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Why Super funds lending to corporates is not a great idea (in general)

- Super funds, with no capital requirements can lend to corporate borrowers much more cheaply than banks can.
- However, liquidity and pricing issues make a large scale move in this direction a very big systemic issue.

We hear you

There has been a bit of squawking recently about the desirability of having Super Funds lend to businesses. Paul Keating's keen, Anthony Pratt has organised numerous forums and the major banks seem to be saying that it's a good thing (does that mean we should be automatically wary?). And the driver is that business lending from capital free Super Funds will be cheaper than from the banks due to the need for banks to earn a return on the capital they have to deploy for corporate loans.

How much cheaper?

About 1.3%. Banks have to put aside capital for every loan they make and the lower the credit quality of the loan, the more capital they need. Banks generally have broad corporate exposures with loans to both investment grade companies and also to lower credit businesses. The average risk weighting is around 100%, which means that the banks need to allocate around 10.5% equity capital and around 4% of hybrids/sub debt. Equity investors need to earn an appropriate rate of return on that capital. If we use an expected rate of return requirement of 12% (which is around the major banks' Return on Equity) and the cost of hybrids and sub debt, you get a starting mark up of 1.3% higher than the banks borrowing cost before you add on the costs of expected default (and there will be some) and administration etc etc. The amount of capital they have to allocate to sub investment grade loans (which make up the majority, by number of borrowers) is higher, so the return they need to earn is even higher. If banks can't earn their cost of capital, they are better off not providing a loan and this might have been the case in Australia where you can arrive at a scenario whereby a bank lending to a normal Australian company has to charge at least 2% more than their borrowing cost. This additional capital cost might have been an impediment to lending to businesses and might have deterred some businesses from borrowing. However super funds do not have specific capital requirements for most of their businesses, so the theory is that they can lend at lower rates than banks and still make an appropriate return for their investors. Win for super funds, win for businesses, win for the banks who can make fees arranging loan sales.

Not so fast. Why do you need capital?

Banks require capital because lending to sub investment grade entities (which is most of corporate Australia) is periodically very risky. The chart below shows 1 year default rates by rating for all sub investment grades. Ba1 is the highest sub investment grade rating and they go down to Caa3 which is nearly default. It's apparent that the "Ba" ratings aren't very volatile, but in bad years around 3% - 5% will default. As you go down the credit rating spectrum, you can see default rates of 10%+ for lower credit ratings during stressed times.

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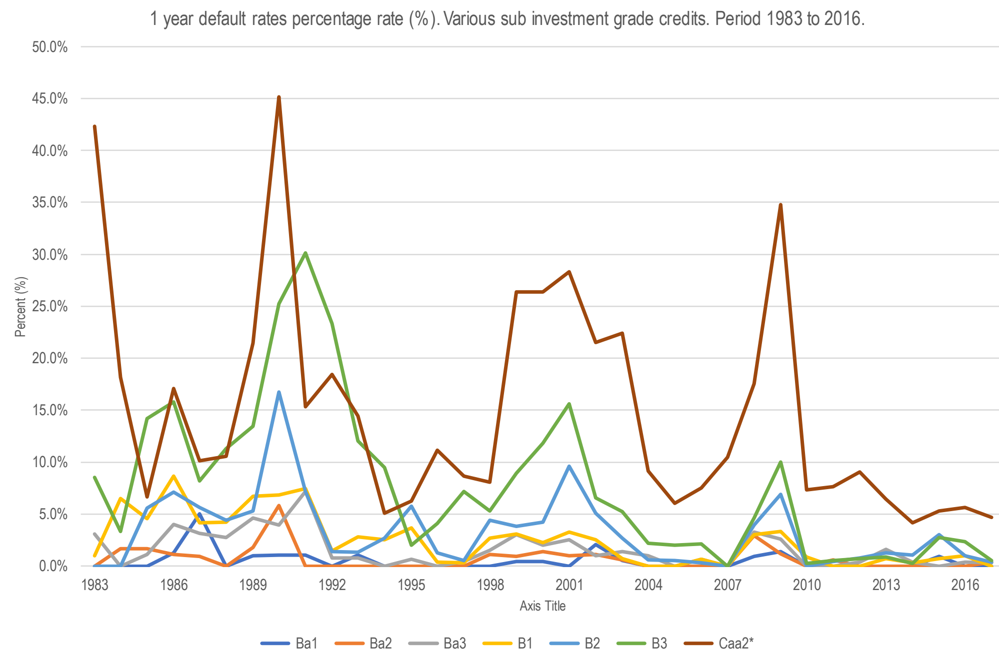

So, banks are required to have capital, so that in those bad years (invariably recessions) they can easily cope with the losses and ensure that they have enough capital that depositors don't withdraw their cash and cause a run on the bank. A system wide failure caused by bank runs inevitably results in a recession accompanied by a 15% - 25% contraction in GDP; it's not a very pleasant thing. If there is sufficient capital, depositors are more confident the bank will be around next morning, ergo no bank runs. APRA requires its regulated entities to have enough capital to withstand a 1 in 200 year event. Depending on which data you use, a capital ratio of around 7% is sufficient capital to withstand a 1 in 200 year event for a portfolio of BBB rated bonds. For BB rated bonds it is around 30% capital.

What happens if the loan is made by a super fund?

This is where we get concerned about the concept of Super fund lending. If it is a normal Defined Contribution Superfund that invests in a sub investment grade corporate loan, the life cycle will be that investors get their 7% return for a few years until a recession hits and the losses emerge over the next 2 or 3 years. At the start of the recession, if the fund has not marked down the loan, the smarties get out and leave the losses to the poor sods who either didn't realise what happened or have made a long-term asset allocation decision and don't sell. The losses are magnified by the smaller fund size after the more knowledgeable investors have redeemed their holdings.

Does this happen in the US?

Pratt, Keating *et al* claim that lots of businesses in the US fund themselves by loans from superannuation funds/life insurers, so there must be some way of solving this problem in Australia. There are three main differences between 'nirvana' in the US and real time Australia.

- Most of the buyers of corporate debt in the US are closed end/annuity/Defined Benefit funds, so there is no possibility of savvy investors pulling their money out early and creating the equity issue that would exist in an Australian instant liquidity fund.

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- The Annuity/Defined benefit funds in the US have capital requirements, so losses can be written off against the capital, so there should be very little volatility in the investor return.
- For those US investors which are unitised/redeemable there is a market for loans, so the investor withdrawing their money are doing so at the market price, which in the case of a recessionary period, would reflect anticipation of increased losses. There is no market in Australia for bank loans and this isn't about to change anytime soon. Corporate bonds are almost as bad.

Why Australia will never have an effective market for large scale corporate debt

To create marketability, you need to have;

- Lots of different types of investors with different time frames and different perceptions of value. Someone has to think it's a "sell" and someone has to think it's a "buy".
- You need the instruments to be sufficiently standard so that no one has to think too much about any of the issues except the price. If one corporate loan or bond has different terms and conditions to another one, the investor has to do some work and decide whether these differences are important. Contrast that to Australian or US government bond markets where the only issue is whether the government will default (guess the chances of that happening?) or whether it's cheap, and everybody will have a different idea on how cheap it is.

Corporate loans/debt in Australia fail on both counts.

- There will be little, if any chance of opinion divergence. Current fund inflows are dominated by Industry Super funds and they are continuing to merge. What happens in 5 years when there are 5 large industry funds and some other assorted fund managers? What are the chances they'll have different enough views on markets to enable liquidity? That's a donut, zero, zilch. And if there is no functioning market to price a loan or a bond, the potential difference between the bid price and "fair value" is enormous.
- Loans are inherently illiquid. Even in the US, which has had a loan market for the past 3 decades, it takes between 2 weeks and 2 months to settle transactions. It will be worse in Australia where the loan market is much younger and immature.

And so what happens.....

So, what happens to your typical investment by super fund investment in a loan portfolio when there is stress or a recession? The loans are clearly not worth $100, but you still have to value them so redeeming investors don't leave existing investors to carry the can. Is it the $95 value that you get from your analysis or the $60 bid you receive from an opportunistic investor? This is not a hypothetical example. This was, in fact, the case in the GFC when the over the counter (OTC) bond market dried up for around 12 months. Luckily continued investor inflows (due to the super guarantee) papered over the issue, but this mitigatant becomes less probable as more and more super funds become cashflow neutral or negative (as the proportion of pension members becomes higher).

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And if you still think it's a good idea….

We've seen regulatory arbitrage before. Prior to the GFC, there was an enormous growth of what is called the shadow finance sector, whereby investors and issuers bypassed the regulatory system (because it was too expensive or too difficult). This caused some of the enormous problems during the GFC because the funding of the assets was inherently unstable and the withdrawal of funding resulted in forced fire sales of assets. We're not sure Australian regulators would be that happy with a wholesale exodus of corporate borrowing for that very reason.

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