-yield as possible. None of the banks would try to fool a big player like us and an extension of pre- and post-transaction transparency is not necessary" (Investor 5).

[11] FSA is 2007:17 Investment firms have to report the highest and lowest clearing price and trading volume at the latest nine a clock the day after the trade transaction took place.

5.2.6 COMBINED EFFECTS OF THE REGULATIONS

Answer to **Question 14:** *"What are the combined effects of the three new regulations on corporate's funding and the corporate bond market?"*

"The new regulations have completely different purposes and are not the slightest correlated" – Lars Nyberg, Former Deputy Governor at the Riksbank

Basel III, Solvency II and MiFID II are taking place in different levels of the market and are likely to have somewhat counteracting effects on the corporate bond market (Governing body 1). Intermediary 1 says that Basel III points in one direction focusing on banks' risk, Solvency II points in another direction when limiting insurance companies' risk exposure and finally, MiFID II aims to transform the whole corporate bond market by greater transparency. Investor 5 argues that all regulations combined have created a lot of uncertainty and the respondent express it as a "deadly cocktail". According to Governing body 5, analyses of the combined effects of the regulations are insufficient.

"Our role is to promote stability and efficiency in the financial system as well as to ensure an effective consumer protection. In my view, good regulation can support the development of markets, but not create them." – Jan Axelsson, Senior Advisor at the Financial Supervisory Authority

There is a challenge for regulators to find the balance between enforcing regulation to prevent another crisis and ensure that the liquidity pools are large enough to support company growth (Governing body 1). Governing body 2 says that banks set their pricing strategy based on expected effects of upcoming regulations. Due to the uncertainty of future regulations it is confusing for banks to predict and set their prices (Governing body 2).

5.3 Corporate Perspective

"Everyone must do their homework. Corporations have to constantly play with the idea that what if the bank says no to further credits. Therefore, all companies are required to consider corporate bonds as alternative financing, for the sake of their shareholders. It is similar as a shooting practice in the military service. You have to go through the process, either in theory or in reality, so that once you have to act, you know what steps needed to be taken and how to proceed." – Olof Manner, Head of Scandinavian Rate Sales at Royal Bank of Scotland

5.3.1 Advantages of using Corporate Bonds

Answer to **Question 15**: *"What are the advantages for corporations of using corporate bonds?"*

Diversified funding sources

According to a majority of our respondents, diversification possibility is one of the main reasons why companies should consider corporate bonds. Investor 4 suggests that companies should learn from their supply chain management strategy when setting up the funding strategy. As an example, a manufacturing company would never rely on just one supplier. Similarly, companies should use various sources for supply of capital (Investor 4). As stated in 4.2.1, corporations felt betrayed by their banks during the financial crisis and were reminded of the importance of having diversified funding sources. Using more than one source of funding decreases the refinancing risk (Intermediary 9). A well-diversified financing strategy also usually leads to a lowered interest rate since the default risk is spread among the counterparties (Investor 6). The argument for diversification can be seen in the perspective of independency, where the power of banks decreases in favor of corporations (Investor 3). The firms get an improved bargaining position by having alternative ways of funding (Intermediary 11).

The flexible structure

Another advantage mentioned by our respondents is the flexibility of the security. Intermediary 9 states that a significant amount of bonds can be issued within a short period of time and as short as a week for a reappearing company. Intermediary 12 states that the construction of the bond is flexible and can be designed from the demand of the unique investors and issuing firms. There is also no need to amortize during the period compared to bank loans and the bond agreement also does not require the same number of strict commitments by the company as banks usually require (Intermediary 12).

Optimized capital structure

Intermediary 12 says that by using corporate bonds the possibilities of achieving an optimized capital structure increases. The capital structure can be improved by using bonds on top of bank loans and equity of a firm, see figure 4.5 (Intermediary 8). Increased leverage through bonds is said to enable a higher return on equity to increase the shareholder value. In some cases the interest rate on bonds can also be lower than bank loans (Intermediary 11).

5.3.2 LIMITATIONS TO USE CORPORATE BONDS

Answer to **Question 16**: *"What are the obstacles for companies to enter the bond market?"*

HIGH COSTS

"The high fixed costs are the main reason why the smallest companies can never enter the market. There is a risk that these companies believe that the market is available to them but that will never happen" - Lars Nyberg, Deputy Governor at the Riksbank

Intermediary 8 states that despite the possible advantages that can be gained from using bonds it will in the end be a matter of costs. The respondent continue concluding, due to the strong tradition of relationship banking, corporate bonds have always been the costlier funding alternative. Intermediary 11 says that the Swedish company prefers the simplicity of bank loans and the high cost on bonds has frightened many possible issuing firms. According to intermediary 12, the Swedish corporate bond market is illiquid and the interest rates tend to be higher due to investors' compensation for liquidity risk. Intermediary 7 also explain that there is a high upfront cost. The financial intermediary's issuing fee stands for the major part of the fixed costs (Investor 3). Law firms are engaged to set up the documentation needed and since the documentation for Swedish companies is far from standardized the cost of this procedure is fairly high. The complex documentation has been a limiting factor especially for smaller corporations (Governing body 4). The lack of established standards makes the transaction process uncertain and unpredictable and this is believed to have excluded many firms from the bond market (Investor 3). Intermediary 9 conclude that the high initial costs involved with issuing bonds lead to firms having to reach large volumes to gain from economies of scale. The fixed costs are spread among a higher volume so that the issuance becomes relatively cheaper. In addition to the higher yield and fixed costs, Governing body 1 underscore the importance of involvement from the company is needed which requires a lot of management time.

VOLUME REQUIREMENTS

The volume is an essential limiting factor for medium-sized corporations, since the fixed cost involved in issuing bonds is significant (Governing body 5). Our respondents' view of the minimal required volume is quite diverse. According to Intermediary 4, an appropriate size for the market to absorb is 500-750 million SEK. The issuing volume should not be lower than 250 million SEK due to the fixed costs and it is reasonable to try to allocate the term to maturity over a number of years to spread the costs (Governing body 5). Volumes below 250 million SEK is very unfavorable since the interest rate increase because of the illiquidity premium (Intermediary 11). Less volume makes it tougher for investors to trade the security (Intermediary 12). Intermediary 2 is optimistic and says that the minimum requirement for issuing bonds can be as low as 100 million SEK. Issuing firm 4 states that lower multiples than 500,000 SEK leads to tougher regulations on information transparency and corporations rarely go below this number.

According to Intermediary 12, the institutional investors usually have two investment requirements: firstly, minimum contribution proportion and secondly, maximum share of the issued debt. Investor 4 does not invest in issues smaller than 500 million SEK. Smaller investments are not worth to manage. The respondent states: "I rather take greater risk with a few large holdings and avoid picking in trifles". Investor 5 also has a limit of 500 million SEK and does not want to invest in the whole debt. Nevertheless, for well-known companies, these investment requirements might be ignored. Investor 5 suggests corporations that aim to issue small volumes to remain using traditional bank loans.

KNOWLEDGE GAP

"Even though you call a CFO at a company large enough to be mid-cap listed, you need to spend the first few minutes explaining what a bond is, how it works, and that it is not just available for the large companies. Education is indeed needed in this area to get the interest started" - Claes Bahri, Head of Fixed Income Sales at Nordic Fixed Income

A majority of our respondents state that there exists a knowledge gap concerning corporate bonds. According to Intermediary 2, the simplicity to contact the local bank official for funding has meant that the level of knowledge is relatively low. Intermediary 12 says that for new issuing firms, it is therefore a high risk of conceptual confusion since it is the first time this asset class has been considered and the choice of emitting structure and instrument features tend to complicated. Intermediary 2 quoted: "The terminology frightens many smaller firms. They do not dare to ask the obvious questions in the boardroom, because they feel too ashamed to confess that they do not have the knowledge about a security they actually should be familiar with". Several respondents expressed that education is needed for all firms and knowledge about alternative ways of funding is crucial.

INCREASED PUBLICITY

"To issue bonds for the first time is like a light version of going public. This will lead to high demands on the transparency of the firm, and the question is whether the company is ready for that." – Fredrik Block, Treasurer at Elof Hansson

Issuing firm 14 and Issuing firm 13 highlight that using bonds instead of bank loans put extra requirements on the transparency of the firm. Medium-sized non-public companies that never been engaged in investor relations will now have to use this tool to be attractive in the eyes of the investors (Issuing firm 13). Intermediary 4 states that the firms have to present its key selling points, historical performance and future development to attract investors. Using corporate bonds also require additional information provided by the financial accounting unit and interim reports need to be conducted. By using corporate bonds, the firm will in general become more public and this decision has to be in line with the business strategy of the firm (Intermediary 8). This might be complicated in comparison to bank loans where the company needs to maintain just on single bilateral relation (Issuing firm 12).

5.3.3 CREDIT RATING

Answers to **Question 17**: *"Why is rating important and what are the rating requirements?"*

The importance of rating has been discussed by many respondents and it has also been brought up earlier in the study. In this part, we address the practical issues for corporations to get a credit rating.

By getting credit rated, the company becomes more accessible in the credit market (Issuing firm 14). A rating can help to communicate the quality of the firm and thereby possibly expand the universe of inventors (Issuing firm 2). According to Issuing firm 4, rating agencies provide independent views of their creditworthiness and help to set a fair price in the capital market. The more creditworthy an issuer is, the lower the interest rate the issuer would typically have to pay to attract investors. The reverse is also true; an issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors (Issuing firm 1). If the corporation aims to reach to foreign investors or markets, then rating is very important (Issuing firm 5).

There is a high threshold cost to gain a rating and additional management time is required to be spent (Governing body 2). According to Intermediary 7, the initial fee of assigning an Issuer Credit Rating (ICR) on an entity is approximately 500,000 SEK and the annual fee is on average 500,000 SEK. In addition the issuer also has to pay a "bond fee" on top of the ICR fee. This is only paid once in the bond's lifetime and is approximately 5 basis points of nominal amount issued. To get a rating the agency need a lot of information. One respondent mentioned as an example, 3-5 years audited annual financial statements and a narrative description of operations and products. Rating agencies require better transparency trough interim reports and annual credit analyses (Issuing firm 3).

The trend in Sweden is to accept unrated companies to a larger extent (Intermediary 2). Investor 4 states that when investing, the most vital aspect is not the rating, but to understand the business model and the fact that it is a stable company. New issuers are suggested to conduct a confidential rating called "shadow rating" and compare with similar companies. If it is believed that the corporation will get a lower rating than BBB, it will be better off unrated (Governing body 5). It is important for a company to analyze the market's perception of the company. Intermediary 2 states: "If investors believe you are an A rated firm but you actually are a high-yield company, stay as far away from a rating as possible". Smaller firms gain lower rating in general, which means that these firms in many cases are advised to remain unrated (Intermediary 2).

5.3.4 PRICING THE BOND

Answers to **Question 18**: *“How is the bond price set for a new issuing firm?”*

”What is the cost? This is the first question every new issuer ask and I am sorry to inform them that it all depends…” – Karl Johan Kulling, DCM & Origination at DNB

When it comes to deciding the coupon, it is very depending on the market environment. The corporate bond market has been described as very binary with respect to its periodic availability. Intermediary 8 liken the market as taps that are either opened or closed. When the market is closed it can be very expensive for companies to borrow the desired amount of money. This can change from one week to another and it is really hard to keep up with the market changes. Therefore, issuing firms have to prepare the prospect to be ready to issue whenever the market opens (Intermediary 8).

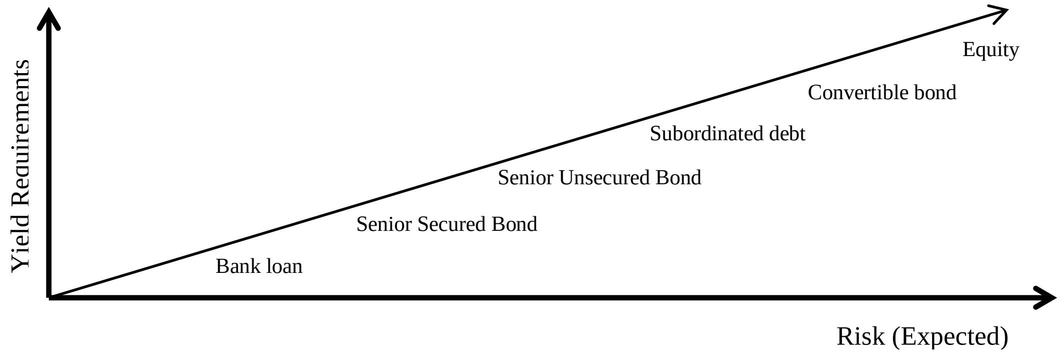
Issuing firm 3 explains that the price is decided through a discussion with the financial intermediary, by following credit indices and comparing yields with similar companies’ bonds. Intermediary 7 states that it is very hard to set the price range for high-yield, since it demands thorough investigation of each unique company and the spreads can differ with as high as percentage points. Respondents have indicated that a new company in the market might have to pay an extra premium since the investors are unfamiliar with the security (Investor 6). This premium usually decreases when the company has been active in the market during a period of time (Intermediary 8). Investor 5 uses the following three steps when analyzing the interest rate of a company: “Firstly, can the corporation refinance the debt when it matures? Secondly, what is the corporation’s debt capacity? Finally, in a case of a default, how much can I retain?”

“Everything good in life cost money. It accounts for boats, cars and corporate bonds.” – Olof Manner, Head of Scandinavian Rate Sales at Royal Bank of Scotland

Intermediary 1 point out that for smaller firms, bank loans are still the cheapest funding alternative and corporate bonds are only less costly for a handful investment grade corporations. However, due to the new market conditions the difference is declining (Intermediary 11). As an example, according to Issuing firm 5 the difference in their funding costs between bank loans and bonds has declined from 4 percent to nearly 1 percent. Intermediate 8 does not recommend a new issuer to use bonds if it is only a matter of costs and states that bonds should be used when a company aims for greater flexibility and is willing to pay for it.

Corporate bonds have different underlying risks depending on the priority in case of a default. The risk associated with the instrument is reflected in the required return demanded by the investors (Intermediary 11). For a new issuing firm it is important to map the different alternatives that are possible to use (Intermediary 12).

Figure 5.4 Levels of risk and yield[12]



If a corporation can use asset-backed bonds it is possible to push down the interest rate (Intermediary 1). The most common is however to use senior unsecured (Intermediary 8). According to Investor 5 unsecured is preferred, since investors gain from higher return and the debt is still senior. Unsecured debt usually comes with some covenants such as net debt and earnings ratios or change of control requirements (Intermediary 12). Maintenance covenant is very common, where the corporation agree to remain the solvency at a certain level (Intermediary 3). It is common for state owned-companies to have a covenant stating that all bonds matures if there is a change in the ownership structure (Issuing firm 13).

[12] Illustration with inspiration from Intermediary 12

5.3.5 CREATE AN INVESTOR BASE

Answer to **Question 19**: "*What is important to consider when creating an investor base?"*

When bonds are issued, the bank takes a role as an intermediary and the corporation needs to focus on the market and the investors (Governing body 1). Intermediary 1 states that there are no typical "bond corporation", but there are some attributes that are especially attractive to investors. Large and well-known corporations with stable history and future solid cash flows are favorable characteristics. Intermediary 1 gives the example of Atlas Copco as a suitable example for bonds. It is listed, well-known all over the world and has a very stable 100-year's history. The market is subject to the importance of name recognition, which means that a firm can gain by having a well-known brand. Medium-sized firms often lack these attributes and it is more important for them to have a good story to support the financial case (Intermediary 4).

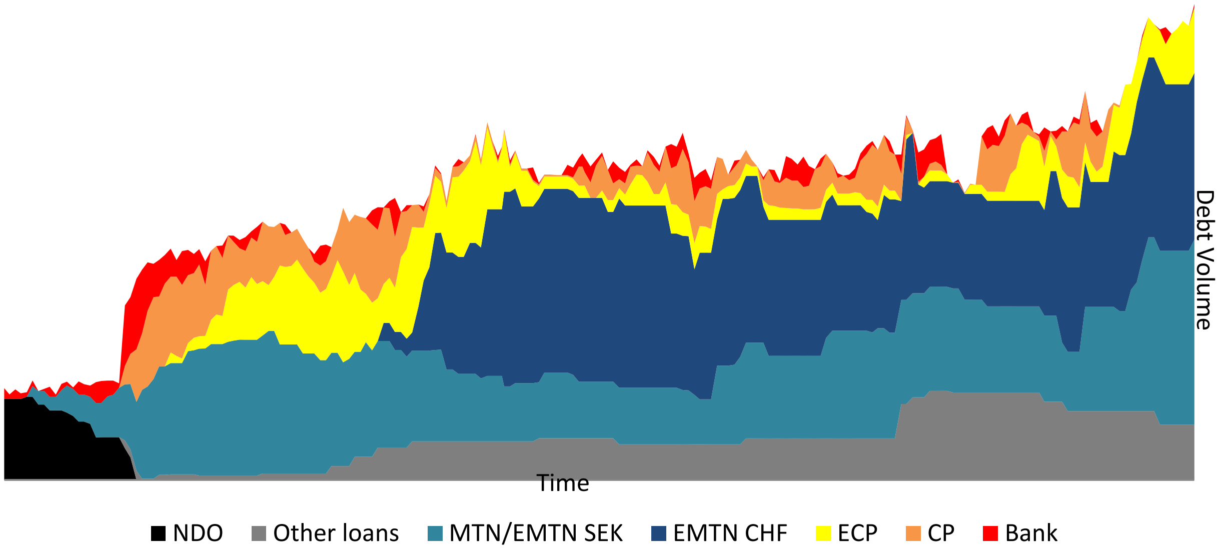
Governing body 1 highlights that companies easily forget the importance of creating a diverse investor base. A result of this is that the firms do not invest the time that is needed and focus on too few investors. It takes a lot of management time and effort to enter the market and to attain investors. Therefore, the investment relations activities should involve the whole company, not just the CEO and CFO (Governing body 1).

Issuing firm 14 underscore the importance of relationship with investors in the bond market and to let the investors be a part of shaping the deal. Issuing firm 13 suggest companies to work opportunistic since it is costlier for a corporation to enforce a bond structure, than to adjust the bond for the investors' preferences. When selecting financial intermediate it is essential that they have a broad investor network so the bonds reach a variety of investors (Issuing firm 5). Even though bonds are seen as an institutional product, private investors have begun to show more interest (Issuing firm 2).

"You have to learn how to crawl before you begin to walk"
– Peter Hjalmarsson, Group Treasurer at Getinge

Issuing firm 14 and Issuing firm 6 suggest a new issuing firm to use a step-by-step approach to be well-known in the market and create a solid investor base. A small firm needs to make intense marketing efforts in order to create a name among the investors. Issuing firm 13 advices firms to start with short term external financing. By using commercial papers, the company reduces the risk of tying up the premium for being new in the market. This strategy helps the corporation to get to know the market and the investors get familiar with the company (Issuing firm 13).

Figure 5.6 Example of a transaction in funding sources[13]



Above is an example of an issuing company's debt distribution from start until today (2012). The company began with bank loans since it is simplest and safest and then used market based financing by issuing commercial papers (CP) and bonds (MTN) in SEK. Next, the firm issued Euro Commercial Papers (ECP) to attract a larger investor group, followed by a European program (EMTN) to attain long-term financing. After discussions with investors it turned out that there were a great demand for the corporation's bonds in Switzerland and the firm issued a program in CHF to push down the interest even further.

According to Intermediary 7, beginning by using commercial papers is a very common suggestion to new emitters. The respondent states: "It is like dipping the toes in the capital market to get a first feeling". Nevertheless, it might not be recommended to all medium-sized corporations to start with commercial papers (Intermediary 7). The respondent argues that investors do not want to invest in a one-off issue and require a long-term commitment by the firm to use commercial papers. Intermediary 7 suggest new issuers that aim for long-term financing to not go the detour by issuing commercial papers, but instead directly start by issuing bonds. The firm can prepare investors by initially issue smaller amounts through private placements (Intermediary 8).

[13] Illustration with inspiration from Issuing firm 13

6. Analysis

The analysis combines the litterature review and the empirical findings by adding our impressions. It narrow down the interview answers to respond to the stated research questions.

6.1 Market Perspective

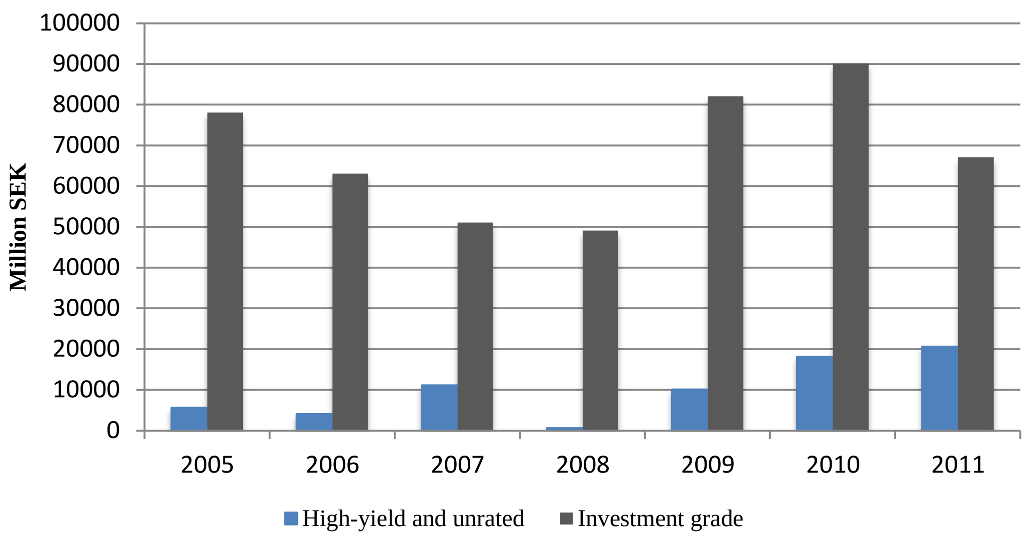
Research Question 1: *How is the Swedish corporate bond market structured and what is needed in order to improve it?*

6.1.1 How is the Market Structured?

A small market dominated by investment grade firms

According to Statistics Sweden and Governing body 5, 7 percent of the total Swedish bond market is represented by non-financial firms. The respondents stated that the Swedish corporate bond market is small in size, measured in number of issuers and trading volume. Our impression is that firms with high credit quality overall are satisfied with the structure of the current market, since the market is designed for large volumes and low-cost funding can be achieved for these firms. Nevertheless, these companies expressed frustration that it might be hard to achieve long-term maturities in Sweden. Issuing firms in the high-yield segment addressed the obstacles of the market. Investors demand a high compensation for the low credit quality and these companies have instead focused on bank loans. According to the responses of the financial intermediaries, it is likely that the majority of new issuing medium-sized firms will be categorized to this segment and therefore it is a market that needs to be developed. A "Catch 22" situation can illustrate the situation that the companies are facing. Several issues are needed to develop the high-yield market but the issuing firms are most likely not interested in the bond market until there is a developed and well-established market.

Figure 6.1 – Investment grade and high yield SEK issues[14]



[14] Data from Bloomberg, provided by Magnus Öhvall and Magnus Berggren at Carnegie Investment Bank

Our respondents point out that the market has traditionally been focusing on the investment grade firms, which is illustrated in figure 6.1 were the volumes issued each year is dominated by high credit quality corporations. In 2011 approximately 40 investment grade firms issued bonds whereas only 15 high yield or unrated firms issued. An explanation behind the market structure is that the market was forced to develop since banks could not provide large volumes of credits to the big manufacturing firms in Sweden and consequently the infrastructure of the market is created for these types of firms. The four large banks are very influential and the strong dependency on bank loans for medium-sized corporations has made the banks not advocate the development of a high-yield market. Also investor respondents concluded that it is stated in many institutional investment rules that investments in high rated firms are prohibited. It has on the other hand been allowed to invest in the stocks of the same firms. Respondents from the investors expressed frustration concerning the investment regulations and have indicated that the regulations will be reformulated in the future, meaning that high-yield bonds will have a more important role. Investor 5 stated that an obstacle is however the required volume of the issues since the institutional investors do not consider investments lower than a certain size. Furthermore, Investor 2 expressed the concern of that the regulations will be stricter if a large high-yield firm defaults and the interest for high-yields can therefore easily fade away.

Several respondents named United States as the birthplace of the bond market. The theoretical framework and the empirical findings conclude that there is a clear difference in corporate funding between the United States and Europe, such as the 80-20 relation expressed by Hässel, Norman & Andersson (2001) and Intermediary 6. According the literature and our respondents the difference is partly due to the differences in banking structure (De Fiore & Uhlig, 2011) and partly because of difference in legal frameworks (La Porta et al., 1997). The Nordic countries have similar legal structure and most of our respondents compare the Swedish market to the Norwegian. However Intermediary 2 underscored that the major differences in company structure makes it difficult to compare these two markets. Norway is to a large degree focused on firms within the high-yield segment since a major part of the companies operate in highly volatile industries. The typical Swedish large firm is on the other hand is a manufacturing company with investment grade rating. Nevertheless, we believe Sweden has lessons to learn from how Norway developed the high-yield market. As an example, the Norwegian market well-developed bond trustee organization Norwegian Trustee.

6.1.2 WHAT ARE THE LIMITING FACTORS AND HOW CAN THE MARKET BE IMPROVED?

STRONG TRADITION OF RELATIONSHIP BANKING

According to our respondents, the major limiting factor for the Swedish corporate bond market is the strong tradition of relationship banking. The financial market in Swedish says to be characterized by the involvement of the four large commercial banks, which have been able to finance corporations at a low cost. In addition, Sweden is mentioned to have a cemented bank structure with corporate spheres. Therefore, there have not been any incentives for corporations to search for alternative sources of financing. A respondent said that the banks have taken care of the companies within the group and people have been members of the board in both banks and firms.[15] Capital allocation was said to have been decided in the boardrooms and there has thus not been any driving forces to develop the Swedish corporate bond market. Our believe is however that the fact that a corporate bond market historically not been seen essential should be considered as a good sign since the firms have been supplied with low-cost credits which has resulted in economic growth.

LACK OF TRANSPARENCY AND LIQUIDITY – THE MARKET-MAKER DILEMMA

The transparency is an important question and was brought up by most of our respondents. Niemeyer (2000) makes the distinction between the information types provided to the investor. The first type of information is company-specific and investor respondents have indicated that there is no need for improvements in this type of transparency. The second type of information concerning the trading activity is said to be insufficient, meaning that there exist market inefficiencies according to theories presented by Fama (1970). It is especially smaller investors and firms in the high-yield segment that expressed their complaints. However, the investment grade firms and the large commercial banks indicate that there is no problem; it is in fact in many cases desired. The banks state that the lack of transparency is a prerequisite for liquidity in the market from a market-maker perspective. Governing body 8 and Investor 3 argued against this statement since a significant part of the deals actually are brokering deals and not market-maker trades. Our impression is that the risk is too high for market-makers and instead they act as brokers between a buyer and a seller in the market.

The information darkness in Sweden is clarified when comparing trading data provided in other countries. Trading data from Bloomberg shows that the Swedish market provides the lowest grade of price information compared to Germany and the United States. Appendix 5 presents the information provided concerning a bond issued by Vasakronan in the Swedish market. Only SEB indicates a value of the security, which is a bid price. Appendix 6 shows the data of a bond issued by Handelsbanken in the Euro market. The Euro market is better where several banks offering bid/ask prices and this is also a way of describing the liquidity of the market. The market in the United States shown in Appendix 7 is the best with regards to the transparency. The bond is issued by Procter & Gamble and data is shown of bid/ask quotes and also post-trade information since a completed trade is reported.

[15] Such as SEB within Wallenberg sphere and Handelsbanken within Lundberg sphere

Our impression is that the issue of transparency and liquidity can be illustrated through a chicken-and-egg problem. Investors do not want to use the market because of the low transparency while banks claim that there are too few investors and insufficient trade in the market to implement a higher level of transparency. The market would probably gain by better information access. The level of transparency should not be considered as black or white. It can be improved without taking it to the high level as in the stock market since a full mandatory transparency might damage the market according to some of our respondents. We believe however the market has to move from total darkness to gray. According to Governing body 6 and Governing body 8 similar level as for mortgage and government bonds is appropriate, where a post-trade transparency is implemented. By using post-trade information reported e.g. every week the investors get an indication of what is traded and how much, even though it will not lead to any precise information. In the current situation, the investors are in a weak position and dependent of the information that the banks provide.

The institutional investors demand a depth of the market and according to Niemeyer (2000) the Swedish fixed income market has the largest depth in the world. However, Intermediary 2 argues that the depth in the corporate bond market does not exist naturally and instead market-makers create a synthetic liquidity. The institutional investors tend to use a buy-and-hold investment strategy and prefer an extra illiquidity premium. This strategy can be argued to be a result of the market structure and the investors are to a large extent only willing to invest if they are prepared to hold the security until maturity. The market has excluded many investors with an active trading strategy since it can be very expensive exit a position prior the maturity.

A DUCK POND WITH SOLID STRUCTURE

Based on our interviews we draw the conclusion that the fixed income market to a large extent is made up by a limited group of people. A majority of these people were fostered in the market when it all started in the 1980s and the number of new recruitments has been considerably low. This has led to a very stable structure, for better or worse. The disadvantage is that changes might have been discouraged and a possible increase in transparency would lead to a less profitable business for these market players. Retirement will however require that new people will be recruited and this might be beneficial for the maturity of the market. The advantages are the simplicity and stability for the market players already active in the market. Respondents argued that to further open up the market for new corporations and maintain the stability, there have to be a united collaboration between all market players and stakeholders. One respondent pointed out the similarities to chess playing, where all pieces are dependent on each other and can only be moved one step at a time. One market player cannot achieve a change by itself and it requires many more conferences and seminars. It is first when all market players begin to collaborate that the market can be improved.

6.2 NEW MARKET CONDITIONS

Research Question 2: *How will new market conditions affect issuers of corporate bonds?*

6.2.1 WHAT ARE THE UNDERLYING FACTORS BEHIND ADDITIONAL INTEREST?

All of our 43 respondents, no matter of size and where they are positioned in the transaction chain, stated that that there is currently a greater interest to use corporate bonds in Sweden. This gives a clear indication that there exists an additional interest for bonds. Nevertheless, the responses of underlying factors behind the interest were quite diverse.

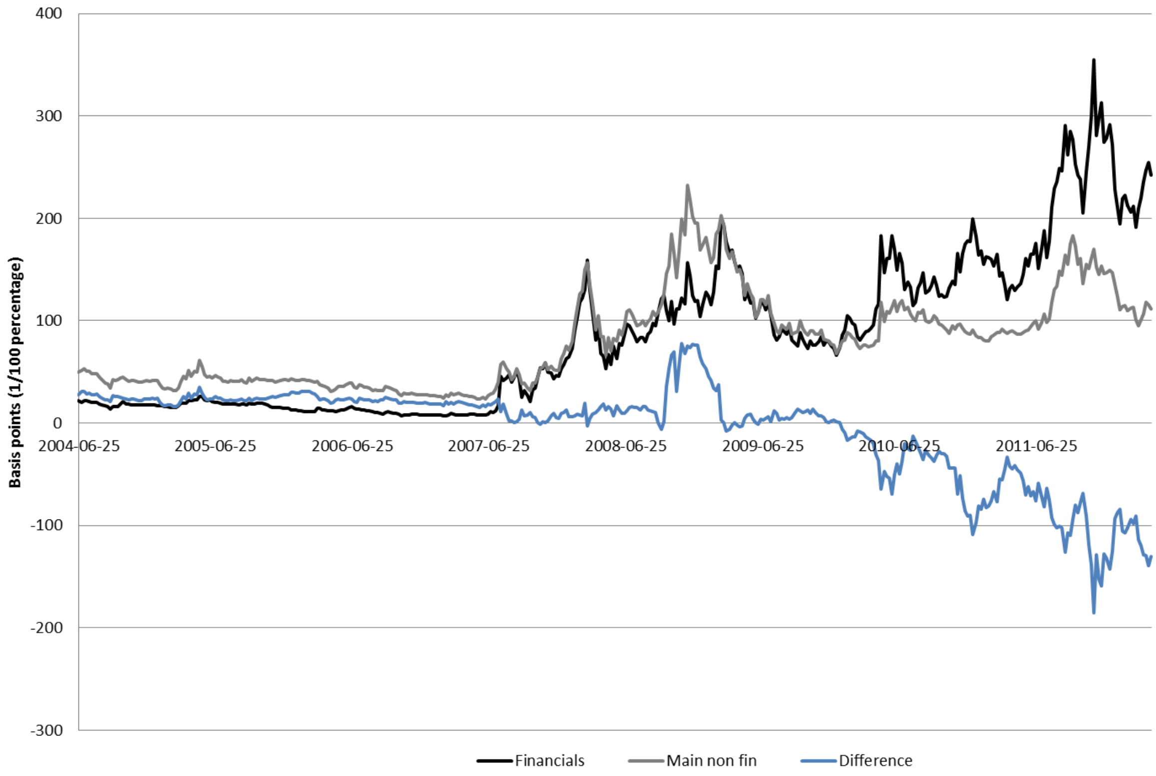
NEW REGULATIONS – BASEL III LEAD TO HIGHER COST OF BORROWING

A majority of the respondents clearly indicated new regulations and primary the Basel III regulation as the cornerstone for the additional interest. According to BCBS (2009), more stringent capital adequacy rules are predicted to lead to higher borrowing rates, which were confirmed by many of our respondents. Issuing firms mentioned that the higher cost of capital for banks already led to increased interests or tougher to get credits from banks. The regulation has forced banks to ease their balance sheets and take a larger role as intermediary for bond issues. Our impression is that this can be the first time that the large Swedish banks show an interest in developing the market, even for firms with lower credit quality. Basel III has given clear profit incentives to limit credit lines and shift focus to act as bond intermediaries. The regulation is aimed for banks but will primary affect smaller corporations' profitability, since respondents state that banks will probably try to maintain their return on equity by transferring costs on to the corporations. Consequently, the empirical findings indicate that Basel III has changed the attitude towards bonds for both banks and corporations.

HIGHER COST FOR BANKS' FUNDING

According to Investor 4, the illiquidity crisis led to higher cost of borrowing for banks and consequently a strong incentive for corporations to use bonds. 2010 was the first time that corporations had cheaper funding than banks on average. The respondent clarified a shift and it is verified by the graph of credit index showed in figure 6.2. The graph compares financials (black line) and non-financials (gray line) corporations' costs of financing in Europe. There has been high volatility in the market due to the macro uncertainty since 2007. The risk involved with bank investment was clarified in 2010 and the statistics point out the newly awakened interest for market financing. Since the indices are based on European numbers the differences might not be as high in Sweden but there is a clear indication that a similar development also is taking place. Our impression is that the graph exemplifies the shift from banks to corporations. It is important to bear in mind that the low cost for corporations accounts for investment grade firms, but higher borrowing costs for banks likely lead to increased credit costs for medium-sized corporations and consequently greater demand for alternative financing.

Figure 6.2 – Credit index difference financials and non-financials[16]



UNDERPERFORMANCE OF STOCKS AND REFINANCING NEED

Our respondents highlighted the underperformance of stocks and the greater attention to the asset-type by the investors'. In the literature review, Richelson & Richelson (2011) stated that bonds had outperformed stocks and many of our respondents also verified this statement. There seems to be a pent-up demand for less risky assets with decent yields. There is a greater interest from investors combined with a greater supply due to the refinancing need for corporations. Swedish banks are well capitalized but international banks are predicted to reduce their presence in Sweden and instead focus on their home markets. Respondents of issuing firms says that they had experienced credit-stop by international banks and mention that the refinancing need combined with less supply of credits consequently will lead to greater attractiveness for bonds.

[16] Data from Bloomberg
The graph is based on Main Index consisting of 125 largest credits in Europe. Financials is based on the 25 banks in the Main Index. Main non fin is based on the 100 corporations in the Main Index

6.2.2 COMBINED EFFECTS – A SHIFT TOWARD MORE BOND ISSUING

NEW REGULATIONS – VAST UNCERTAINTY AND STAY UNRATED

Basel III's capital requirement is stated to lead to more bond issues. In addition the respondents clarified that the regulation's liquidity ratio (LCR) might have negative effects on the demand for medium-sized corporations' bonds. Governing body 2 states that it is nearly impossible for smaller corporations with low rating to qualify to banks liquidity reserve under the new requirements.

Solvency II sets up new capital requirements on a risk basis and Gunnardottir & Lindh (2011) states that the regulation might significantly affect the demand of Swedish corporate bonds. According to Investor 6, credit risk requirements can have negative impact on the demand for bonds. The respondents further suggest medium-sized issuers to not get a rating if they are believed to be subject to a categorization within the high-yield segment, since the Solvency II might drastically limit the investor base for high-yield corporations. However, Governing body 5 states that there might be positive demand due to that long-term liabilities have to be matched by long-term assets and the credit risk requirements can be offset by maturity matching to a certain degree.

MiFID II was the most questioned regulation by our respondents. We could clearly distinguish between the answers of our respondents. Smaller investors and intermediaries did in general not question MiFID II, but large investors and intermediaries argued against the rule. Smaller market players would benefit by greater transparency, but large banks risk losing their market-maker position and large investors their extra illiquidity premium. Representatives from governing body have a neutral position and state that transparency is good, but implementing a too high level might strangle the market. We experienced vast uncertainty about the MiFID II rules and it is stated to likely be rewritten in the near future.

The combined effects of the regulations are said to be ambiguous. In the literature review Di Giorgio, Di Noia & Piatti (2000) states three objectives of financial market regulations: increase stability, investor protection and promotion of competition. Our impression is that the new regulations combined aim for achieving the first objective, but it is however questioned if it is fulfilled. Basel III, Solvency II and MiFID II have created a lot of uncertainty instead of stability in the financial industry. One respondent states that the regulations are not the slightest correlated. We believe that there is a clear risk of imposing these three regulations without close collaboration and experience of the preceding regulations. It is questioned if it is wise to impose these regulations due to the macroeconomic uncertainty within Europe. There is a risk that some of these new regulations act as a barrier for new market participants and can hold back the growth of the corporate bond market.

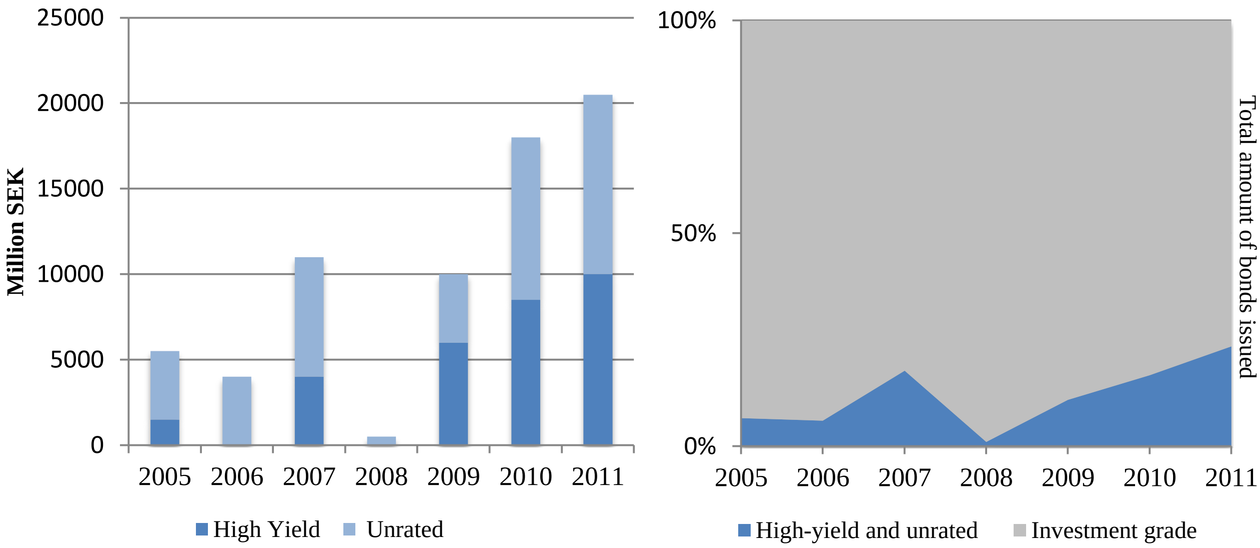
IS THE NEW CONDITIONS "OVERHYPED"?

The additional interest can be questioned. Intermediary 1 expressed that the attention to bonds is "overhyped". Our respondents are key-players in the fixed income industry in Sweden and our impression that there is a risk of wishful thinking. We believe that smaller financial intermediaries and investors stand in the forefront to expand the market. A respondent from one of the large banks explained that the smaller investment banks are dependent on the development of the corporate bond market, since the stock market has underperformed. The number of new funds willing to soak up these papers has increased significantly. Therefore, we believe it is logical that there is a larger media-attention and marketing effort to attract issuers and investors to this market. This can explain the provocative statements such as Citibank global markets (2010): “The end of a cult” and Investor 3 states: “the era of relationship banking can be over in Sweden”.

A SHIFT IS LIKELY TO HAPPEN

Overall, the underlying reasons for the greater interest is predicted to overcome the obstacles and respondents clarify that there will be a shift with more corporations issue bonds. Nevertheless, it is important to highlight that growth in the bond market is unlikely to be dramatic. Basel III and other underlying factors have made it possible for a shift, but the cost hurdles of issuing bonds indirectly determine the minimum size of firms able to enter the market. We have illustrated favoring as well as limiting factors in Appendix 4. It is believed that the new market conditions will lead to a larger market but the size of the shift is dependent on the future macro-economic development. The statistics verify our impression of a greater interest and that more medium-sized firms likely will enter. Figure 6.3 shows that high-yield and unrated firms increased their issuing significantly since the financial crisis in 2008. In 2011 the volume was nearly double the amount prior the crisis and there is an increasing trend of issuing in comparison to investments grade firms. According to intermediary 13 the figures for the first interim reports from 2012 show record high volume issued by high yield and unrated firms. Our impression is that the shift with new market entrance will be represented mainly by large family-owned businesses that are big enough to accumulate a significant amount of debt and also mid-cap listed firms that already achieve the transparency requirements.

Figure 6.3. Volume issued as high-yield and unrated in SEK as well as a comparison to investment grade volumes[17]



[17] Data from Bloomberg, provided by Magnus Öhvall and Magnus Berggren at Carnegie Investment Bank

6.3 CORPORATE PERSPECTIVE

Research Question 3: *What should new emitters consider when structuring the bonds?*

DIVERSIFICATION, FLEXIBILITY & OPTIMAL CAPITAL STRUCTURE

The strongest argument for bonds according to our respondents is the diversification possibility. A diversified funding is said to reduce the refinancing risk and increase the bargaining power of the firm. Respondents said that bonds can be issued within a short period of time and can be designed for the unique demand of investors and the corporations. By increasing the level of leverage the firm can obtain a higher return on equity and also benefit from tax reduction. Intermediary 8 suggests new issuers to use bonds on top of traditional bank loans to gain an optimal capital structure, since it is possible in a market with imperfections as stated by Modigliani & Miller (1963).

According to Governing body 2, one industry that is believed to use corporate bonds in a greater extent than others is the commercial real estate industry. This is due to the fact that these companies are the primary borrowers from the banks and that the banking industry has a large exposure to this type of companies. Another factor said by Intermediary 9 is that banks do not have much other business relations with these firms, which means that it is not possible to compensate low interest rates with higher margins on other services. Commercial real estate is a standardized asset that is easily valuated and respondents have indicated a future increase of secured-backed bonds. Intermediary 8 stated that secured-backed bonds has not played a prominent role as investors have preferred to get an extra premium paid by invest senior unsecured.

COST OF ISSUING

The high fixed costs in combination with an interest rate that in many cases is higher than the cost of bank loans are said to have limited the medium-sized corporations' usage of bonds. The fixed costs mentioned by our respondents are summarized with an example in table 6.4. Nevertheless, the pricing is unique for each company and the amount just gives an indication about the costs involved in issuing. Intermediaries' higher fee for low credit quality firms are significant, where it cost approximately 2 percent of the nominal amount compared to investment grade firms' 0.5 percent. The reason behind high-yield firms' higher intermediary fee is that it requires extra marketing and sales efforts by the intermediary. Intermediary 8 clarifies that this is a success fee, which means: "no deal, no fee". There is a risk that high-yield issues fail, which is not likely to happen for investment grade firms.

Table 6.4 Fixed cost example of a 500 million SEK issue[18]

Costs	Investment grade (SEK)	High-yield (SEK)
Intermediary:		
Intermediary fee	2 500 000[19]	10 000 000[20]
Agent/Trustee fee	100 000	100 000
External lawyers	500 000	500 000
Listing:		
Listing fee	8 000	8 000
Annual listing fee	10 000	10 000
Prospect & Program:		
MTN annually	100 000	100 000
Update prospect annually	400 000	400 000
Rating:		
Initial rating fee	500 000	500 000
Annual rating fee	500 000	500 000
Bond rating fee[21]	2 750 000	2 750 000
Total:	7 368 000	14 868 000
Percentage of nominal amount	1.47%	2.97%

The high fixed costs result in that a large volume of debt needs to be raised to be economically viable. By issuing a large amount it also enables trading in the security, which reduces the illiquidity premium. Our respondents state an average minimum issuing volume of 250 million SEK. This makes is easier for large firms, which can gain from many benefits that a medium-sized company cannot achieve. The fact that none of the 50 largest firms in Sweden is younger than 40 years is an indication of the obstacles for medium-sized firms to develop an extra level. Our belief is that one way to make it easier for medium-sized firms to grow would be by give these firms a broader access to the bond market.

Issuing firm 3 suggested the interest rate of the bond to be decided through a discussion with the financial intermediary, pre-sounding with investors, follow credit indices as well as compare yields of similar companies' bonds. Examples of yields are presented in Appendix 2 and 3. Investment grade firms have lower cost, with 3 to 4 percent on average in comparison to high-yield and unrated firms that have a spectrum from 3 to 11 percent. Intermediary 8 underlined that interest rate highly depends on the unique financial case of the firm and the periodic availability of the market. An important factor to bear in mind for the issuing firms is that it might be very expensive to enter the market during some periods since the investors require higher yield to compensate their risk.

[18] Approximate price information from our respondents
[19] 0.5 percent of the nominal amount
[20] 2 percent of the nominal amount
[21] 5.5 basis points of the nominal amount

Figure 6.5 ITRAXX Crossover index[22]

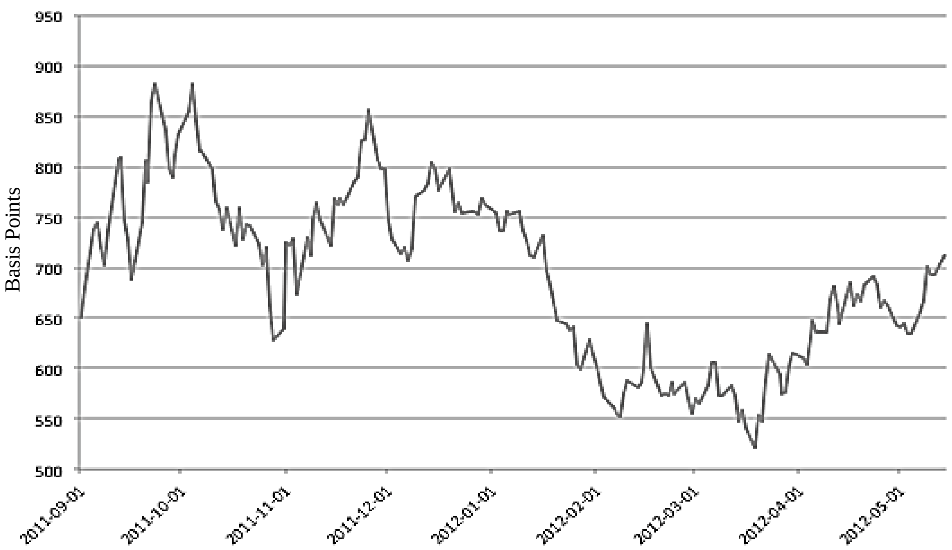


Figure 6.5 shows the European ITRAXX Crossover, which is a Credit Default Swap index composed of 40 sub-investment grade credits. The index shows that when the risk increases it is more expensive to buy insurance. A good example of when the market was not very accessible was the second half of 2011 when it was hard for companies to enter the bond market. This was especially due to the Euro-crisis, which made the investors concerned. In January 2012 the market reopened which made that several issues were made at historically low levels, something that is further explained in Appendix 2. However, during the second quarter of 2012 new uncertainty arose about Greece, which led to higher index levels and increased costs when entering the bond market.

INCREASED PUBLICITY

Firms are said to carefully consider the greater transparency impact that a bond issue will have on the company. Issuing firm 13 stated that the firms have to meet external investors' demand of information about key selling points, operational performance and financial data. Additional accounting activities are needed to put in place and companies that have only used annual reporting will now have to produce interim reports to meet listing requirements. Furthermore, management time have to be spent on investor relations. Since we had an advantageous insight in a company that considers issuing bonds, we experienced the transparency requirement as an obstacle. The firm is not used to this exposure and the transformation to become more public must be in line with the business strategy. Medium-sized firms are used to maintain a less complicated bilateral relation with a bank and it is convenient to provide the banks with important information without exposing the firm to publicity. Our impression is that there is a publicity-transformation that a new issuing firm have to go through that should not be underestimated.

[22] Data from Bloomberg

Conceptual confusion and knowledge gap

As many firms have not needed to consider alternative ways of funding, a knowledge-gap exists about this security. Our impression is that intermediaries thus have a clear information advantage. The intermediaries are able to directly influence the financing structure of the firm. Due to new market conditions, an intermediary might recommend a firm to enter the bond market just to keep the relation with the company. It is therefore a risk that non-appropriate corporations will issue bonds. By representing a potential issuing firm we identified that there also exist conceptual confusion among the intermediaries. For a new issuing firm there are many new phrases and words to learn there are high risk of misconception. Intermediary 2 underlined the importance of education for smaller corporations about the instrument. This is important in order to get a balanced picture and not be misled by selling arguments.

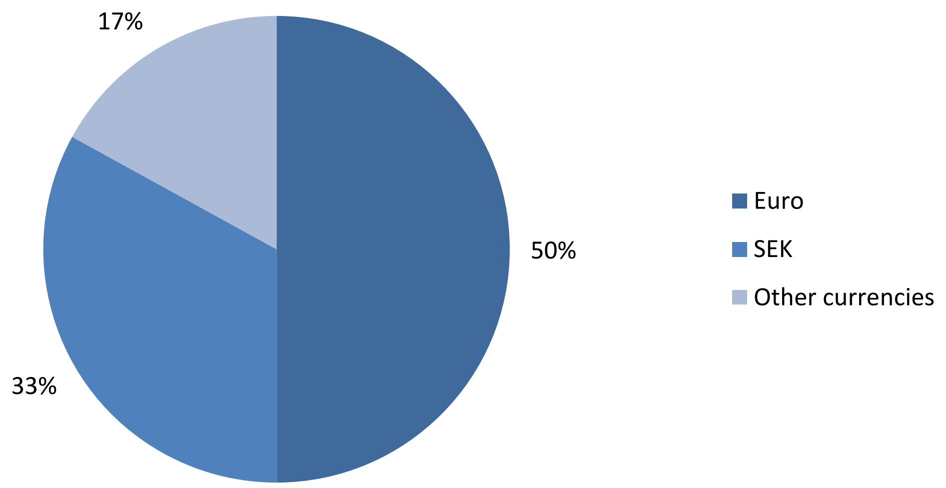
Credit rating a strategic decision

The importance of credit rating was raised by most of our respondents and rating is a central part of the market. Respondents explained that by doing a credit rating the company opens up a broader spectrum of investors and it is an easy way to communicate the creditworthiness of the firm. It also enables investors to set a fair price. Governing body 5 suggested new issuers are suggested to conduct a confidential rating called “shadow rating” and compare with similar companies. The respondents also highlighted the importance for a company to analyze the market’s perception of the company. If the company is believed to be an investment grade rated firm but in reality is a high-yield firm it is probably better to stay unrated. New regulations was also said to give incentives to not attain a credit rating for expected high-yield firms. Our perception is that foreign investors are more concerned about the credit rating compared to domestic investors that are more affected by the name recognition and financial case of the firm. However, most of the large Swedish institutional investors demand that the company is investment grade rated.

Investor relations

Respondents of issuing firms emphasized the importance of a close relationship with investors to secure the demand of the bonds. A lot of management time has to be allocated to attain investors. Issuing firm 13 suggested new issuers to work opportunistic and adjust the bonds after investors’ preferences. One way to open a broader investor universe is to issue in foreign currencies, which stand for over 60 percent of the outstanding corporate bonds. 50 percent are issued in Euro, 17 percent in other currencies and 33 percent in SEK (Statistics Sweden, 2011). The increasing importance of foreign investors should not be underestimated since the group accounted for only 40 percent ten years ago (Statistics Sweden, 2011).

Figure 6.6 Swedish corporations' bonds issued divided per currency[23]



Issuing firms advice new issuers to use a step-by-step approach, starting by commercial papers to create name recognition in the fixed income market. Nevertheless, this strategy was questioned by intermediaries since commercial paper investors require long-term commitment. Our impression is that it is problematic for potential issuers firms to take the decision how to proceed to attain investors and gain the lowest interest.

[23] According to Statistics Sweden & Bloomberg (Gunnarsdottir & Lindh, 2011)

7. CONCLUSION

The study aims to address the possibilities for corporations to enter the Swedish bond market.

From a *market perspective,* the financial markets in Sweden have been characterized by relationship banking, where banks have taken care of all the services demanded by the firms. Limitations in banks' balance sheets have however enforced the development of a corporate bond market, which is dominated by large investment grade corporations. The market is small and respondents from high-yield firms as well as smaller investors have indicated that there exist several flaws in the market. Swedish investors have a tradition of investing in stocks and institutional investors with buy-and-hold strategy control the fixed income market. These factors combined have resulted in few incentives to develop the market. Our impression is that the transparency needs to be improved in order to attract new investors and an implementation of a post-trade transparency is suggested. In conclusion, the structure of today limits the possibilities for medium-sized firms to use bonds.

Due to *new market conditions*, all respondents confirmed an additional interest in bonds. The primary underlying reason is Basel III, which makes traditional bank loans costlier and gives incentives for banks to assist in bond issues. In addition the financial crisis and volatile stock performance have attracted investors to the corporate bond market. Nevertheless, Solvency II indicates less demand for bonds and incentives for medium-sized corporations to stay unrated. Smaller market players demand greater transparency but how MiFID II will be finalized is still uncertain. In conclusion, for the first time all market players show interest to develop the market and the possibilities for corporations will therefore be improved.

From a *corporate perspective*, a bond issue enables firms to gain diversified funding and greater flexibility. However, the benefits come with high costs. On average, the intermediary fee and interest rates are higher for low credit quality firms and the issue should be at least 250 million SEK to be economically viable. Another obstacle to overcome is the increased transparency requirements for non-public firms and the importance of investment relations. Credit rating is a strategic decision where it can be beneficial for low credit companies to stay unrated. The study underlines that there exists a knowledge gap and conceptual confusion for new issuers and education about the security is needed. In conclusion, the possibility for firms to use bonds is unique for each company and highly dependent on the financial case of the firm.

The possibilities for medium-sized corporations to enter the market can be questioned. The market has an institutional focus and is constructed for investment grade firms. Nevertheless, our study concludes a clear indication of a united interest by all market players to develop the market. From a corporate perspective, issuing of bonds can be challenging and it all depends on the unique business if a company is suitable for this type of security. As a conclusion, the study shows that there will be a slow transformation, where more medium-sized corporations will issue bonds in the future, mainly represented by large family-owned companies and listed firms. With the awakened interest in mind we see a clear indication of "a shift in the balance of power" but it is impossible to know how big this shift will be.

8. References

8.1 Published Sources

Akerlof, George. (1970) *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, The Quarterly Journal of Economics, Vol. 84, No. 3. pp. 488-500.

Bessembinder, Hendrik & Maxwell, William. (2008) *Transparency and the Corporate Bond Market*. forthcoming, Journal of Economic Perspectives, Spring 2008.

Basel Committee on Banking Supervision. (2009) *Strengthening the resilience of the banking sector*. December 2009.

Bao, Jack., Pan, Jun & Wang, Jiang. (2011) *The illiquidity of Corporate Bonds.* The Journal of Finance, vol LXVI, No 3. June 2011.

Barr, Daniel. (2011) *Den svenska företagsobligationsmarknaden – En förstudie.* Stockholm: Svensk Näringsliv.

Bibow, Jörg. (2005) *Liquidity Preference Theory Revisited—To Ditch or to Build on It.* Working Paper No. 427, The Levy Economics Institute.

Boot, Arnold & Marinc, Matej. (2008) *The evolving landscape of banking, industrial and Corporate Change*, 17, 1173–1203.

Choudhry, Moorad. (2004) *Corporate Bonds and Structured Financial Products.* Oxford: Elsevier Butterworth-Heinemann.

Citygroup Global Markets. (2010) *The End of a Cult, Corporate Securities Strategy.* Global Equity Strategies (September 1, 2010).

David, Parthiban., O'Brien, Jonathan P & Yoshikawa, Toru. (2008), *The implications of debt heterogeneity for R&D investment and firm performance*. Academy of Management Journal, 51, 165–181.

De Fiore, Fiorella & Uhlig, Harald. (2011) *Bank Finance versus Bond Finance.* Journal of Money, Credit and Banking, Vol. 43, No. 7 (October 2011) The Ohio State University

Di Giorgio, Giorgio., Di Noia, Carmine & Piatti, Laura. *Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area*

Diamond, Douglas. (1993), *Seniority and Maturity of Debt Contracts*, Journal of Financial Economics 33, 341-368.

ECB. (2007). *Potential Impact of Solvency II on Financial Stability.* Frankfurt, Germany.

European commission. (2010) *Impact of the financial crisis on corporate finance: how big is the shift from bank financing to bonds.* The European Commissions' Quarterly Report on the Euro Area, volume 9, no. 4 2010.

European Commission. (2011) *Proposal for a Directive of the European parliament and of the council on markets in financial instruments repealing Directive 2004/39/EC,* Brussels, 20.10.2011

Fama, Eugene. (1970) *Efficient Capital Markets: A Review of Theory and Empirical Work,* Journal of Finance 25, 383-417

Gatzert, Nadine & Martin, Michael. (2012) *Quantifying Credit and Market Risk under Solvency II: Standard Approach versus Internal Model.* Friedrich-Alexander-University of Erlangen-Nuremberg working paper, vol1

Gunnarsdottir, Gudrun & Lindh, Sofia. (2011) *Markets for Swedish non-financial corporations' loan-based financing.* Stockholm: Sveriges Riksbank economic review 2011:2

Green, Richard & Biais, Bruno. (2007) *The Microstructure of the Bond Market in the 20th Century*, working paper, Carnegie Mellon University.

Hässel, Leif., Norman, Marie & Andersson, Christian. (2001). *De finansiella marknaderna i ett internationell perspektivt.* 3rd ed. Stockholm: SNS Förlag

Imeson, Michael. (2010) *MiFID review makes bond dealers nervous,* The Banker, Published: 03 March, 2010

Jaffee, Dwight & Russell, Thomas. (1976) *Imperfect information, uncertainty and credit rationing*. Quarterly Journal of Economics 90 (November): 651–66

Jaffee, Dwight & Walden, Johan. (2010) *The Impact of Basel III and Solvency 2 on Swedish Banks and Insurers - An Equilibrium Analysis.*

Lambe, Geraldine. (2011) *MiFID II: an end to the reign of OTC transactions.* The Banker, Published: 01 December, 2011

La Porta, Rafael., et al. (1997) *Legal Determinants of External Finance.* Journal of Finance, 52, 1131–50.

Modigliani, Franco & Miller, Merton. (1958) *The Cost of Capital, Corporation Finance and the Theory of Investment.* The American Economic Review, Vol. 48, No. 3. (Jun., 1958), pp. 261-297.

Modigliani, Franco & Miller, Merton. (1963) *Corporate income taxes and the cost of capital: a correction*. American Economic Review 53 (3): 433–443.

Modigliani, Franco & Sutch, Richard. (1966) *Innovations in interest rate polic.* American Economic Review 56, 178-179.

Myers, Stewart. (1977) *Determinants of Corporate Borrowing.* Journal of Financial Economics 20, 293-315.

Niemeyer, Jonas. (2000) *Värdepappershandel i Sverige*, Bilaga 12 till Finansmarknadsutredningen, Stiftelsen Kapitalmarknadsgruppen

Nordea Markets. (2010) *The Maturity Wall of Debt.* Results of Nordea's analysis of the debt maturity pattern in the Nordic region. Stockholm: Nordea

Nyberg, Lars., Viotti, Staffan & Wissén, Pehr. (2006) *Penningmarknaden.* 4th ed. Stockholm: SNS Förlag

Piozot, Hughes., et al. (2011) *Solvency II Set to Reshape Asset Allocation and Capital Markets*, Insurance Rating Group Special Report, Fitch Ratings.

Rajan, Raghuram. (1992) *Insiders and Outsiders: The Choice Between Informed and Arm's-Length Debt*, Journal of Finance 47, 1367-1406.

Richelson, Hildy & Richelson, Stan. (2011) *Bonds: The Unbeatable Path to Secure Investment Growth.* 2nd edition. Hoboken, New Jersey: John Wiley & Sons, Inc.

Standard & Poor's. (2011), *Guide to Credit Rating Essentials - What are credit ratings and how do they work?*

Statistics Sweden. (2011) *Finansmarknadsstatistik.* Balance of Payments and Financial Market Statistics Unit on behalf of the Riksbank, Stockholm

Swedish Financial Supervisory Authority. (2001) *Riskmätning och kapitalkrav - Baselkommitténs förslag till nya kapitaltäckningsregler ur ett svenskt perspektiv.* 2001:1, Stockholm

Swedish Financial Supervisory Authority. (2011) *Frågor och svar om förslaget till högre kapitaltäckningskrav för de stora svenska bankgrupperna.* Premoria, Stockholm: *2011-11-25*

The Riksbank. (2010) *Financial Stability Report February 2010, How life insurance companies can affect financial stability*. Stockholm

The Riksbank. (2010) *Penningpolitisk rapport Oktober 2010*, Stockholm

8.2 DIGITAL SOURCES

Cervenka, Andreas. (2009) ”Visionen är en obligationsbörs”. Svenska Dagbladet. http://www.svd.se/naringsliv/visionen-ar-en-obligationsbors_3813049.svd (Accessed May 14, 2012)

Forsberg, Birgitta. (2011) Skräpet rycker fram. Affärsvärlden. http://www.affarsvarlden.se/tidningen/article3126955.ece (Accessed February 5, 2012)

Munkhammar, Viktor (2012) Bolagen lånar till rekordlåga räntor. Dagens Industri. http://di.se/Artiklar/2012/4/4/263581/Bolagen-lanar-till-rekordlaga-rantor/ (Accessed May 13, 2012)

Petersen, Leif. (2011) Bra tryck på marknaden för företagsobligationer. Svenska Dagbladet. http://www.svd.se/naringsliv/bra-tryck-pa-marknaden-for-foretagsobligationer_6782561.svd (Accessed February 2, 2012)

Svensk FastighetsFinansiering AB (publ). (2011) Grundprospekt Program för Säkerställda Medium Term Notes. http://www.fabege.se/PageFiles/281194/SFFAB_Grundprospekt_2011-12-22.pdf (Accessed April 22, 2012)

8.3 METHODOLOGY SOURCES

Blumberg, Boris., et al. (2008) *Business Research Methods*, 2nd edition, Maidenhead: McGraw-Hill Education

Bryman, Alan. (2002) *Samhällsvetenskapliga metoder*, Trelleborg: Liber Ekonomi

Holme, Idar Magne & Solvang, Bernt Krohn. (1997). *Forskningsmetodik om kvalitativa och kvantitativa metoder*. Lund: Studentlitteratur

Lindlof Thomas. & Taylor Bryan. (2002). *Qualitative Communication Research Methods*. Second edition. Thousand Oaks, CA: Sage Publications

Paulsson, Ulf. (1999) *Uppsatser och rapporter: Med eller utan uppdragsgivare,* Lund: Studentlitteratur

8.4 RESPONDENTS

GOVERNING BODY

Ministry of Finance. **Erik Thedeén,** State Secretary, May 18, 2012.

Nasdaq OMX. **Mikael Estvall,** Head of Fixed Income. March 9, 2012.

Nasdaq OMX. **Fredrik Von Platen,** Manager Listing Service. March 9, 2012.

OECD. **Sofia Lindh**, Policy Analyst. April 10, 2012.

Swedish National Debt Office. **Daniel Barr,** Head of Bank Support Department. February 14, 2012.

Swedish Trustee. **Louise Sjödahl,** Company Secretary. March 7, 2012.

The Financial Supervisory Authority. **Jan Axelsson,** Senior Advisor. February 24, 2012.

The Financial Supervisory Authority. **Björn Bargholtz,** Head of Division Bank Analysis. February 14, 2012.

The Riksbank. **Lars Nyberg,** Former Deputy Governor. February 13, 2012.

ISSUING FIRMS

Akademiska Hus. **Åsa Elgqvist,** Deputy Treasurer. April 27, 2012.

Akademiska Hus. **Mikael Risberg,** Deputy Treasurer. April 27, 2012.

Elof Hansson. **Fredrik Block,** Treasurer. January 15, 2012.

Elof Hansson. **Mikael Ehrenborg,** Group Treasurer. January 15, 2012.

Elof Hansson. **Lennart Hedström,** CEO Elof Hansson Properties. February 17, 2012.

Elof Hansson. **Mikael Lundström,** Chairman of the board at Elof Hansson Properties. January 20, 2012.

Elof Hansson. **Stefan Hellgren,** CFO. May 2, 2012.

Getinge. **Peter Hjalmarsson,** Group Treasurer. March 29, 2012.

Getinge. **Martin Riman,** Treasurer. March 29, 2012 .

Stena Finans. **Rolf Mählkvist,** Deputy Finance Director. February 23, 2012.

Volvofinans. **Jens Jirvell,** Trader. March 20, 2012.

Volvofinans. **Lars Norlander,** Group Treasurer. March 20, 2012.

Volvofinans. **Johan Oskarsson,** Treasurer. March 20, 2012.

SKF. **Magnus Ericsson**, Treasurer. 5 April, 2012.

FINANCIAL INTERMEDIARIES

Carnegie. **Magnus Berggren,** Structured Finance. February 29, 2012.

Carnegie. **Niklas Ekman,** Fixed Income Origination. March 7, 2012.

Carnegie. **Peter Bergmann-Stumpp,** Director Fixed Income Origination. March 7, 2012.

Danske Markets. **Louis Landeman,** Head of Credit Analysis. January 26, 2012.

Danske Markets. **Johan Hansen,** Head of DCM Origination. February 9, 2012.

DNB. **Karl Johan Kulling,** DCM & Origination. March 8, 2012.

Handelsbanken. **Ulf Stejmar,** Head of Corporate Bonds, Debt Capital Markets, May 3, 2012.

Nordea Markets. **Erik Blomberg,** Head of Pricing Principles & Capital, FICC Sales. February 9, 2012.

Nordic Fixed Income. **Claes Bahri,** Head of Fixed Income Sales. March 7, 2012.

Nordic Fixed Income. **Kristoffer Löfgren,** Head of Fixed Income Sales. March 7, 2012.

Pareto Öhman. **Stefan De Geer,** Head of Corporate Finance. March 8, 2012.

Royal Bank of Scotland. **Olof Manner,** Head of Scandinavian Rate Sales. March 6, 2012.

SEB. **Hans Beyer,** Head of Fixed Income. March 9, 2012.

INVESTORS

AFA Försäkring. **Andreas Nordvall Lagerås,** PhD Mathematical Statistics. April 18, 2012.

Alecta. **Tony Persson,** Head of Income and Strategy. March 8, 2012.

Amf. **Magnus Röstlund,** Portfolio Manager. May 25, 2012.

Carnegie. **Peter Werleus,** Portfolio Manager. March 7, 2012.

Proventus. **Daniel Sachs,** CEO. March 14, 2012.

Simplicity. **Henrik Tingstorp,** CFO and Fund Manager, May 14, 2012.

SKF. **Richard Magnusson,** Manager Pension fund. April 5, 2012.

APPENDIX 1. – INTERVIEW QUESTIONS

GENERAL QUESTIONS

Q1. What is your relation to the Swedish corporate bond market?

Q2. What is your impression of corporate bonds as an external funding source and investment alternative?

1. MARKET PERSPECTIVE

Q3. What are the characteristics of the Swedish corporate bond market?

Q4. How developed is the Swedish corporate bond market in an international perspective?

Q5. What factors have limited the development of the market?

Q6. How efficient is the market with regards to transparency and liquidity?

Q7. What is needed to make market more active and developed?

Q8. What is needed to attract new investors to the market?

Q9. How does the future for corporate bonds look like?

2. NEW MARKET ENVIRONMENT

Q10. Do you experience an increased interest in corporate bonds at the moment? If yes, what do you believe are the reasons behind this?

Q11. What effects will Basel III have on corporations' funding and the corporate bond market?

Q12. What effects will Solvency II have on corporations' funding and the corporate bond market?

Q13. What effects will MiFID II have on corporations' funding and the corporate bond market?

Q14. What are the combined effects of the three new regulations on corporate's funding and the corporate bond market?

3. Corporate perspective

Q15. What are the advantages for medium-sized corporations of using corporate bonds?

Q16. What are the obstacles for medium-sized companies to enter the bond market?

Q17. Why is rating important and what are the rating requirements?

Q18. How is the bond price set for a new issuing firm?

Q19. What is important when creating an investor base?

APPENDIX 2. – INTEREST RATES FOR INVESTMENT GRADE FIRMS

The risk appetite boosted the market for corporate bonds in the first quarter of 2012 which made that companies took advantage of the strong demand with several issues. Investment grade firms are in general having low-cost funding and several issues have been made at lower interest rates than the banks can achieve for funding. Table A3 shows a sample of recent SEK issues made by firms within the investment grade segment. The credit rating gives a good indication of the interest rate but other factors are important such as name recognition. This might explain why a company like Scania has a lower interest rate compared to Förvaltnings AB Framtiden.

Table A3 Recent investment grade issues in SEK[24]

Company	Coupon rate	Issued amount	Date	Term to maturity	Credit rating
Förvaltnings AB Framtiden	3.50%	500 MSEK	03-2012	5 years	AA-
Scania	3.20%	1000 MSEK	02-2012	3 years	A-
TeliaSonera	Stibor+1.45%	1150 MSEK	01-2012	4 years	A-
Vasakronan	2.875%	200 MSEK	05-2012	2.5 years	A-
AB Industrivärlden	3.45%	300 MSEK	01-2012	1.5 year	A-
Electrolux	Stibor+1.20%	500 MSEK	03-2012	3 years	BBB+
SCA	4.00%	1800 MSEK	02-2011	5 years	BBB+
Securitas	Stibor+1.65%	600 MSEK	01-2012	3 years	BBB+
Sandvik AB	4.55%	300 MSEK	11-2011	6 years	BBB+
Swedish Match	4.76%	250 MSEK	12-2011	4 years	BBB

Corporate bonds worth 62.9 billion euros were issued in the European market during the first quarter. This is more than twice as much as during the first quarter of 2011 and more than half of the whole of last year's issuance. Investment grade firms like Atlas Copco and Scania have been active in the European market and both firms issued bonds at European all time low levels. Atlas Copco issued securities in March with seven years maturities worth 500 million euros to 2.625 percent interest rate. The truck manufacturer Scania (Munkhammar, 2012) borrowed 300 million euros in form of a four-year bond paying 1.75 percent interest rate. This means that the Swedish companies pay less than e.g. Belgium for their borrowing in the European market. The combination of low underlying interest rates and strong demand from investors, which pushed down interest premium compared to central bank interest rates have led to record low interest rates. Companies like this are therefore having lower cost of debt than most banks. Other Swedish companies such as TeliaSonera, Electrolux, Investor and Securitas have also been active in the European market (Munkhammar, 2012).

[24] Table with inspiration from Intermediary 9 and data from Bloomberg

APPENDIX 3. – HIGH-YIELD FIRMS STILL STRUGGLE

High-yield rated firms and unrated firms are usually categorized under the same subgroup in the bond market. A clear distinction is however that an unrated firm can take on debt at a low interest rate if it is profitable and looks like a good deal in the eyes of the investors. Firms with a low credit rating on the other hand usually have to pay higher interest rate, due to their limited possibilities to fulfill the agreement. Table A4 consists mainly of unrated firms and it is easy to see the differences between these companies in terms of credit-worthiness. Large companies such as Com Hem and SAS issued bonds with coupon rates of 9.25% and 10.50% respectively, which indicates that the investors are doubtful concerning the financial cases.

Table A4 Recent high-yield and unrated issues in SEK[25]

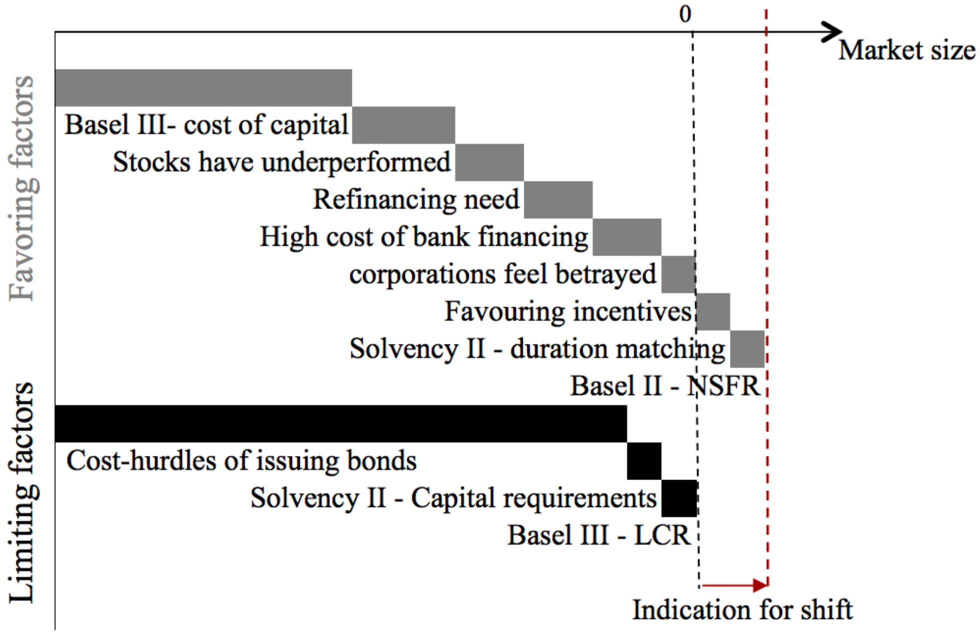
Company	Coupon rate	Issued amount	Date	Term to maturity	Credit rating
SFFAB	3.65%	400 MSEK	12-2011	3 years	N/A
Tele2	4.875%	800 MSEK	05-2012	5 years	N/A
Arla	5.00%	1150 MSEK	06-2011	5 years	N/A
Klövern	Stibor+4.00%	500 MSEK	02-2012	3 years	N/A
AB Sagax	6.50%	350 MSEK	03-2012	5 years	N/A
Värmevärden	7.00%	900 MSEK	02-2012	5 years	N/A
Medstop	9.00%	700 MSEK	05-2011	5 years	N/A
Com Hem	9.25%	3500 MSEK	10-2011	7 years	B
SAS	10.50%	1300 MSEK	03-2011	3.25 years	N/A
Rusforest	11.00%	500 MSEK	05-2011	3 years	N/A

A high-yield firm that has issued bond recently is Sefyr Värme AB, parent company of Värmevärden AB. The company has issued a senior secured bond of 900 million SEK directed to selected Nordic institutional investors. The bond has a coupon of 7 percent and has five years term to maturity. Värmevärden AB is an energy company with operations in the production and distribution of district heating. Something that used to be said about the market is that the issue must equal a certain amount to be able spread the large fixed costs. Sagax is a good example of a loan of lower volume since the company issued a five-year unsecured bond loan on the Swedish market. The bond loan volume equals 350 million kronor and has a fixed interest rate of 6.50%.

[25] Table with inspiration from Intermediary 12 and data from Bloomberg

APPENDIX 4. – ILLUSTRATION OF A SHIFT

Indication of opportunity for more firms to use corporate bonds[26]



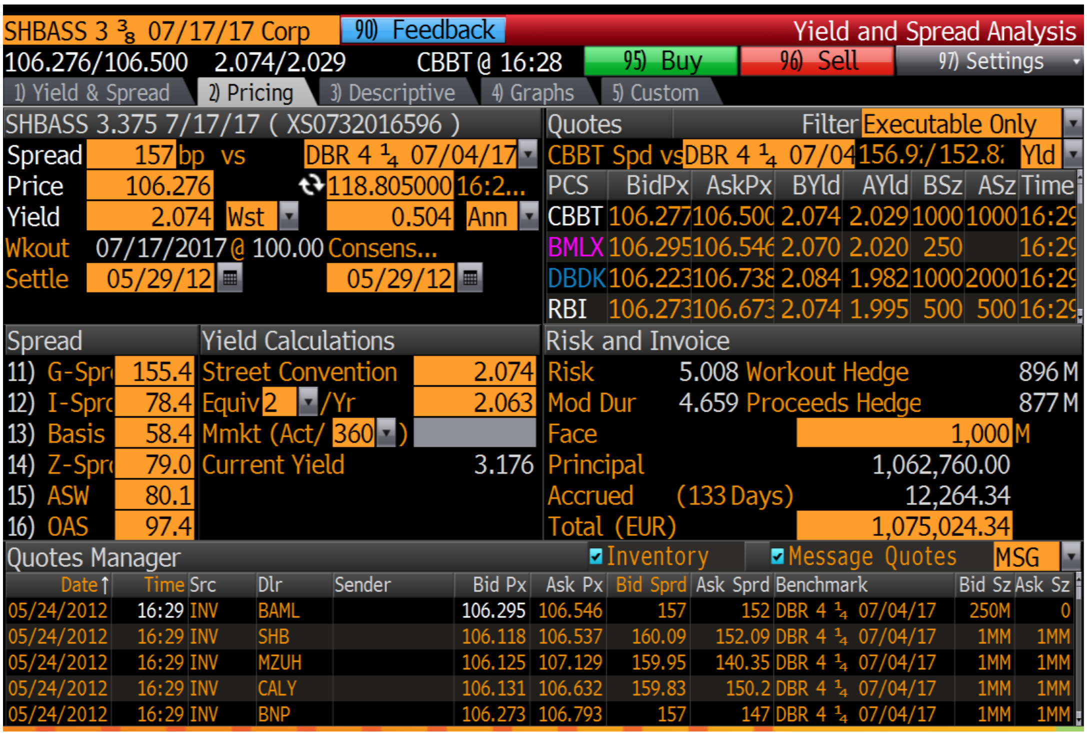
APPENDIX 5. – TRADE INFORMATION SWEDEN

The information darkness in Sweden is clarified when comparing trading data provided in other countries. Only SEB indicates a value of the security a bond issued by Vasakronan in the Swedish market, which is a bid price.

[26] Simplified illustration based on our impression

APPENDIX 6. – TRADE INFORMATION GERMANY

The Euro market is better than the Swedish where several banks offering bid/ask prices of the bond issued by Handelsbanken and this is also a way of describing the liquidity of the market.



APPENDIX 7. – TRADE INFORMATION UNITED STATES

The market in the United States is the best with regards to the transparency. The bond is issued by Procter & Gamble and data is shown of bid/ask quotes but also post-trade information since a completed trade (at 114,512) is reported.