

Why do so Many Australian Borrowers Issue Bonds Offshore?

Address by Mr R Battellino, Assistant Governor (Financial Markets), to the Australian Credit Forum 2002, Sydney, 26 November 2002.

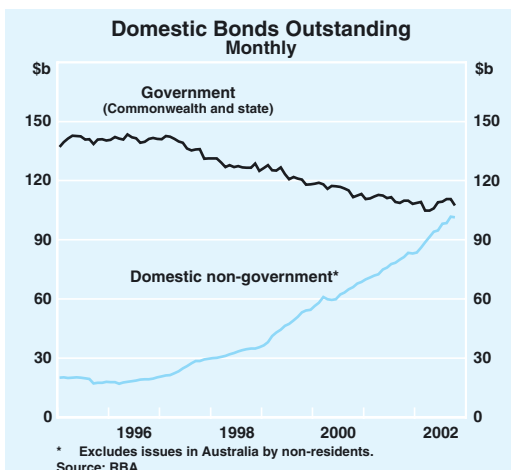
Much of the recent debate about the future of the Australian bond market has focused on the pros and cons of maintaining the Commonwealth Government bond market. Today I would like to focus on a separate issue, but one which nonetheless is relevant to the future of the Australian bond market. The particular topic I want to address is: why do so many Australian borrowers issue bonds in offshore markets rather than doing so domestically?

I think most people are well aware of the rapid rate at which the domestic corporate

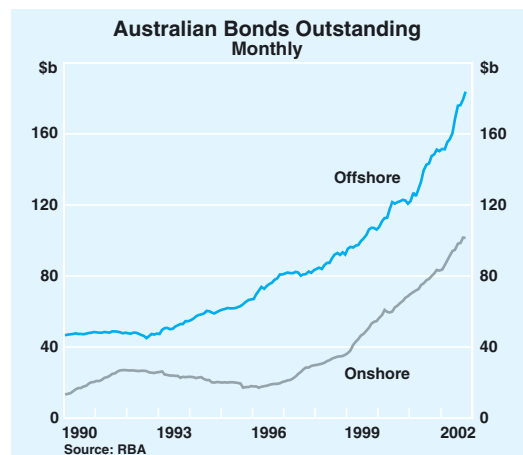
bond market has developed over recent years. After having been fairly flat in the first half of the 1990s, non-government bonds on issue domestically increased from around \$20 billion in 1995 to around \$100 billion today. This amount is now around the same size as the combined outstandings of the Commonwealth and state governments (Graph 1).

What is perhaps not so well known is that, over this period, the volume of bonds issued offshore by the non-government sector has increased just as quickly and this market segment is larger than the domestic market by around 80 per cent. Total bonds issued offshore by Australians currently stand at \$180 billion (Graph 2).

Graph 1



Graph 2



If the issuance and trading of some of these bonds were to occur in the domestic market, it would represent a substantial addition to local market activity. I think it is important, therefore, to ask why issuers are going offshore. To help answer this question, I thought it might be useful to set out some of the salient features of the offshore bond market.

Issuance by Sector

The first aspect I want to look at is which borrowers are issuing bonds offshore.

It turns out that financial institutions have been by far the most active group. They account for around half of all private sector offshore bond issuance (Graph 3). Among the financial institutions, banks dominate, accounting for 85 per cent of financials' offshore issuance.

Offshore issuance by non-financial companies has increased at a much slower pace than that of the financial sector, and the amount outstanding is only about half as large.

The other main group of borrowers issuing offshore are the various vehicles issuing asset-backed securities. These have a relatively short history, as the first offshore issue of an Australian asset-backed bond took place as

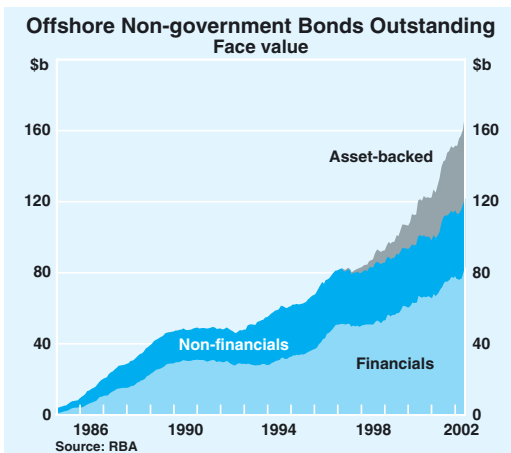
recently as 1997. Since then, however, offshore issuance of these securities has increased dramatically and the amount on issue now stands at about \$50 billion. All asset-backed securities issued offshore so far have been backed by residential mortgages, whereas there has been a broader range of assets backing these securities when issued domestically.

It is also interesting to note how offshore issuance by these groups compares with their respective domestic issuance (Graph 4). In the case of the financial sector, offshore issuance has expanded at a much faster pace than domestic bond issuance. Since 1996, for example, the financial sector has increased its domestic bonds on issue by \$20 billion, while the amount of offshore bonds on issue has risen about double that. Offshore bonds now account for 8 per cent of the funding of the Australian balance sheets of banks.

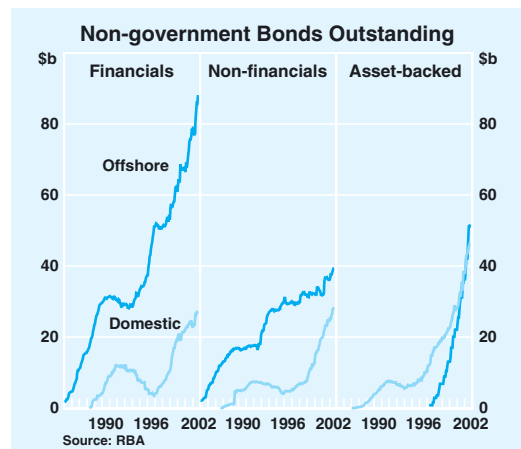
In the case of the non-financial sector, the experience is the reverse of that of the financial sector. In particular, over recent years the non-financial sector has expanded domestic bond issuance much faster than offshore issuance. Whereas the financial sector has almost four times as many bonds on issue offshore than domestically, the non-financial sector has a much more even balance between onshore and offshore funding.

Asset-backed securities on issue are also relatively evenly balanced at present between

Graph 3



Graph 4



domestic and offshore. However, with offshore issuance increasing at a significantly faster rate recently, the relative size of the two market segments may be quite different in the next few years.

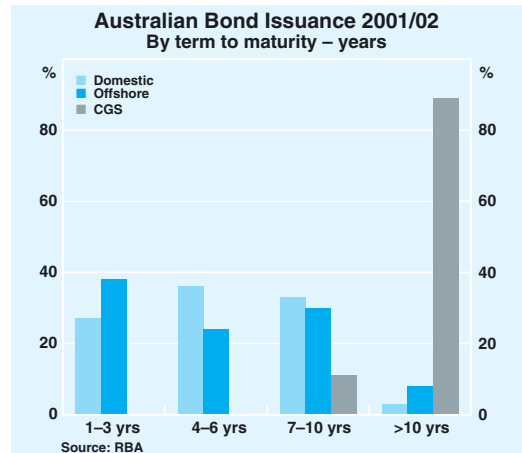
Maturity Structure

The maturity structure of non-government bonds tends to be substantially shorter than that of government bonds. In recent years the Commonwealth Government has issued only at the long end, to help maintain the yield curve. Even before then, however, a large proportion of its issues were around the 10-year mark. Issues of non-government bonds, on the other hand, tend to have maturities mainly less than 10 years. This is the case for both onshore and offshore bond issuance (Graph 5). There does not seem to be much difference in the maturity structure of the two market segments. Over the past 4 years, 40 per cent of offshore issues have had a maturity of less than 3 years. The average maturity has been around 4 years.

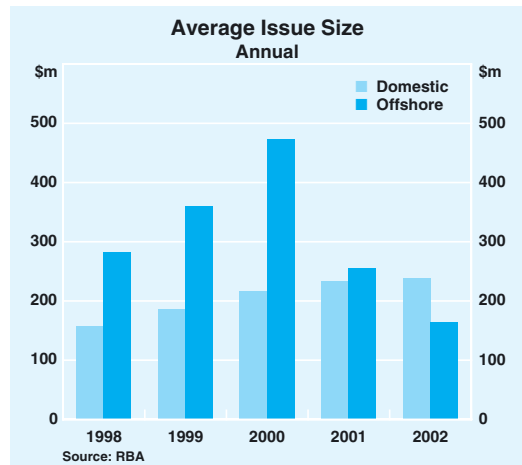
Average Size of Issue

In the past, the average size of offshore issues tended to be much larger than for domestic issues (Graph 6). Recently, average offshore issue sizes have dropped due to the financial sector making smaller but more frequent issues. At the same time, average issue size for domestic issues has steadily increased suggesting a growing capacity of the local market to absorb bonds. Nevertheless, offshore markets have greater capacity to handle larger issues reflecting the much larger investor base in some of these markets. Australian borrowers have placed issues as large as \$2.5 billion offshore, while the largest domestic issue has been \$1.7 billion.

Graph 5



Graph 6

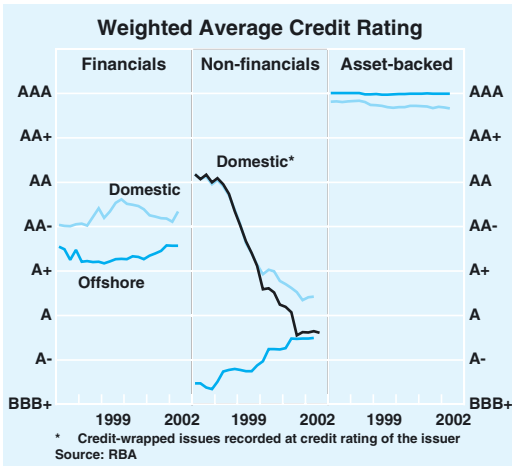


Credit Quality

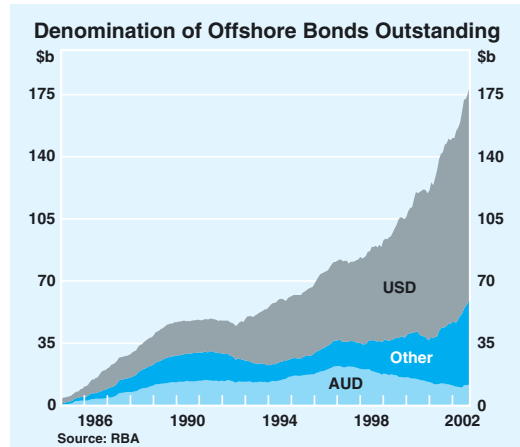
When it comes to credit rating, there are significant differences between offshore and domestic issues, with the average credit rating of offshore issues lower than that of domestic issues. While more than half of all domestic issues are rated AAA, only a third of offshore issues carry an AAA rating.

Comparisons of the average credit ratings in the main market segments shows that, in both the financial and the non-financial sectors, the ratings of domestic issues are

Graph 7



Graph 8



higher than those of offshore issues (Graph 7). This is particularly the case for the non-financial sector where almost 30 per cent of domestic issues are rated AAA but only 4 per cent of offshore issues are so highly rated. In the domestic market, the average rating is boosted by the fact that many of these issues are backed by third-party credit support ('credit-wrapped issues').

Unlike issues by financial institutions and other corporates, offshore asset-backed issues are, on average, slightly more highly rated than domestic issues. This is because domestic issues are backed by a more diverse range of assets.

Overall, even though a wider range of issuers have accessed the domestic market in recent years, it appears that offshore markets continue to have a greater capacity to finance lower-rated credits.

Currency Denomination

The proportion of offshore bonds issued in Australian dollars has diminished considerably since the early 1990s, from close to 30 per cent to less than 7 per cent this year. Most issues (around 70 per cent) are now denominated in US dollars (Graph 8). Of the non-US dollar foreign currencies, there has

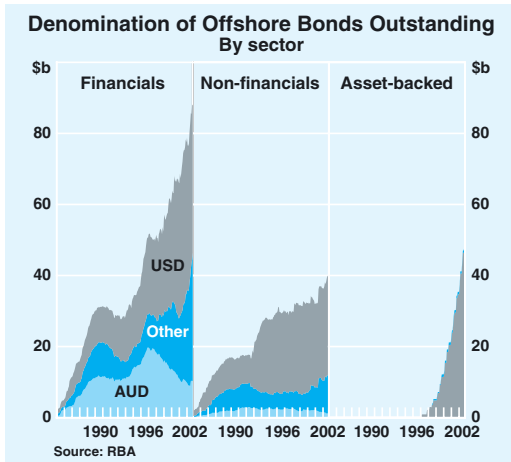
been a substantial increase in bonds denominated in euros. These now account for around 10 per cent of total outstandings.

Even though offshore bond issues are heavily weighted towards foreign currencies, most are hedged back to Australian dollars, mainly using cross-currency swaps. We know this from a survey the ABS conducted on behalf of the Reserve Bank in 2001. It showed that the finance sector had virtually all its foreign currency debt hedged through derivatives, while the corporate sector hedged its foreign currency liabilities through derivatives, holdings of foreign currency assets and export receivables.

Australian borrowers are going offshore to access a wide range of investors, not to take on exposures to foreign currencies. In effect, the existence of a deep and liquid cross-currency swap market allows the credit risk on debt issues to be separated from the currency risk, allowing borrowers access to a much larger potential investor base.

Financial institutions make use of the widest range of currencies, reflecting the fact that they are well equipped to identify, and take advantage of, any pricing anomalies in offshore markets and because they are keen to diversify their funding. This group has offshore bonds outstanding in excess of A\$1 billion in each of eight different currencies, though the bulk is still in US dollars. The finance sector is also the group

Graph 9



that makes most use of A\$-denominated bonds in offshore markets (Graph 9).

The non-financial sector seems to limit its borrowings largely to the three main currencies: US dollars, euro and yen. It also has a small amount of bonds on issue denominated in Australian dollars.

Asset-backed bonds issued offshore are almost entirely denominated in US dollars. Only two issues are not US\$ denominated. This partly reflects the US market's familiarity with asset-backed bonds as residential mortgage-backed securities are widely issued in the US market.

Factors Contributing to the Growth of the Offshore Market

Let me turn now to possible reasons why Australian borrowers continue to use the offshore bond market.

One could be tempted to jump to the conclusion that use of offshore bond issues simply reflects the fact that Australia as a whole has a shortfall of savings relative to investment, as evidenced by the current

account deficit. But while this explains why we need to access foreign savings, it does not by itself provide an adequate explanation of why corporations issue bonds offshore. The bonds could be issued onshore, for example, and marketed to foreign investors.

There must, therefore, be other reasons why borrowers go offshore. Some of the possibilities that come to mind are as follows:

1. Offshore issues provide access to a broader range of investors than do domestic issues. Offshore issues are able, for example, to tap into the well-developed distribution and marketing channels that exist in the larger offshore markets. Also, the issue arrangements for offshore bonds (e.g., prospectus requirements and settlement arrangements) are more likely to be familiar to foreign investors as they are those of the investor's home country.
2. Offshore issues are also more likely to be in the home currency of the investor, which allows the borrower to tap into those investors who do not want to take on foreign currency risk. We can conclude from the fact that the bulk of offshore issues are in foreign currencies that the investors buying them are looking to take on exposure to Australian credits rather than to Australian currency (and interest rates). This suggests that they may be less inclined to invest in bonds issued in Australia, as these would normally be in Australian dollars.¹ It is true that foreign investors could buy A\$-denominated bonds and hedge their currency risk, but it is easier and probably most cost-efficient for the Australian borrower to issue in foreign currency and to hedge its currency risk than for the many individual investors to undertake the hedging.
3. Offshore issues provide an important form of diversification in funding for financial intermediaries. It is not surprising that banks have been the highest users of

1. There will be some periods (and I think we might be in one of those now) when a combination of relatively attractive interest rates and favourable or stable expectations for the exchange rate encourage foreign investors to buy bonds issued in Australian dollars. We are seeing this, for example, in very strong demand at present from Japanese retail investors through the so-called 'uridashi' issues.

offshore markets as they value having a diversified funding base. What is not clear is whether their recourse to offshore markets is solely driven by diversification objectives, or whether banks are to some extent being forced into offshore markets by strong competition for funds in domestic markets. Anecdotal reports from banks suggest that the latter is a factor in their behaviour.

4. Offshore bond markets at this stage still seem to be able to handle issues that are larger in size and have a greater diversity of credit quality. Trading of credit risk is a relatively new activity in Australia and therefore probably not as well developed as in, say, the US. Corporate borrowers using the domestic market are more likely to need credit guarantees than would be the case in offshore markets. Also, those seeking to make very large issues are more likely to be tempted offshore.

Some of these considerations suggest that offshore issues have innate advantages in terms of tapping into foreign savings. Such issues are therefore likely to remain an important part of the financial arrangements used by Australian borrowers. Other factors that currently induce borrowers to issue offshore, however, simply reflect differences in the state of development between the Australian and US corporate bond market. This will change over time as the local market continues to expand. Local institutional investors are rapidly building their credit management skills, which in due course will make it easier for a broader range of credits to issue into the local market. Also, we can be confident that local demand for fixed-income products will continue to expand, which should allow the market to handle issues of larger size and greater diversity. ✎