Australian Corporate Bond Market Prospects

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Over recent decades, Australian non-financial companies have not been major issuers of corporate bonds in the domestic market, although larger corporates have made significant use of international bond markets. [1] But in recent years there has been a growing interest in developing a domestic corporate bond market leading to a number of legislative changes designed to facilitate market growth.

The growing interest reflects a number of both supply and demand factors. On the demand side, increased volatility of equity prices post-GFC has lead investors to seek opportunities with less risk and more reliable returns, fixed interest products such as corporate bonds fit this bill. It has also become increasingly clear that the growing pool of investible funds held by superannuation funds (including self-managed funds) have allocations which are argued by many to be underweight fixed interest – particularly given the ageing of the population.

From a supply point of view the potential for bonds has also improved. Changes in bank regulation emanating from Basel may well increase the competitiveness of capital markets debt financing for businesses, relative to bank lending. Capital markets can also provide increased competition to the banking sector in loan markets, potentially lowering costs for borrowers – as was seen in the case of residential mortgage lending from the late 1990s with the growth of securitisation. A final factor, although less frequently heard since the Global Financial Crisis, is that a well-developed bond market may help promote financial stability – acting as a "spare tyre" if a banking crisis eventuates.

The Australian Government through ASIC have taken a number of steps towards encouraging the growth of a domestic bond market. These relate primarily to altering new issuance requirements, which were seen as a significant impediment. Historically, bond issues required the production and distribution of a prospectus which, while meant to be a vehicle for conveying relevant information to potential investors, was typically of door-stopper size attempting to provide legal coverage for the company against future claims by any disgruntled investors.

The early steps in prospectus liberalisation were taken in May 2010, when ASIC provided relief from legislative requirements and allowed listed companies to issue "vanilla" bonds under either a short-form prospectus or a two part prospectus model.[2] In the latter model, a company could lodge a base prospectus with a life of two years with ASIC and subsequently use a shorter offer-specific prospectus (which updates the base prospectus) to make an offer to retail investors. The short-form prospectus approach created a degree of consistency with equity issues by listed companies who are subject to continuous disclosure requirements.

The most recent change was the introduction of legislation on March 20, 2013 enabling the two-part prospectus regime for issues of "vanilla" corporate bonds to retail investors (with the base prospectus having a life of three years). The legislation also aims to reduce the potential legal

[1] A long-term historical overview is given in Susan Black, Joshua Kirkwood, Alan Rai and Thomas Williams "A History of Australian Corporate Bonds" RDP2012-09, Reserve Bank of Australia. http://www.rba.gov.au/publications/rdp/2012/2012-09.html

[2] ASIC *Facilitating debt raising,* Regulatory Guide 213. May 2010

liability for directors of a company which makes a retail bond issue – by removing *automatic* personal liability for any misleading or deceptive statements in the prospectus.

As well as disclosure requirements, development of a successful market requires effective, low cost primary issuance arrangements, together with a liquid secondary market in which corporate bonds can be traded by investors wishing to adjust their portfolio positions. The former requirement does not seem overly problematic, with the major banks, and others, eager to advise and underwrite issues by corporate clients and distribute bonds through their networks of financial advisers and by other means. But the development of a liquid secondary market raises the "chicken and egg" problem – that liquidity will attract investors, but until there are sufficient investors there will not be adequate liquidity.

A further issue may be the potential for a large issuance of a major firms, say a bank, to "crowd out" the fledgling market. Developing a deeper, more liquid market will take some time, and while it is quite likely that some major Australian issuers will continue to access international debt markets, which are already liquid and offer a lower level of local scrutiny, concerns have been expressed that this could reduce the attractiveness of a domestic bond market for smaller issuers.

Encouraging liquidity is a critical issue for the market to succeed. In late 2012 legislation was passed to enable Australian Government Bonds to be traded on the ASX in the form of *depository interest*, rather than the bonds themselves. This mechanism will facilitate market development by linking wholesale and retail markets and enable supply available to retail investors to adjust to the demand. (Certificates of Depository Interest (CDIs) are essentially indirect claims on some portion of a parcel of bonds via a third party who has placed those bonds into a trust (or other) structure and issued claims against them). The ability to trade CDIs on corporate bonds will greatly assist the development of liquidity in this market also.

But ultimately, the creation of such a market requires that (a) issuers perceive that this is a cheaper way to raise funds than via other means, and (b) investors find the yields offered attractive for the risks involved. It is here that the development of a domestic corporate bond market faces significant challenges.

Consider first retail investors (such as self managed super funds). An obvious alternative investment is bank term deposits. Under the Financial Claims Scheme, depositors are protected against default risk for amounts up to $250,000 at any individual bank – whereas corporate bonds carry default risk. Also, increased competition by banks for retail deposits has pushed term deposit yields above equivalent maturity government bond yields (raising the interest rate hurdle for corporate bonds). And for retail investors, the issue of portfolio diversification is relevant.

For institutional investors, these factors do not come into play, but they generally have access to international markets and alternative wholesale fixed interest investments (RMBS, Covered Bonds, Kangaroo Bonds) – increasing the competition which domestic issuers face to become attractive investments. On the positive side, however, the limited stock of Australian Government debt available to investors and its low yield, reflecting partly the higher demand induced by bank liquidity requirements and needs, limits competition for corporate bonds from this source.

There is also a question mark over the incentives for companies to issue corporate bonds rather than use other financing sources. In contrast to most overseas countries, Australia's dividend imputation tax system does not create a tax advantage to debt financing over equity financing when investors are Australian taxpayers. And this is reflected in the relatively low leverage of Australian companies by international standards. While the Basel capital and liquidity regulations may make bank loans less attractive, it is not clear that this should be expected to lead to a substitution into bond financing rather than into more equity financing.

Critical in this regard is the risk premium that investors demand before they will invest in corporate bonds rather than other securities. If the premium demanded to take on credit risk is too high, companies will have little incentive to issue corporate bonds. And few, particularly retail, investors have strong skills in assessing credit risk and determining a fair risk premium. In these circumstances, it can be expected that investors will gravitate to blue chip bond issuers, such as banks and companies with household names, where credit risk is assumed (perhaps inappropriately) to be minimal. While there have been some recent bond issues by other smaller, potentially higher risk, companies, it seems likely that this will be more the exception rather than the rule.

Finally macro-financial conditions are also relevant for shorter-term development of the market. The general downtrend in interest rates over the last decade or so, in conjunction with the equity market collapse after 2007 has meant that historical fixed interest investment returns have compared favourably with equity returns. While this is conducive to investor interest in fixed interest (even though historical returns are generally no guide to the future), the current low levels of interest rates leave arguably more scope in the medium term for future increases in interest rates to impose capital losses on fixed interest investments than the reverse.