Development of the Australian Corporate Bond Market

House of Representatives Standing Committee on Tax and Revenue

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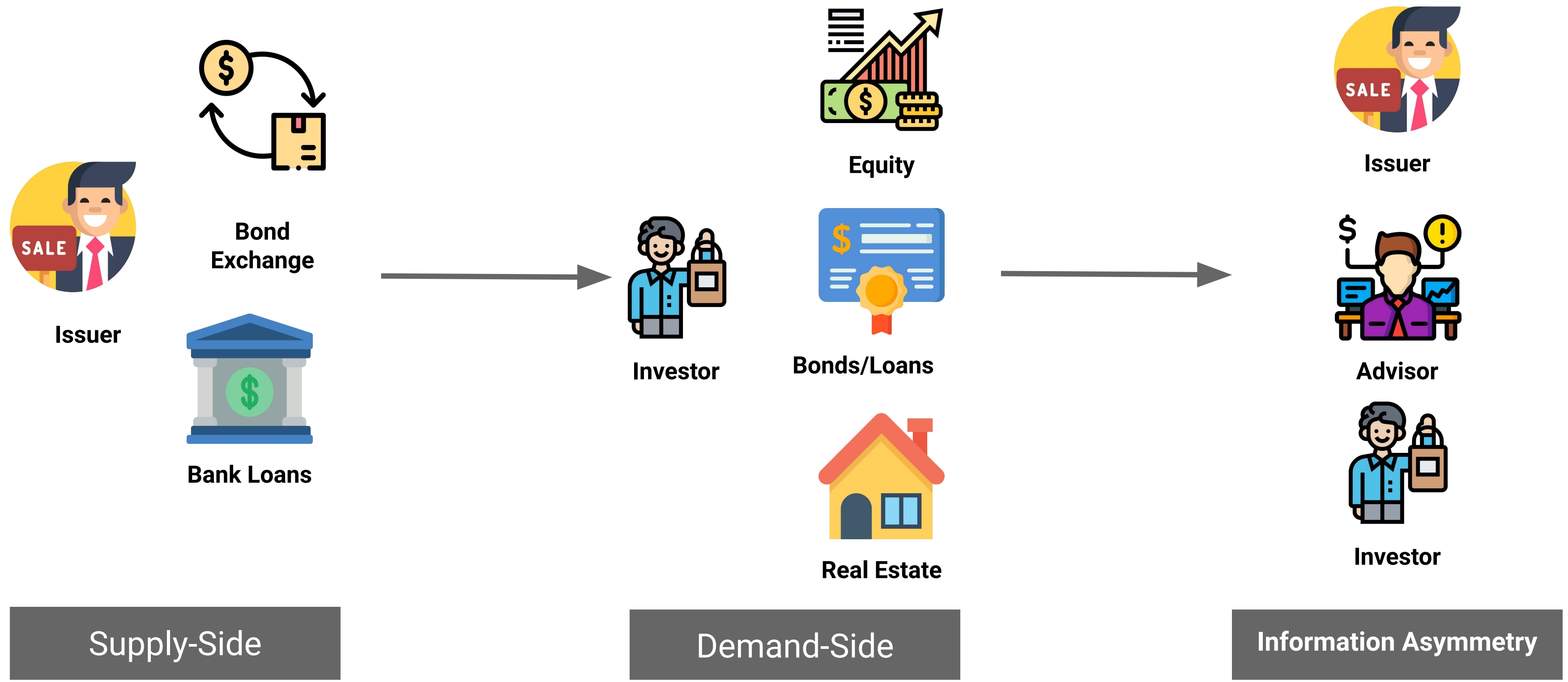
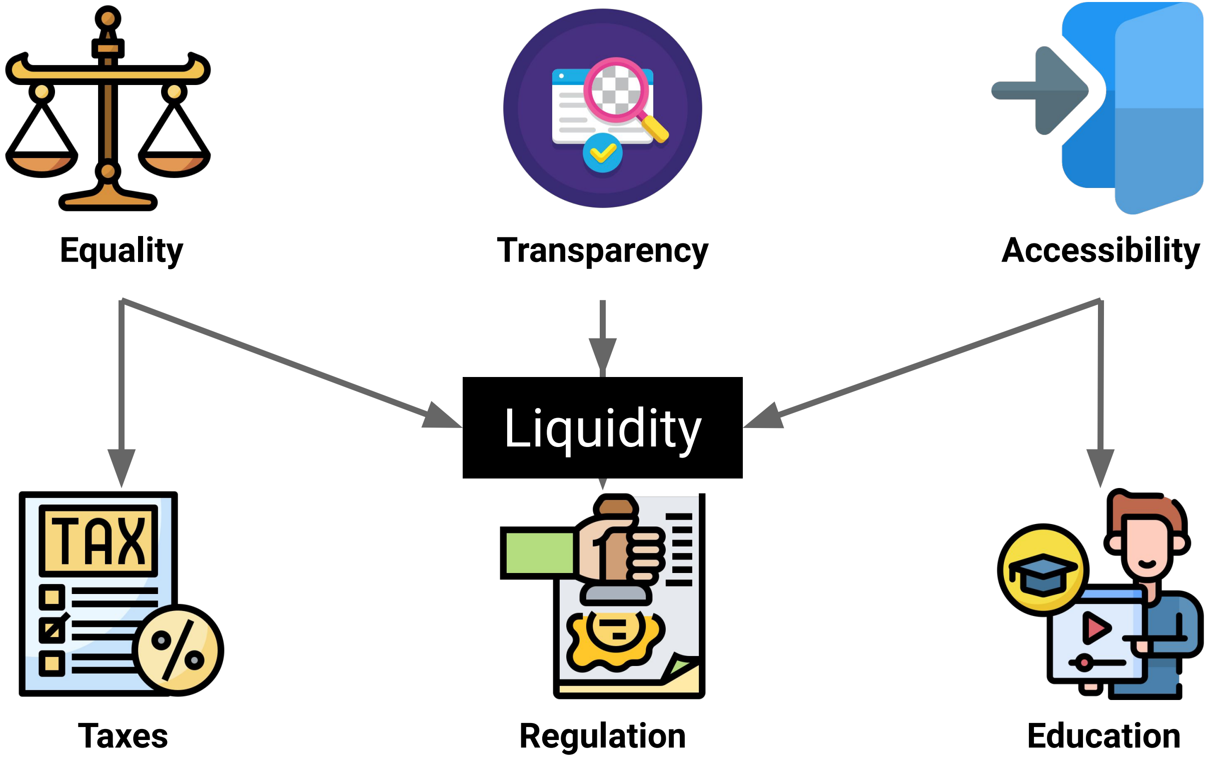
Corporate bond market activity



Key Objectives



Taxes

Objectives

- Level out the playing field with equities & real-estate.
- Nudge asset allocation toward high-grade corporate bonds in retirement funds.

Proposed solutions

- Franking credits for bond coupons accessible by SMSF or Australian investors only.
- CGT concessions for SMSFs to swap up to 40% of total holdings towards corporate bonds.
- Tax concessions on superannuation accounts when re-allocating assets from equities to corporate bonds along a investment glidepath that increases the asset allocation towards fixed income over time.

Regulation

Objectives

- Bond trading across multiple venues but centralized record-keeping.
- Focus upon credit-related corporate disclosures.
- Lending based on credit criteria only.

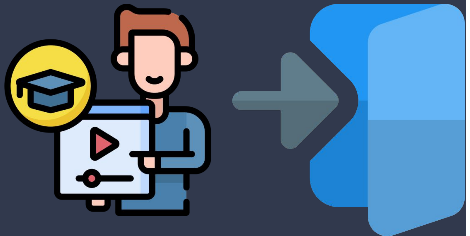
Proposed solutions

- Introduce a centralized bond pricing and transaction reporting for all OTC bond transactions with compliance from all exchanges (see TRACE in the US).
- Financial information of all corporate bond issuers must be available to assess issuer’s financial strength, ability to pay debt obligation, collateral/recovery upon default.
- Introduce “cleansing notice” scheme for corporate bond issuers but focusing on financial metrics that are debt-specific.
- Bank’s corporate lending must be based on credit criteria only, not on relationship.

Education

Objectives

- Provide investors with succinct, comprehensible information on corporate bonds that is free from conflicts of interest.
- Encourage financial advisors to exercise prudent asset allocation.



Proposed solutions

- Fund universities to create an quantitative corporate credit rating and bond pricing analytics framework that is accessible to members of the public.
- Introduce the requirement for financial advisors to include prudent asset-allocation in their code of ethics.
- Allow retail investors to participate in OTC bond market with both simple, complex, and subordinated bonds

Retirement underfunding

Issues

- Current low-interest rate environment makes it difficult for investors to obtain yield from low-risk assets.

Problem that poses:

- **Increased risk-seeking behaviour.** Investors may start to purchase complex securities in an attempt to increase the yield from corporate bonds.
- **Longevity challenge.** Retirees can outlive their superannuation/retirement portfolios.

ARTICLE – The Swedish market for corporate bonds

To have the capacity to provide further support to the credit supply for Swedish companies, the Riksbank is looking to broaden purchases on the commercial paper market to also include corporate bonds. The corporate bond market has grown in recent years, not least as a result of substantial demand from investors when low-risk assets have been associated with very low yield. For many companies, bond borrowing has been more favourable then bank borrowing. In contrast with other Swedish bond markets, however, there are no market makers and the terms and creditworthiness differ relatively considerably between individual bonds. Overall, these factors make it more difficult to value corporate bonds than other bonds. The lack of market transparency and characteristic low turnover on the secondary market complicates the Riksbank's efforts to formulate appropriate purchases of these securities. This article aims to provide an overview of the Swedish corporate bond market.

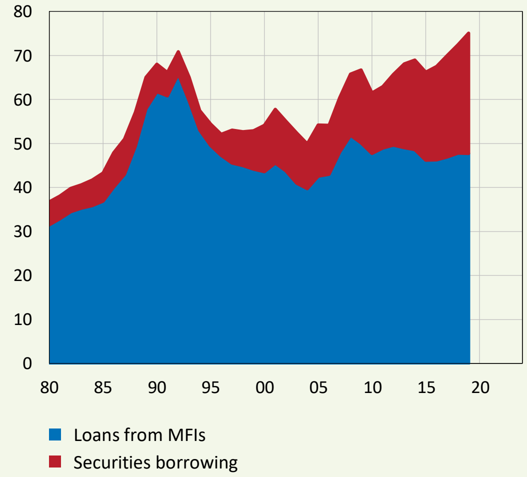
Wholesale funding among Swedish non-financial corporations has increased in recent years

Companies can fund their operations in three main ways: borrowing from banks and other agents, obtaining funding on the market, which is to say issuing commercial paper and bonds, and using equity from profits and shareholders' contributions. Wholesale funding makes up a relatively large part of US companies' total credit supply. In Sweden and Europe, the credit supply has instead traditionally taken the form of bank loans and it is not until recent decades, particularly after the banking crisis, that wholesale funding has increased in significance. The driving forces behind the credit growth in recent years include low funding costs for companies and strong cyclical development. At the same time, the very low interest rates have made it difficult for investors to obtain yield from low-risk assets. In light of this, investors have viewed corporate bonds as an increasingly attractive investment option, which in turn has made corporate bonds, as a form of funding, relatively more favourable for companies.[15]

For Swedish non-financial corporations, bank loans are still the main source of funding, but wholesale funding, which is particularly common among larger companies, now amounts to about a third of total borrowings. This corresponds to just over a quarter of GDP (see Figure 2:12).

A greater share of securities borrowing reduces the concentration of credit risk in the banking sector. This is positive from a stability perspective, but may at the same time affect the resilience of individual companies in the event of financial shocks. Securities borrowing can help a company if bank lending is more expensive or is not available to the same extent, but there is always a risk that the company encounters problems in renewing its funding if turbulence were to occur on financial markets when the companies bonds fall due.

Figure 2:12. Borrowing among non-financial corporates
Per cent of GDP



Note. Yearly data, includes securities borrowing and loans in both Swedish kronor and foreign currency. Securities borrowing 1980–1984 is based on the older classifications in the Financial Accounts.

Sources: Statistics Sweden and the Riksbank

[15] The European Central Bank has in recent years also bought corporate bonds for monetary policy purposes and thereby contributed to increased liquidity on the European market.

Property companies important on the Swedish market

The wholesale funding of companies can generally be divided up into commercial paper, which has maturities of up to one year, and corporate bonds, which have maturities of more than one year.[16] In May of this year, the outstanding volumes of commercial paper and corporate bonds amounted to SEK 134 billion and SEK 1,249 billion respectively, issued by approximately 350 non-financial corporations. Of these, SEK 102 and SEK 556 billion respectively were issued in Swedish kronor.[17]

The Swedish corporate bond market is concentrated to a small number of larger companies. In May of this year, the ten largest issuers were responsible for just under 30 per cent of the total outstanding volume issued in Swedish kronor, divided among just over 260 bonds. In a sector perspective, the bonds of property companies make up just under half of the total volume.[18] The average volume amounts to just under SEK 550 million per bond, but the volume in individual bonds varies between as little as SEK 100,000 and up to SEK 5 billion.

Other distinguishing features of the Swedish market are that a relatively small proportion of companies have credit ratings, and that the average maturity of a corporate bond is shorter than the maturity for the equivalent bonds in many other countries and that corporate bonds are relatively often issued with variable coupon rates.

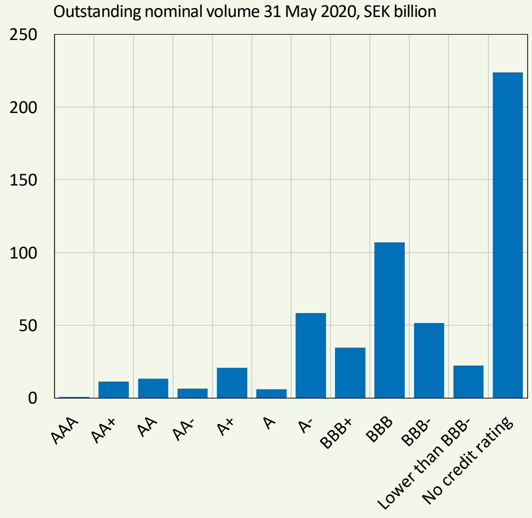
The corporate bond market is heterogeneous

The Swedish corporate bond market differs from other bond markets in Sweden in several ways. As companies regularly issue bonds to meet their funding needs, the bonds, even when issued by the same company, often have different terms. Among other things, these terms concern maturities and how interest payments are to take place, as well as which investors will receive compensation in the event of a company bankruptcy. In addition, the companies that issue bonds often have poorer credit ratings than issuers on other bond markets, for example central government and municipalities, and credit rating variations between companies are considerable. For investors overall, this means that the credit risk is comparatively high and also specific to each individual bond. One way for companies to facilitate the valuation of individual bonds and attract investors has been to obtain a credit rating. In May of this year, 60 per cent of the bond volume issued by non-financial corporations in Swedish kronor had such a rating (see Figure 2:13).[19] As a credit rating entails a cost for the company, it is primarily relatively large and creditworthy companies that have a rating.

The heterogeneity of the corporate bonds makes them more difficult to standardise. Companies wishing to issue a bond normally use a bank or other financial institution to examine interest from investors and when the bond is issued, the price is usually determined in an auction, although there can also be elements of negotiation between issuer and investor. After the bond is purchased on the primary market, which is to say directly upon issuance, it may then be traded in the secondary market, where banks and other brokers act as intermediaries. On the secondary market, however, there are no market makers, which is to say dealers who guarantee that they are always prepared to purchase or sell bonds for a stated price. This is an important difference from, for example, the government bond and covered bond markets, which can make corporate bonds relatively difficult to trade.[20] Many investors buy corporate bonds with the intention of retaining them until maturity, but some investors, such as mutual funds, may quickly need to sell some of their holdings under stressed circumstances, which contributes to large price movements.

Corporate bonds issued in Swedish kronor are owned, to a significant degree, by mutual funds and money market funds (30 percent) and insurance and pension institutions (almost 20 per cent). Foreign investors also own a significant proportion of bonds issued in Swedish kronor (almost 30 per cent) and completely dominate the holdings of Swedish corporate bonds issued in foreign currencies.

Figure 2:13. Credit ratings for corporate bonds issued by Swedish non-financial corporates in Swedish kronor
Outstanding nominal volume 31 May 2020, SEK billion



Source: Statistics Sweden

[16] In April, outstanding commercial paper issued in Swedish kronor by non-financial corporations had an average original maturity of almost 5 months.
[17] About 70 companies had outstanding commercial paper in April. However, this article focuses on the corporate bond market, the longer-term funding that forms a much greater proportion of companies' funding.
[18] This proportion s slightly larger than the property sector's share of bank lending.
[19] The percentage refers to the bonds where either the individual bond or its issuer has a credit rating. If the corresponding bonds issued in foreign currencies are also included, the share rises to close to 80 per cent.
[20] In the United States, work to increase transparency on the corporate bond market has come further than in Sweden and other European countries. There are also more agents who set prices and provide electronic platforms for trade.

Important to increase transparency on the Swedish market

In Sweden, corporate bonds as a form of funding are still fairly unusual in comparison with bank lending, but have increased in significance in recent years. Corporate bonds are issued with varying terms by companies with varying creditworthiness and the secondary market lacks market makers or other systems to ensure good transparency. Overall, these factors mean that the market is characterised by a lack of transparency and that the turnover on the secondary market is normally low.

These factors mean that the market is particularly vulnerable in the case of shocks and they complicate the Riksbank's work on buying these securities. The fact that the Riksbank nevertheless has decided to purchase corporate bonds during the period 1 September 2020 to 30 June 2021 reflects the importance of being able to offer broad support to the supply of credit to Swedish companies and have the capacity to handle a situation in which the credit supply to companies further deteriorates. Ultimately, a more well-functioning market requires considerable effort to increase transparency, something to which both market participants and public policy makers can contribute.