Our financial system's missing link - developing a retail corporate bond market

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Introduction

The need to develop the retail corporate bond market is widely supported by Government, ASIC and market participants. Despite this apparent consensus, progress has proven to be very slow.

In March 2009 Tabcorp issued a 5 year retail senior bond at the height of the GFC, at a time when banks were only lending for three years. This was the first vanilla retail bond since Telecom Bonds in the 1980s/90s.

However since then there have been less than five large listed issues. The Johnson report of November 2009 cited the need for an active retail corporate bond market and release of the Treasury consultation paper occurred in December 2011.

There has been little public development since.

At this rate of primary issuance a deep and liquid market will never be developed.

A deep and liquid retail corporate bond market would provide access to capital for Australian corporations, lower risk and less volatile investment options for investors looking for long-term security and predictable income streams, such as self-managed superannuation funds, and create space on bank balance sheets to support Australian businesses, particularly small and medium business.
NAB’s Rick Sawers recently said:

“If I arrived from outer space this morning I could probably buy shares online by 5pm today, but it is much more difficult to buy a bond.”

The retail corporate bond market should be comparable with the equities market. It should be as quick and as simple to purchase bonds as equities.

It makes no sense to have very simple access to one type of investment, equity, yet have almost no access to lower risk corporate bonds. A transparent system in which the two types of asset can be compared and assessed side by side is needed.

The Coalition understands that until there is a comparable market, government has not fulfilled its role and once there is, government should allow the market to function.

The recent step of creating a market for Commonwealth Government Securities (CGS’s) is a useful start, and will allow retail investors to buy and sell CGS’s, at least for diversity purposes. However, with a coupon at 3 per cent Government bonds can’t compete with Government-backed bank term deposits at 5 per cent.

Elmer Funke Kupper of the ASX has, not surprisingly, stepped in and said that the ASX will soon offer a platform for retail investors to trade government bonds.

These steps are in the right direction, however we need to do much more, much more quickly.

Stephen Bartholomeusz wrote last December that:

“If we are still talking about this issue next December, the failure to attempt to create a market that has been talked about for decades may not just represent a missed opportunity to capitalise on the risk aversion and strong appetite of retail investors for high-quality yields but a failure to create some insurance against the risk posed to the stability of the domestic system by the disturbing developments in debt markets offshore.”

This is right and progress has been far too slow.

Government must act now to remove the barriers and facilitate and encourage the development of this market. It must support the development of bonds as an asset class comparable to and competitive with property, shares and cash/term deposits. And to do this it needs to deal with the bureaucracy and red tape that hold this development back and take much too long.

Quality regulation is the key issue. Better regulation, not more regulation, can help remove barriers and create over time a competitive low cost market that is a genuine and viable alternative to issuing overseas whilst providing investors with greater choice of investments.
The Coalition understands that the market needs to have confidence in regulatory settings and will avoid piecemeal change, constant change and change for the sake of change.

If the Coalition gets the privilege of Government we will examine the regulations that influence both supply and demand, to look for ways to stimulate the development of the retail corporate bond market. These include:

1. Examining the scope for greater use of a short form prospectus – because prospectus requirements to issue corporate bonds may sometimes make issuing them unduly onerous relative to issuing equities to the retail market;
2. Utilising the continuous disclosure regime within the ASX – because the inability to use this existing system increases regulation and increases the documentation requirements unnecessarily;
3. Reviewing the director’s liability for prospectus in line with the COAG review of director’s liability and investigating the scope to align it with the current requirements for short form prospectuses and cleansing notices;
4. Improving accessibility - because just as issuing of retail corporate bonds should be easier, the purchase of retail corporate bonds should be simpler; and,
5. Educating the market – because there is inadequate knowledge of corporate bonds among market participants and potential participants.

These steps will create the framework for a retail corporate bond market that is comparable with other asset classes, particularly the equities market.

The current situation

Australia’s retail corporate bond market is severely under-developed and has a concentration of issuers and relatively short maturities. This underdevelopment is highlighted by the fact that the retail corporate bond market is dominated by subordinated issuance and very rarely sees senior vanilla issuance.

Stephen Bartholomeusz has gone so far as to describe the state of the bond market as a “glaring deficiency in what is otherwise an exceptionally sophisticated financial system.”

The Wholesale market, being mostly institutional investors and investors that meet the Corporations Act definition of a professional investor, have had significant access to corporate bonds, whilst access for a retail investor has been limited.

The Global Financial Crisis (GFC) had a profound impact on global capital markets. In the post GFC environment demands of and for capital have changed.

For banks Basel III liquidity reforms have set new standards. The Liquidity Coverage Ratio (LCR), which aims to ensure that authorised deposit-taking institutions (ADI’s) have sufficient high-quality liquid assets to survive liquidity stress for a period of 30 days, and the Net Stable Funding Ratio (NSFR), which aims to provide more stable
sources of funding, are challenging in countries such as Australia in which the amount of eligible assets on issuance is limited.

Whilst banks should continue to have sufficient capital and credit risk appetite to support corporate lending the requirements for funding loom as a source of increased constraint on bank balance sheets.

In this context some of the financing needs of the corporate and infrastructure sectors may be better held within a retail corporate bond market. Indeed, given the expected constraints on bank balance sheets, a retail corporate bond market may prove vital in order to meet business funding needs when credit growth returns.

The post GFC context has highlighted Australia’s lack of any considerable retail corporate bond market. From 2008 until late 2011 only a handful of issues came to market and these were mostly the domestic banks.

However demand has gone in the opposite direction. The underperformance of equity investments and increasing number of investors requiring more conservative and/or diverse investment portfolios has led to greater demand for retail corporate bonds, driven by financial planners and the self-managed super industry.

The sheer volumes and growth within the self-managed super industry - self-managed superannuation fund balances already exceed $478 billion and are growing at over $30 billion per annum - make a compelling case for the development of a deeper, more liquid and sustainable retail corporate bond market.

This is because SMSF’s and other investors with long-term horizons are looking for security of returns and diversity. This makes sense when you consider that Australian shares are still more than a third off their 2007 highs.

However while the investors are interested, issuers are not providing sufficient supply to meet the demand for corporate bonds. Although the banks are large issuers in the retail bond market it is principally for non-senior or subordinated issues.

The anticipated increased cost of borrowing within the Australian banking system under Basel III will mean that the capital markets are likely to be more attractive as a financing market. This may help with the development of a domestic retail corporate bond market, however it is time for government to act quickly to facilitate the rapid development of this market in order to support and improve the Australian financial system.
Why does Australia need a deep, liquid and sustainable retail corporate bond market?

All stakeholders in the Australian financial sector will benefit from the development of a deep, liquid and sustainable retail corporate bond market.

Issuers

For issuers simpler access to the local market should mean, particularly over time as scale develops, cheaper and easier to access funding.

However at the moment while companies raise equities on the domestic market, they tend to go offshore to issue corporate bonds.

This is because offshore markets, such as the USD 144a market, are much deeper and more liquid, despite dearer documentation.

Over the last decade, the corporate loan market has more than doubled, from $218 billion in January 2002 to $486 billion in December 2011 (with a high of $530 billion in November 2008), and usage by Australia of other countries’ savings via Australian corporate offshore issuance has tripled, from $41 billion to $138 billion.

Domestically we have seen a recent wave of blue-chip corporate issuance, however this has been available to wholesale investors only. And, even when there is retail access, liquidity limits the capacity for issuance to be freely traded on a market platform; for instance ASX listed turnover in 2011 was only $200 million of debt securities, including hybrids.

For 2012 year-to-date we have seen approximately $13 billion issued in the listed hybrid/bond market, compared to around $11.4 billion in the wholesale corporate bond market, of which $1.75 billion comes from BHP and Telstra alone.

Although there has been growth in domestic wholesale issuance it is clear that the majority of debt raising is taking place offshore. In 2012 to date there has been approximately US$31 billion of bond issuance completed by Australian corporates in offshore markets, and this excludes several very large issues by BHP and Rio Tinto.

Australian companies have been accessing US and Asian markets and have been issuing senior as well as subordinated/high yield bonds and hybrids. This debt has been bought by a large range of institutional investors.

Investors

For investors the benefits of diversity of offerings and stability of returns are very appealing.

There is demand for a new investment class for retail investors who are looking to diversify their investments and will accept a lower return for less risk. And most
advisors will tell an investor that corporate bonds should be an important part of any investment or superannuation portfolio.

Yet a recent OECD report found that Australian superannuation funds, with 50 per cent average allocation to shares, were the highest in the world. In contrast only 14 per cent of the funds are allocated to bonds, far lower than Japan, 56 per cent, the Netherlands, 50 per cent, and even the UK at 35 per cent and US at 27 per cent.

This low proportion of superannuation investment is even more marked when it comes to self-managed super funds, where a meagre 1 per cent is invested in corporate bonds.

Compulsory superannuation and savings from a prosperous economy delivered large pools of cash in funds under management in Australia.

These investments suffered during the GFC. Many retirees suffered significant capital losses. This was exacerbated by the increased risk associated with the focus of Australia’s superannuation sector on equities.

With no income to top up account balances, investors are now looking for different ways to structure their investment portfolios.

Post-GFC, retail investors now have a greater interest in less volatile returns, safer regular income streams, and more diversified investment portfolios.

Corporate bonds provide investors with greater income and capital certainty than equity investments, as well as lower volatility of returns.

In a post GFC context retail corporate bonds would be a welcome addition to equities.

Increased liquidity will also promote institutional investor participation. Many Australian fixed interest institutional investors currently participate in the USD 144a market and hedge the asset back into AUD, the reverse of Australian companies that issue USD then hedge the liability back into AUD. A liquid retail bond market in Australia in many instances could remove the need for both our investors and companies to hedge.

The benefits of promoting institutional participation will be increased retail investor confidence in the market, and increased issuer confidence in tapping funds.

Retail and institutional participation is complementary and will assist with liquidity, confidence and the efficient pricing of risk.

**Banks**

The benefits for banks are important. Prior to the GFC Australian banks had a heavy reliance on international wholesale financial markets to fund economic growth,
particularly short-term funding. As the domestic retail corporate bond market develops the potentially improved ability of banks to attract more domestic funding would reduce their reliance on offshore funding.

Research by the world’s largest bond trader PIMCO found that, in dollar terms, Commonwealth Government Securities were our second biggest export in 2011-12 at $58 billion, emphasising the government’s reliance on debt.

Our determination to start paying off Commonwealth net debt will of course see a commensurate reduction in the issuance of government bonds.

Consequently, the emergence over time of a substantive retail corporate bond market would further diversify our financial system by providing ready access to an asset class with many similar characteristics to Commonwealth Government Securities, which are currently 85 per cent foreign owned.

In the context of the increased constraints on bank balance sheets discussed earlier this opportunity for diversification could assist Australian institutions seeking to comply with Basel III regulations that have direct implications for funding and liquidity.

Another benefit, that would assist both banks and businesses, is the space that might potentially be freed up on balance sheets to support small and medium sized enterprises.

**Business**

This balance sheet capacity for banks to support small and medium businesses would benefit businesses by assisting them to get greater access to capital.

Traditionally it has been easier for corporations to raise capital with equity than with retail corporate bonds, particularly for companies that are not rated investment grade.

The appropriate development of a deep, liquid and sustainable retail corporate bond market would support business by providing companies with a competitive alternative to bank funding and equity.

**What does the Coalition propose?**

The Coalition understands that there is a role for government in facilitating the development of a deep, liquid and sustainable retail corporate bond market, but not in running it.

This means that the market should be supported to develop adequate depth and liquidity to function efficiently, however it also means that the market must be left to function.
There are barriers, such as low participation, execution risk for issuers and onerous conditions, and at present there are advantages in issuing offshore.

However there are also a number of things government can potentially do to assist the development of the market.

Moves to allow retail investors to trade CGS’s have helped to create momentum. The ASX’s continued commitment to providing a platform for traded retail corporate bonds in Australia continues this momentum.

The time for government to capitalise on this momentum, the market conditions and the growing demand from issuers, banks, investors and businesses is now.

The Coalition understands that the time is now and understands that regulation is the key issue. Better regulation, not more regulation, can help remove barriers and create a competitive low cost market that is a genuine and viable alternative to issuing overseas.

From the beginning Government must work with all stakeholders, from originators, issuers, investors, trading houses and advisors to regulators and ratings agencies.

The Coalition will ensure that the process of developing the retail corporate bond market is comprehensive and consultative and that the best outcome for Australian businesses and investors is achieved.

As the retail corporate bond market develops comprehensive consultation will continue in order to make certain that the market attains the depth and liquidity to function effectively as quickly as possible.

I said earlier that if the Coalition gets the privilege of Government we will examine the regulations that influence both supply and demand, to look for ways to stimulate the development of the retail corporate bond market. I will now go through some of the areas for possible change in greater detail:

1. Examining the scope for greater use of a short form prospectus – this is important because prospectus requirements to issue corporate bonds may sometimes make them unduly onerous relative to issuing equities to the retail market.

Corporate bonds have an additional layer of protection compared to equities, as holders of bonds rank ahead of equity in the event of insolvency. The increased disclosure requirements are therefore arguably counter-intuitive, at least in some cases.

If you look at any prospectus for a debt security, be it a corporate bond or a hybrid security, the vast bulk of the prospectus is taken up describing what you are buying. In the wholesale markets banks and companies establish debt
programmes under which all terms of their debt are established and each new issue of debt is based.

We will investigate the scope for this concept to be utilised for retail bonds, with issuers establishing a set of terms that would be a platform that then covers subsequent issuance across a range of maturities and interest rate structures.

Essentially for equity issues this is the position in the market now – neither rights issues nor placements require a prospectus.

As retail corporate bond issues have lower risk than equity, there may be scope, where a debt programme has been established, for a term sheet to replace existing prospectus requirements – or, where there is a need for additional information due to complexity or risk, for a simpler short-form prospectus to be used.

For issuers, changes in this area could potentially reduce repetitive administration, simplify the process, reduce the preparation time required and significantly reduce the cost of issuing – subject to appropriate, strong protection for investors always being retained. For investors, changes might assist with informed decision making by enabling simpler comparison of bonds and providing easier to understand documentation.

2. Utilising the continuous disclosure regime within the ASX – this is important because the inability to use this existing system increases regulation and increases the additional, repetitive, documentation requirements for new issuers.

Every corporation listed on the Australian Securities Exchange (ASX) must comply with continuous disclosure requirements under the Corporations Act. This ensures that the market is advised of information and events as they occur.

Rather than creating additional reporting requirements, there may be efficiencies and benefits in prospective retail corporate bond issuers who are already required to comply with continuous disclosure requirements being able to utilise the information they have already provided to the marketplace.

The Coalition, whilst recognising the different risks associated with corporate bonds, will examine the scope to utilise existing reporting requirements where possible, rather than using separate and additional requirements and documentation.

For issuers this may have the potential to reduce duplication in reporting and reduce the costs associated with issuing. For investors, up-to-date information
would ensure timely understanding and information and a more equal knowledge of investments due to having the same access to information.

In addition all market participants stand to benefit from the good governance imposed by continuous disclosure and the likelihood that it will assist the market to efficiently discover and set prices.

3. Review the director's liability for prospectus in line with the COAG review of director's liability and investigate the scope to align it with the current requirements for short form prospectuses and cleansing notices.

Consistent with the COAG Reform process regarding the personal liability of directors there should be a review of the existing director's deemed liability regime for retail corporate bonds.

Provided any reforms in this area could be undertaken without compromising the integrity of the system and investor protections, any such reforms would have the potential to simplify issuing and reduce costs. For investors this could make retail bond issues more attractive and lead to a broader range of issuers potentially utilising the market.

4. Improving accessibility – this is important because just as issuing of retail corporate bonds must be easier, the purchase of retail corporate bonds must be simpler.

The goal must be that investors can access the market as easily as other markets, such as equities. This should include access through trading platforms that can be used on laptop, tablet and mobile phone.

With a growing number of investors looking to take a more active role in managing their portfolios, they must have access to the market.

Furthermore there may be benefit in providing greater clarity around the definition of a 'sophisticated investor' under the Corporations Act.

For issuers increased participation will enhance liquidity. For investors, improved accessibility will allow access to new investments that can provide certainty of income stream, lower capital risk and longer duration. For many investors, particularly those approaching retirement, these benefits are potentially substantial.

5. Educating the market – this is important because there is inadequate retail corporate bond market knowledge among market participants and potential participants.
The Coalition will task ASIC to work closely with the industry to develop a comprehensive education campaign to encourage and facilitate better knowledge and understanding of this asset class.

The approach to education should be collaborative. It is necessary to improve retail investors’ understandings of all aspects of corporate bonds including terminology (such as duration, yield and coupon), features, the benefits and risks, the capital structure and where corporate bonds rank in relation to other assets.

For issuers education will help with understanding of the market and the role the retail corporate bond market could play as a new source of funding, including longer term funding and the potential for this to reduce refinancing risk. For issuers education will lead to greater understanding of the investment and therefore reduce the risk of purchasing an unsuitable investment.

**Conclusion**

The Coalition understands that the issues I have just discussed are important areas of potential reform for Government which can see the market grow and develop.

Many other aspects are up to the market to progress, such as relative pricing, fees, tenor, volume, etc

Importantly the Coalition will consult with stakeholders before making any changes.

As the market develops additional issues will doubtless be raised which may require further consideration by Government.

For example, one area raised by some in the financial market relates to the scope and merit of facilitating existing “seasoned” wholesale bonds being moved to the listed debt platform, so they can be traded by retail and wholesale investors interchangeably – similar to the approach being taken for Commonwealth Government Securities.

It is suggested that this would allow a large number of wholesale bonds to be available to retail investors, thereby creating better price transparency, more liquidity and a good foundation for future primary issuance, versus trying to build the market one new issue at a time.

These and other issues would be matters for future consideration.

In the meantime much can be done quickly to breathe real life into the development of a sustainable retail corporate bond market. The Coalition stands ready to take such action.