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Australian Institute for Business & Economics

AIBE Thought Leadership Discussion Series

AUSTRALIAN BOND MARKETS

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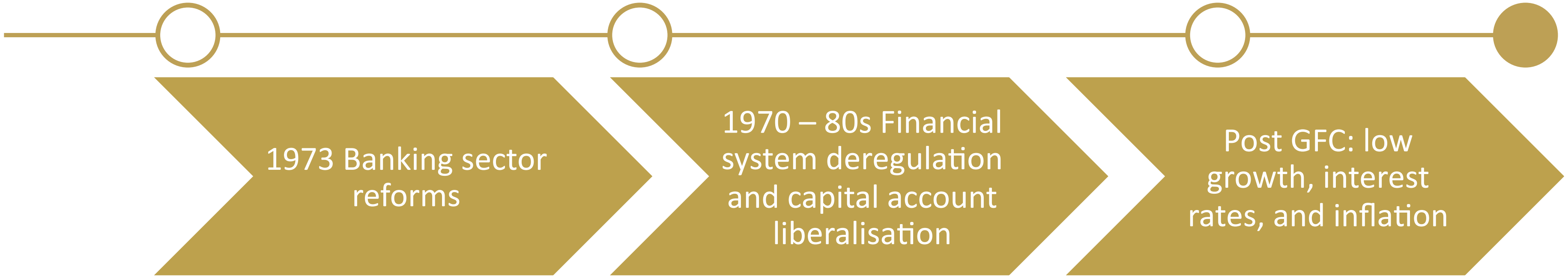
History and Overview of the Australian Corporate Bond Market



Key phases

1. Banking reforms resulting in a dramatic improvement in banking competitiveness. The banks' domestic balance sheets grew exponentially at an average annual rate of 13 per cent since 1985

2. 1970-80s financial system deregulation and capital account liberalisation were key drivers in the development of the domestic corporate bond market. Elimination of capital controls also meant that Australian corporates were free to issue in offshore markets

3. Increased global interest in bond markets as an alternative to bank finance. Strong returns in corporate bond markets, relative to other investments as a result of economic climate.

Overview

- Corporate bonds are primarily issued into the wholesale market and traded over the counter (OTC). A small number of public offers of listed corporate bonds are made to retail investors each year via the Australian Stock Exchange (ASX).

- There are current 6 corporate bonds listed on the ASX and 47 corporate bonds are accessible through investing in exchange-traded bonds (XTBs).

Social Impact Bonds

- SIBs are an outcome-based contract of social impact investment. Private investors provide the capital to launch or expand the public good initiative, and if the expected social benefits are achieved within a given period, investors receive their capital back with a rate of return.
- In Australia, SIBs, also known as social benefit bonds in NSW, were pioneered in NSW by implementing two SIBs:

Newpin
Courage to change together

Newpin bond: The bond was shown to achieve social benefits and investors received a 12.2% return in 2016 as a result.

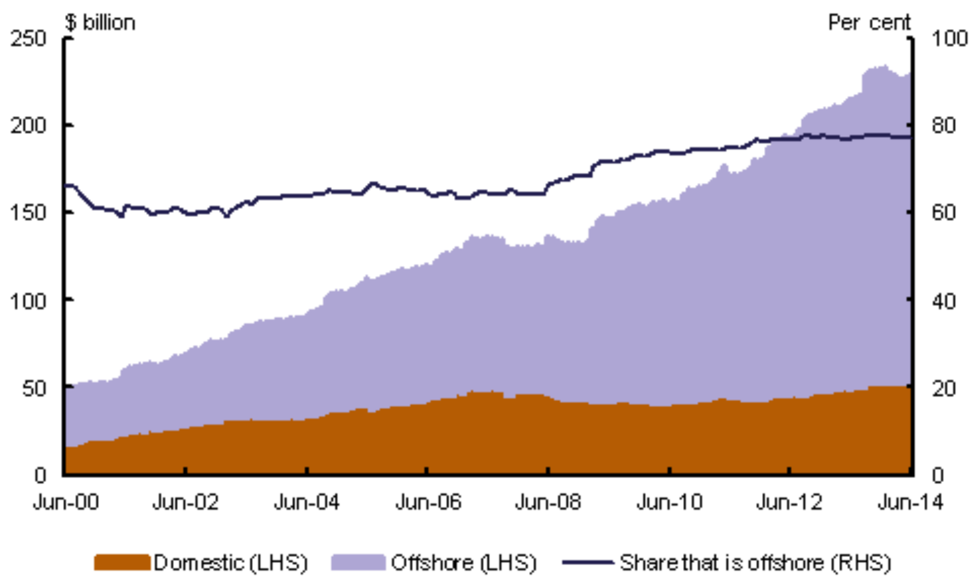
benevolent SOCIETY

Benevolent Society bond: The bond has recently achieved a 12% performance percentage to June 2015.

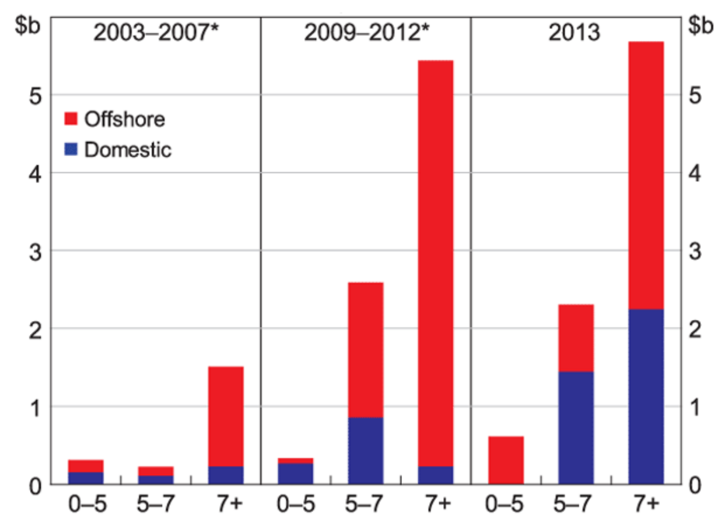
Party	Benefits	Risks
Government	• Increased innovation, quality of services, transparency, collaboration with industry, and efficiencies. • Shared risk with the private sector	• Financial risk and moral hazards • Negative or ineffective intervention • Reputational and operational risk
Investors	• Diversification and aligning investment with values	• Financial risk • Philanthropy vs. investment tradeoff
Service providers	• Increased funds and flexibility to achieve objectives	• Reputational risk and altered incentives

The Australian Corporate Bond Market in a Global Context

- Over the last decade, bond issuance from Australian corporates has been growing steadily, and 80% of this issuance has occurred in offshore markets.
- In offshore markets Australian companies are able to obtain longer tenors, larger sizes, at lower cost, and to lower-rated issuers than domestically.
- This represents a lost opportunity for Australia's financial sector.



RBA, 2014

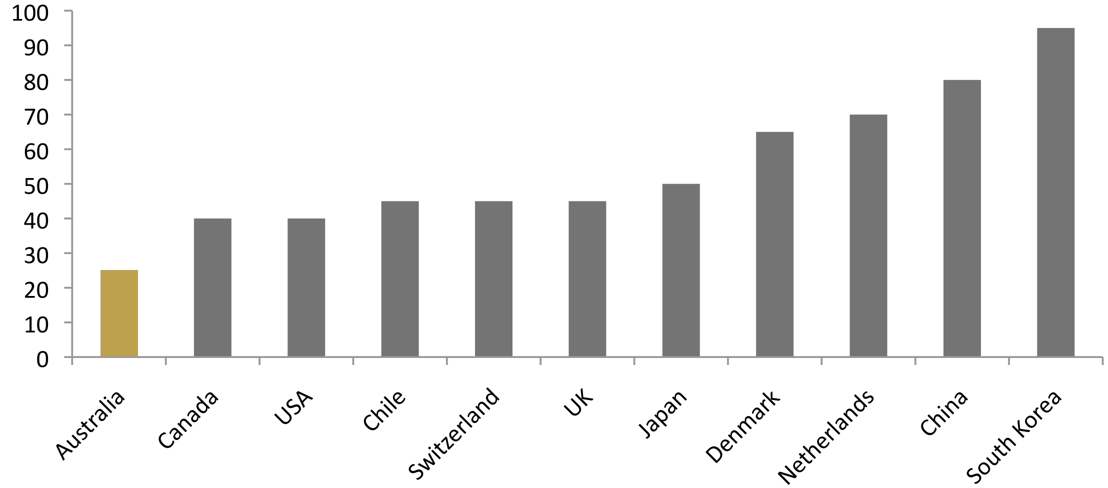


RBA, 2014

Corporate Bonds and the Investor

- The Australian market for loanable funds is currently characterised by an over-reliance on the equity market.
- Self-Managed Super Funds (SMSFs), which now account for approximately a third of Australia's retirement savings, only have 1% is invested in fixed income assets.
- Barriers for investors:
  - **Liquidity and availability**: 'liquidity spreads' making bonds less attractive, retail requirements
  - **Minimum parcel sizes**: often $500k parcel sizes preclude even sophisticated investors
  - **Transparency**: limits new entrants and creates systemic risk

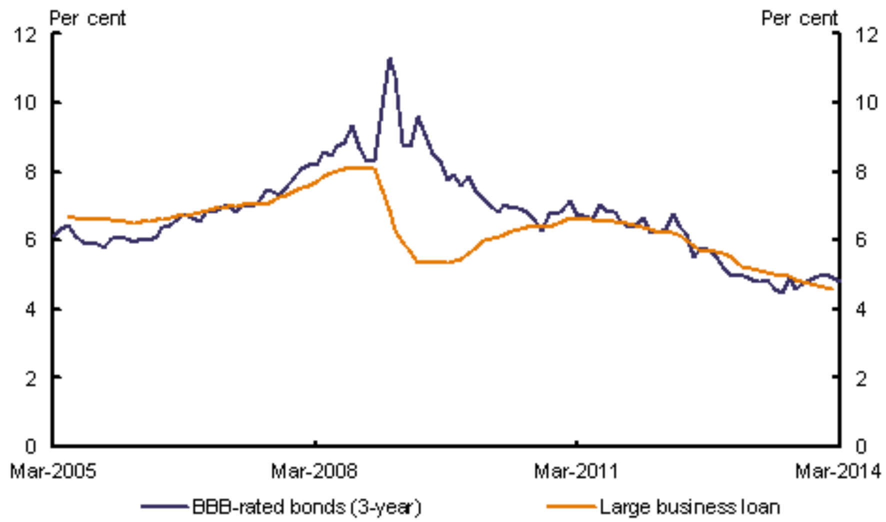
Proportion of superannuation in fixed income (%)



Source: Mercer (2014)

Corporate Bonds and the Issuer

- On average, the long-run cost of debt is lower in the corporate bond market compared to the loan market (Bayley, 2013). Tax and regulatory factors better explain underdevelopment of corporate bonds.
- Competitive advantage of bonds over loans is longer-term funding. However this advantage is not currently present in the Australia corporate bond market, with the average term to maturity of a corporate bond being 4.7 years compared with 4.1 for large business loans.
- Small and medium-sized enterprises often do not have access to capital debt markets and must rely on banking.
- Barriers for issuers:
  - **Taxation of debt vs. equity**: large explanatory factor for offshore issuance
  - **Credit ratings and information asymmetry**: additional fixed cost to issuance, often cannot be used in prospectus
  - **Reporting, liability, and governance**: risk and increased fixed costs



Source: RBA, 2014

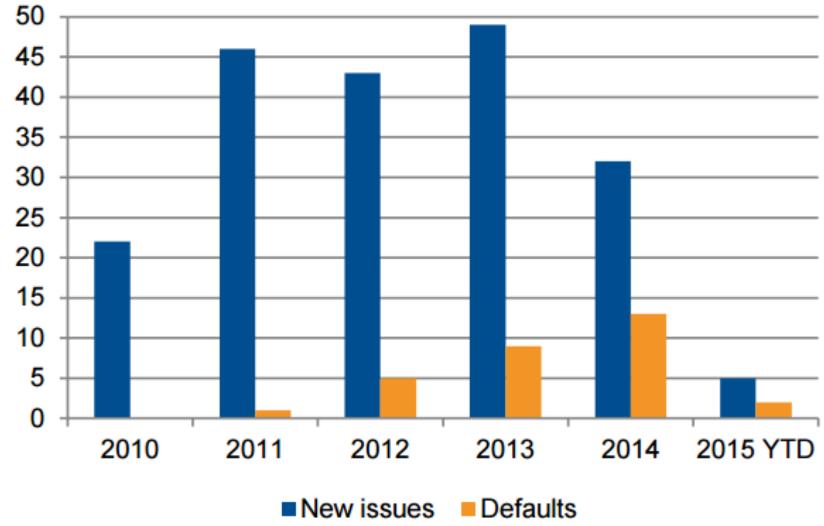
Economy-wide Benefits and Risks of Corporate Bond Market Development

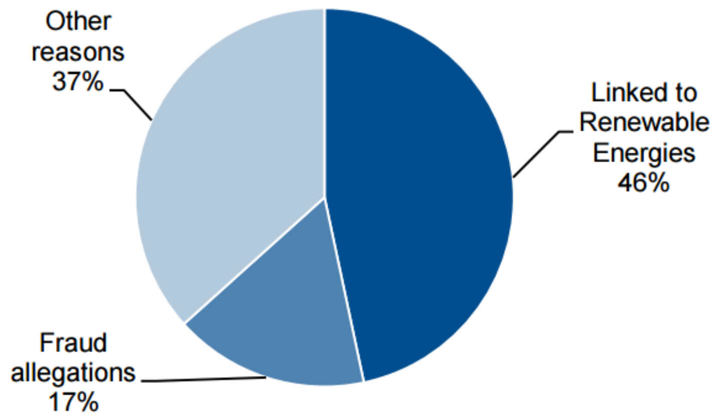
- Capital markets can act as a ‘spare tire’ in case the banking system becomes impaired.
- A more diversified financial sector with a balance between capital debt markets and banking reduces systemic risk and the probability of a crisis.
- **For investors**, a reduction of equity-bias would result in a more diversified portfolio. Bond market returns are generally correlated negatively with equity returns, particularly if the bonds selected have low correlation with equities in an investor's portfolio.
    - The recent strong performance of bonds may reflect the downward trend in interest rates over recent years. Therefore, the risk exists that the disappearance of a low interest rate world presents risks for corporate bond market attractiveness.
- **For issuers**, bond markets can provide firms with a stable source of funding, at a lower cost of capital, as an alternative to bank finance.
    - Bond markets have risk-sharing factors in spreading the cost of large projects over many stakeholders and risk-shedding character. This theoretically means that bond investors are much more willing to make large, long-term commitments than banks.
- Innovative financing solutions such as SIBs also have benefits and risks of development for the Australian economy.
    - SIBs may see increased innovation, efficiency, and value for money in achieving social goals. However, SIBs may come with significant financial and operational risk.

Case Study: German SME corporate bond market experiences

- Bond issue by firms, including medium and smaller sized firms has emerged in Germany and other EU countries as a means of raising capital in an era of less easily available bank finance.
- The German experience has been largely positive with remarkable growth in debt capital markets pointing to structural change in corporate finance.
- Stock exchanges in Germany, with the exception of Hamburg/Hannover, require the issuer to be rated by a credit agency, unless the company is already listed on a regulated stock exchange.
- The German small and medium enterprise (SME) bond market has suffered 34 corporate bond defaults since 2010 (a default rate of 17%) totaling debt volume of EUR 1bn.
- Lessons learnt: more selective investor and debt advisors, stronger creditor protection through covenants and asset pledges, stricter listing requirements

Figure 1: Decreasing number of new bond issues with increasing number of defaults





Score Ratings, 2015

Pathways to Reform

- In summary, the analysis indicates that corporate bond issue can be an effective means for diversifying and deepening a financial sector

- The regulatory environment needs to be right. For international successes to be successfully translated into the Australian experience requires a number of issues to be solved:

    1. On the demand side, investors need to be offered the correct mix of risk and return to justify switching from equities.
    2. Complementing this is an appropriate regulatory structure to safeguard investor interests.
    3. Companies need to become aware of the potential for bond issues to solve the development capital issue and able to access the capital market.
    4. Requirement (3) will call for the services of financial advisers with bond issue experience.
    5. There is a case for a role to be played by high yield non-investment grade bonds supported by appropriate legislative frameworks.

Discussion

1. Should credit ratings be a requirement, as in German markets, or should Australia permit unrated bond issues?
2. Should there be increased disclosure requirements in OTC markets to increase transparency? For example, the ASX publishing all transaction prices and volumes settled on Austraclear
3. Would Australia have a net benefit from a SME / below investment-grade corporate bond market? How should one be promoted?
4. What role should Social Impact Bonds have in achieving social outcomes?
5. What could be done in order to increase the tenors of Australian corporate bonds. For example, simple corporate bonds have a legislated maximum term of 10 years, this requirement could be removed.
6. What are possible avenues for encouraging fixed interest in the SMSF market?

Contact Us

Australian Institute for Business & Economics

Level 3, GPN3, Building 39A,
Cnr Campbell Road and Blair Drive
The University of Queensland
Brisbane QLD 4072

T: +61 (0) 7 3346 0628
E: enquiries@aibe.uq.edu.au
W: aibe.uq.edu.au

Economics & Law Research Institute

11/66 Eagle Ln
Brisbane QLD 4001

T: +61 (0) 7 3040 0403
E: info@elri.com.au
W: www.elri.com.au