

UK FCA publishes interim report of investment and corporate banking market study

The UK Financial Conduct Authority (FCA) has found that, while many clients feel well served by primary capital market services, contractual and other practices may need to be addressed to facilitate competition. Further consideration is also being given to barriers to entry / expansion as well as the IPO process.

Proportionate proposals?

The study, launched in May 2015, arose from the FCA's 2014 review of competition in the wholesale sector.

The study covered debt and equity capital markets, mergers and acquisitions, and acquisition financing (primary market) services carried out in the UK. Links with related services such as corporate lending and broking, and ancillary services, were also in scope.

The FCA's interim report, published on 13 April 2016, focused on (i) the choice of banks and advisors faced by clients when selecting services, (ii) transparency, and (iii) cross-selling, bundling and cross-subsidisation.

Interim findings – concerns identified

Choice and cross-subsidies

The FCA's analysis indicated that most, particularly larger, clients are well served by banks and advisers. However, the FCA considered that

Key issues

- Which issues raise possible concerns?
- What potential remedies might the FCA seek to impose?
- What is the timing for the remainder of the study?

under the universal banking model, lending and broking services are usually provided at a low rate of return or below cost in exchange for more lucrative primary market transactional business. The FCA cited concerns that:

- Clients may not always be able to award primary bank mandates to the bank that best suits their needs
- It is difficult for new entrants to break into primary market services without also offering lending and/or broking services

- Banks seek to use contractual provisions, such as right of first refusal and right to act clauses in engagement letters, to restrict a client's choice in future transactions.

The FCA emphasised that these concerns are less likely to apply to larger clients, but could affect small and medium sized corporate clients. The FCA also recognised that cross-subsidisation can bring benefits to clients such as cost savings from banks' more detailed knowledge of clients.

League tables

The FCA considered that certain practices employed by banks can distort league tables and reduce a client's ability to compare providers. It noted for example that some banks engage in transactions at a loss with the main aim of gaining league table credit, and many banks routinely present league tables to clients in a manner which distorts their own position.

The IPO process

The interim report cited concerns that the 14 day 'blackout period' between publication of research by syndicate

banks and circulation of the pathfinder prospectus, combined with lack of access to the issuer's management, leaves analysts from independent research providers with little or no information. As such, the diversity of information available to investors during the investor period is limited. The FCA considered these concerns further in a separate discussion paper.

Allocation of shares in IPO book-building

The FCA identified the potential for conflicts of interest to arise in the IPO allocation of shares, as banks may seek to reward favoured investor clients where this is not necessarily in the issuing client's interest. The FCA's analysis showed that IPO allocations are skewed towards investors who account for significant revenues to the bank from other business lines. This is more pronounced in relation to some institutions than others. The FCA noted that the skew may prevent smaller buy-side investors from gaining access to IPOs in the primary market.

Other practices

The interim report also considered syndication, and reciprocity (whereby a bank issuing its own financing awards mandates to another bank partly based on how much business it will receive in return), but the FCA did not identify significant concerns in these areas.

In addition, the FCA considered whether the role of corporate finance advisers could give rise to conflicts of interest, but found no evidence of advisers giving advice which would be against the client's best interests or trying to unfairly influence the research on IPOs.

During the wholesale sector review, concerns were also raised about the

transparency for clients of the scope of services and fees. However, the FCA's review of engagement letters found that transparency is not a material area of concern at this time and that transparency will be enhanced further as a result of MiFID II.

Potential remedies

In order to address the concerns identified, the FCA has invited feedback on the following proposed remedies and aims:

- Removing the practice of banks using contractual clauses that restrict client choice
- Reducing barriers to entry and/or expansion for non-universal banks without undermining the efficiencies of cross-selling
- Improving the IPO process to ensure that more diverse and independent information is available earlier, possibly by re-sequencing the publication of the prospectus and research and providing independent analysts with access to management
- Investigating further with individual banks whether there are questions about conflicts in relation to IPO allocations
- Improving the credibility of league tables, for example by considering criteria for how league tables are presented to clients, and removing incentives for conducting trades carried out at a loss purely for the purpose of gaining league table credit.

The interim findings do not provide detailed proposals in relation to the measures that might be introduced to achieve these aims, but instead request views and suggestions from stakeholders.

Next steps

The FCA has requested feedback by 25 May 2016. It has also asked for views on its separate IPO discussion paper by 13 July 2016. Once it has received and reviewed this feedback, the FCA will draft its final report, which it expects to publish in summer 2016. This report will set out the FCA's findings and conclusions as well as proposed actions.

Comment

The FCA emphasised the need for any remedies to be effective and proportionate. At this stage, it does not consider that widespread or "highly interventionist" measures, such as separation of lending and transactional services, would be warranted.

The FCA Director of Strategy and Competition commented that the market study shows that many investment and corporate banking clients are "getting a service they want" and that "this is a package of proportionate measures intended to remove potentially anti-competitive practices".

While the remedies proposed so far appear measured, further input is also invited and conclusions awaited on key areas related to barriers to entry / expansion and the IPO process.

Market participants should also bear in mind the potential for individual enforcement action arising from FCA market studies. This recently occurred with the issuance of two "on notice letters" to firms in respect of specific competition law infringement concerns identified during the course of the FCA's retirement income study.

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