VANILLA BONDS & ARTIFICIAL SWEETENERS

Critics claim that Australia's undeveloped corporate bond market needs a government solution. But is an artificial sweetener the right approach?

STORY **ELIZABETH FRY**

There is constant commentary that Australia's corporate bond market is moribund and incentives should be introduced to kickstart issuance. It has been common for financiers to claim that the outstanding value of corporate bonds issued domestically – hovering at around A$210 billion at the beginning of the year – is too low and that the rules governing debt issuance are onerous. Some say this is causing too much reliance on bank debt. Others claim it is cutting off options for Australian superannuants.

In recent months these claims have been largely dismissed by the most detailed investigation of the financial markets in more than 15 years – the Financial System Inquiry chaired by former banker David Murray. The inquiry noted that "a range of regulatory and tax factors" had limited the corporate bond market's development in Australia. But it made clear it did not see the size of the corporate bond market as a huge problem for Australian finance.

And picking apart recent deals, experts also see the Australian corporate bond market broadening its base and becoming more diversified. According to veteran fixed interest specialist Warren Bird, executive director of treasury and investment services for Uniting Financial Services, the list of issuers is expanding, and the structure of the market is improving in terms of duration and credit quality. >

“Does it matter whether or not we have a corporate bond market?”

PHILIP LOWE, RBA

While the Reserve Bank of Australia (RBA) also sees the possibility of corporate bond raisings adding a new source of competitive pressure, it doesn't see an urgent need for change. The central bank wants the local corporate bond market to act as a “spare tyre” that can be expanded when needed (see “The RBA on Australia's corporate bond market”, opposite).

NATURAL GROWTH

Checked by the global financial crisis, Australia's corporate bond market in 2015 is roughly where it was in 2007, at least in terms of bonds outstanding. A- and AA-rated issuance has largely ceased since the financial crisis. And just a small group of Australian companies is issuing: on the RBA's count, about 30 bonds per year have been issued in the domestic market over recent years.

But the RBA, Murray, Bird and others all see the market continuing to develop without artificial sweeteners from government.

The stark truth, says Bird, is while the local corporate bond market might continue to grow incrementally, it will always be small and relatively undiversified, just like the share market and the broader Australian economy.

“While the corporate bond market should perhaps be bigger than it is, it doesn't actually have to be as large and vibrant as some people feel is necessary,” Bird argues.

Much of the discussion presumes that domestic investors lack the opportunity to get corporate credit risk, but that's not true. Globally there is no shortage of bonds. Most super funds take a global perspective of the debt market, and unless they are offered more diversity and more choice – both in terms of who is doing the issuing and the mix between investment grade and higher yielding issuance – they will be tempted to go offshore.

Thousands of global credit funds are trying to persuade investors to buy them, across the credit risk rating spectrum. Some funds can give people perhaps 500 different corporate bond exposures, all currency-hedged. “There's a place for Australian bonds in that, but there are many industries that we don't have that should be part of a credit portfolio,” argues Bird.

Australian corporate bonds account for only around 1 per cent of total superannuation assets, leading some experts to believe that things would be better if the government offered incentives to help shift money away from equities. But even if Australia's super funds increased their exposure to corporate bonds, much of that allocation would still flow offshore. Given the sheer size of the assets held within super funds, they would have to go offshore for liquidity and diversity.

“Knowing funds were actively looking to invest more in corporate bonds would act as an incentive for corporates to issue here, but I doubt that this would be enough to cause a massive expansion in corporate issuance,” says Simon Doyle, the head of Fixed Income & Multi-Asset at Schroders.

HIGH DEMAND FOR LOCAL PAPER

It's not so much that there is no demand for Australian corporates. A whole variety of investors, including super funds and self-managed superannuations funds (SMSFs), have a very strong demand for good-quality and even low-quality high-yielding issuance. Most people would argue that Australia's equities market is vibrant, with a lot of global appeal, despite having only a small market capitalisation.

Many local investors – both retail and institutional – like owning local bonds. And while currently narrow, there is no reason why Australia's corporate bond market couldn't develop further. Companies seeking more diversification in their capital structure would be a positive. Clearly it is good for corporates to diversify their funding base and not just rely on domestic super funds or SMSFs to provide them with capital.

That said, corporates depend on banks for funding lines in periods of difficulty. So companies don't necessarily want to leave their lenders behind while they issue their own paper. They know that at some point in the future, they will need their lenders again.

The problem is a lack of diversity outside the banking and finance sector. With so many bonds being issued by banks and financials, the shortfall lies with the non-bank corporates. But Australian non-bank companies rarely access bond markets to finance their operations – and if they do, they mostly go offshore. Sourcing capital from a variety of bigger markets allows companies to issue securities at lower cost and lower yield, even after swapping that currency back into Australian dollars.

Mark Paton, the chief executive of FIIG Securities, reckons Australia has a very good institutional-grade bond market relative to its size.

The real issue, Paton says, is the lack of retail participation. Several brokerage firms are having reasonable success in bringing together SMSF investors, smaller institutions and not-for-profit organisations for corporate bond investments. FIIG, the country's largest fixed-income broker, provides retail investors with direct access to bond markets. The broker is also bringing wholesale-qualifying investors, personal investors, and a variety of SMSFs together with unrated issuers.

“You don't go far down the ASX before you start to run out of companies that have a credit rating, so it's important to get those with a solid market cap and a good story to come into the market,” he notes. Still others are working on developments that could open the market further via listing on the ASX.

The retail participation rate is low because people are not as aware as they should be about the benefits and opportunity to directly invest in bonds. The big boom in the financial markets has been compulsory super – and people have invested in managed funds that dominate the ownership of fixed assets within the super portfolio. But investors don't own bonds directly, preferring instead to put their money into equities and property. >

The RBA on Australia's corporate bond market

RBA deputy governor Philip Lowe, speaking in March 2014, explained that the RBA sees the corporate bond market as a form of insurance against bank funds drying up:

“Does it matter whether or not we have a corporate bond market and does it matter what the size of that market is? After all, the Australian economy and financial system have performed well over the past two decades and there does not appear to have been systematic difficulties for the corporate sector in accessing finance ...

“Bank-based finance remains the dominant form of finance for Australian companies. Superannuation funds have been prepared to finance banks and have effectively outsourced the credit assessment function for much of the corporate sector. Partly as a result, the development of a deep and liquid corporate bond market is still a work in progress.

“But an equally important observation is that we do have the infrastructure that could support a strong and very active bond market in times of stress or inadequate competition. In this way, this infrastructure provides a form of insurance.”

“The market is developing without artificial sweeteners from government.”

For all that, Bird's view continues to be that corporate bond investing at the retail level should only be undertaken in a well diversified way, and this is best done through managed funds. Most individual investors don't have enough funds to get the degree of diversification required, he says. In contrast, the right mix of Australian and global bond funds can give you exposure to perhaps 500 different corporate bonds, currency hedged. Try doing that with direct bond purchases.

FIXING THE MARKET?

Some commentators say higher funding charges might spur growth in the corporate bond market. And it's true that corporates might well issue more bonds if they had less access to bank funding, if it became too costly to borrow from the banks or if they wanted to diversify their capital structure. As the RBA's deputy governor, Philip Lowe, observed last year, since the global financial crisis, Australia's banks have lent much more willingly than many of the North Atlantic banks. For some companies seeking European finance, the corporate bond market has been cheaper than bank lending.

Things are slowly changing. The impact of tighter liquidity rules is certainly forcing lenders to hold more capital and to increase funding from sources such as deposits. If the cost of borrowing rises, they will typically pass this on to their customers in terms of higher rates. But again, this would only help the bond market expand at the margin, says Schroders' Doyle. It would not transform the market.

Other suggestions for improvement range from better systems and better distribution networks to tax incentives and less onerous disclosure rules. The idea is that easing disclosure rules for listed companies wanting to issue vanilla bonds will boost issuance by simplifying an expensive process.

Yet focusing on such issues is nonsense, according to Bird. Listed companies already have to issue boxloads of material to the ASX and the credit rating agencies, so issuing the same information to bond investors shouldn't impose a much greater burden. And as bonds provide no capital appreciation, only a downside if things go wrong, it is actually even more important that investors have complete information about what's going on at a company, not less.

Importantly, fixed interest securities are not homogenous. This is a huge challenge for fixed income investors: each issue has a list of terms and conditions as well as risks that can be very different depending on factors such as the degree of subordination and convertibility. High-quality issuers are typically low risk, but lower-quality issuers issuing long-dated bonds with a whole raft of different conditions can carry a very high risk. "It's a difficult market to make simple, and investors need to make sure they aren't taking risks they're not aware of," says Doyle.

None of these factors suggests Australia's low level of issuance in the domestic corporate market will change anytime soon. While an easier disclosure regime or less access to bank debt may lead to some marginal growth, the only things that really matter for the issuer are cost, liquidity and diversity. It's still all about economics. ■

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> WARREN BIRD, UNITING FINANCIAL SERVICES

Bond options from the Murray Inquiry

David Murray's Financial System Inquiry noted that as Australia's superannuation system matures and the population ages, demand for fixed income products will probably rise. It listed – but did not recommend – three options to help retail investors enter the corporate bond market.

- **Allow listed issuers to issue listed "vanilla" bonds directly to retail investors without the need for a prospectus.**
- **Review the size and scale of corporate "vanilla" bond offerings that can be made without a prospectus where the offering is limited.**
- **Review the size and scale of corporate "vanilla" bond offerings that can be made without a prospectus.**

David Murray