AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

COMMENTARY

Can a Corporate Bond Market solve the Super Equity Bias?

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The stars appear to be in alignment for a beneficial structural reform of the Australian financial system to kill two birds with one stone. On the one hand, almost everyone seems to support initiatives to develop a local corporate bond market to broaden corporate funding sources. On the other, almost everyone believes that super funds have an excessive equity bias and need more fixed interest (bond) investments.

But corporate bond market development and super fund investment switches towards those securities, even if it were to happen, would not bring all the benefits sometimes touted. There are macro-financial issues to consider.

For example, development of a domestic corporate bond market would not reduce Australian reliance on overseas funding – that is driven by our savings and investment imbalances and consequent balance of payments outcomes. The conduits through which international financing would occur may change, but not the aggregate.

Similarly, super funds holding less equity might reduce their exposure to stock market volatility. But in aggregate, someone has to hold those equities and bear that risk. Exactly how the structure of equity holdings might change, and that risk be redistributed among Australians (and international investors) is not clear. But Australian residents could end up just transferring the risk out of their super accounts onto other parts of their financial wealth.

The implications of these sorts of interlinkages run more deeply, as can be seen by asking the following question. If Australian companies can meet more of their financing requirements by issuing bonds, what other source of financing will be less used? (And don't think that creation of a bond market will magically lead to more corporate investment and thus increased financing needs, rather than involving primarily a substitution effect!)

Consider first the possibility of bond financing replacing some equity funding, such as by a bond issue financing a share buyback. That could achieve both objectives at once (reducing the equity bias and expanding debt markets) and there may be merit in the Treasury looking at measures to promote arrangements such as bond for equity swaps.

For example, allowing a company to provide all shareholders with pro rata tradable rights to swap some of their equity for new bonds to be listed on the exchange, would not involve any redistribution of wealth among shareholders. (And it involves substituting a more senior claim on the company for part of their equity). It is difficult to see why such an offer to existing shareholders would necessitate major disclosure requirements. Subsequent potential purchasers of those rights or of the bonds could evaluate their merits based on available company information, traded market prices, and information about the key characteristics of the bonds.

But it needs to be asked whether any such financial restructuring involving increased leverage (more debt, less equity) is good corporate strategy. In Australia, the imputation tax system reduces or removes tax benefits of debt financing. And while debt may "look" cheaper", increased leverage increases the cost of equity, as shareholders demand a higher rate of return to reflect increased risk.

There may be benefits from bond issuance, in the form of better signalling of corporate prospects or improved monitoring and market discipline, but in the current state of the financial world, it seems unlikely that higher leverage is likely to be attractive, suggesting that corporate bond issues would not generally be substituting for equity financing.

That indicates that corporate bond issues are likely to be primarily at the expense of bank loans – and Basel III capital and liquidity requirements are also providing incentives for banks to encourage corporate use of debt markets rather than providing on-balance sheet lending. But what other market wide adjustments would be a consequence, and will investor demand for corporate debt be there?

If banks focus more on leading corporates to the debt markets rather than on-balance sheet lending, their funding requirements also decline. One possible adjustment process could be reduced bank reliance on international capital markets, with more of our balance of payments financing involving direct foreign purchase of Australian assets such as equities. While that might help super funds reduce their equity bias, it is only one among a wide range of adjustment possibilities (about which we understand relatively little).

Another possibility could be less bank reliance on domestic term deposits, with investors switching from deposits to corporate bonds. And here is a real killer in terms of the much desired retail corporate bond market. What yield must be offered to individual investors (including self managed super funds) to encourage them to invest in risky corporate bonds rather than bank deposits which are guaranteed up to $250,000 at each bank.

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