

Should superannuation funds do more direct lending?

DISCUSSION PAPER
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ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for industry super funds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million members. The views in this paper belong to the authors and do not necessarily reflect those of ISA. All errors belong to the authors. Please direct inquiries to:

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SHOULD SUPERANNUATION FUNDS DO MORE DIRECT LENDING?

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SUPER FUND AND DIRECT LENDING - SHARED PROSPERITY

\$

\$2.7 trillion

Australian total superannuation assets

\$2.0 trillion

Superannuation assets excluding SMSFs

\$632 billion

Industry superannuation assets

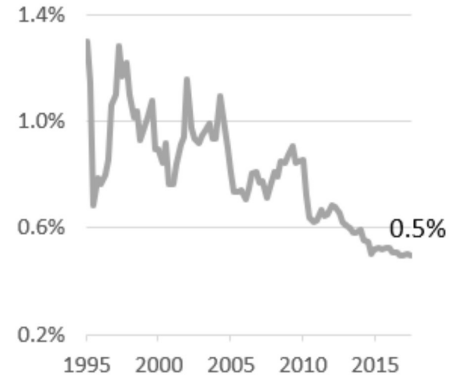
\$1.2 trillion

Total non-financial corporation credit liabilities

Shared prosperity:
workers' contribution matters to super, industries and the economy

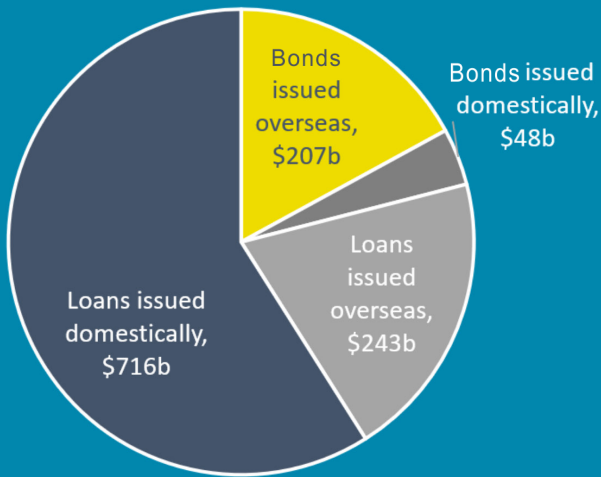


Non-financial corporation credit as % of Superannuation FUM*

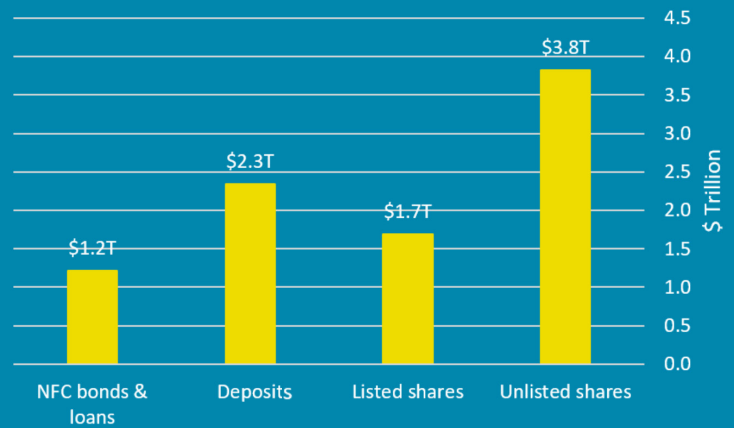


*Excluding SMSFs and the Future Fund

NFC loans and bonds issued

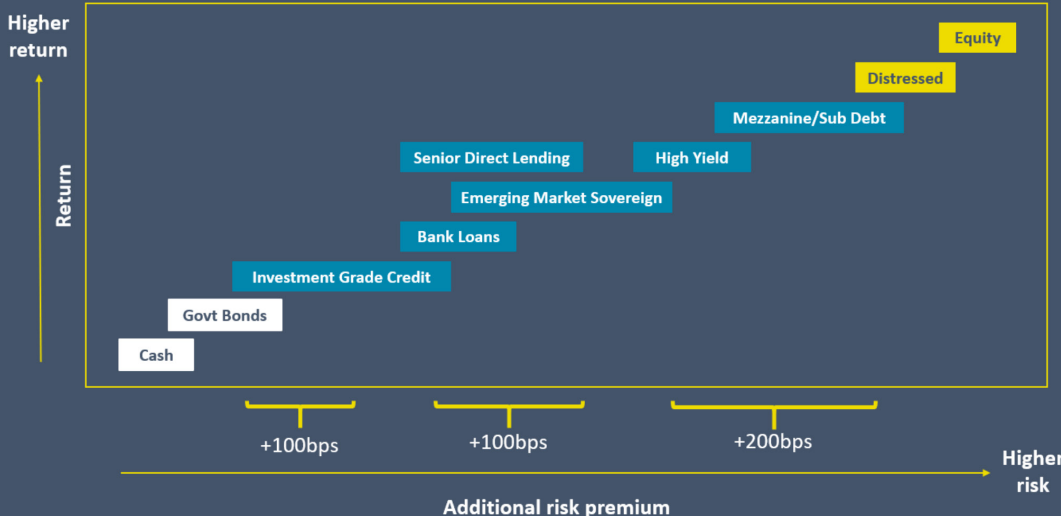


Comparison of Australian asset classes*



*as of June 2017

Premiums expected for taking higher risks



Direct loan premium over bank loans: 200bps to 400bps

Executive Summary

Interest in facilitating Australian corporates' access to alternative sources of debt is rising. Direct lending, where businesses obtain funding directly from institutional investors, for example, superannuation funds (rather than from a bank) is on the rise. Here the borrower, a non-financial corporation (NFC), sells a debt instrument directly to a fund, either locally, in AUD, or overseas, normally in USD.¹

In this paper we examine the emergence of direct lending as an alternative to traditional business banking and explore the role of Australian superannuation funds in developing this market. Specifically, it considers whether these deals represent value for superannuation funds' members, as well as Australian corporations.

Australian superannuation funds hold, as of June 2017, approximately **\$6.6 billion** in bonds and **\$3.9 billion** in loans issued by NFCs. This is minor relative to the total credit liability of Australian NFCs of **\$1.2 trillion**, comprising \$255 billion in bonds and \$959 billion in long-term loans held by domestic and international institutions. For Australian superannuation funds, these combined holdings translate to just under 0.9 per cent of total NFC credit (bonds and loans) issued. The big lenders are actually banks and foreign institutions which account for approximately 62 per cent and 25 per cent of loans respectively. However, since the GFC banks have been limiting their exposure to commercial debt due to tighter regulation and more restrictive funding ratios imposed under Basel III.

Why do Australian superannuation funds have so little exposure to the corporate credit market, especially when compared with their overseas counterparts and Australian banks?

Relative to overseas pension funds, most domestic superannuation funds are classified as defined contribution (DC) schemes. Where these DC funds are in accumulation phase (with steady positive inflows) they favour portfolio allocations featuring greater concentrations of growth assets. This tends to raise risk adjusted returns over time and contrasts with defined benefit (DB) schemes popular overseas. These schemes have a better understanding of their future liabilities so can match accordingly with similar assets.

Relative to Australian banks, superannuation funds must also manage each investment as a separate 'profit center' and therefore cannot cross subsidise this activity via other cross selling opportunities. Australia's major banks have historically cornered the market in small and large business banking. In addition, larger non-financial corporations have been able to access relatively cheap funding from offshore sources, e.g. the United States, just not in AUD.

Some prominent business leaders argue that superannuation funds should play a more significant role in financing Australian companies. Superannuation funds are often better placed in terms of liquidity than banks and are in a vastly superior position to commit to long-term loans. Proponents argue that if fund investment staff choose the right deals superannuation fund members will be better off while borrowers will benefit from a deeper and more competitive credit market in Australia. They argue these alternative sources of funds will help to grow businesses and improve the productivity of the Australian economy. Furthermore, access to AUD funding will mitigate risks for borrowers and the broader financial system.

Funds have responded to these calls by questioning whether a genuine market niche for these products exist. Right now a plethora of investment opportunities offer the same or better risk-return attributes as direct loans with proven track records that are well understood by fund investment staff.

Concurrently, direct lending by superannuation funds requires funds to internalise additional functions to enable both loan administration and ongoing credit monitoring. Historically, funds have had little internal experience in writing and managing loans to corporations. However, over recent years some funds have

¹ That NFC, may *in theory*, be a large, small, listed or unlisted enterprise.

recruited investment staff with lending backgrounds and commenced lending. Nevertheless, it is fair to say they have been more focused on infrastructure transactions, or in larger corporate transactions, rather than providing funding for small or medium sized businesses. Often these investments have been alongside banks in syndicated transactions.

Certainly, superannuation funds must continue to innovate. Expanding long-term credit provision is desirable in the face of adequate rewards for this class of risk asset, but superannuation funds must require a pay-off that's much closer to an equity return. That said, we do acknowledge there are additional dimensions to risk than time horizon alone which makes comparing equity and debt investments more difficult.

A genuine market failure is currently occurring in the provision of capital (debt and equity) to small and medium enterprises (SMEs), and superannuation funds may be able to help circumvent this deficit. Historically, banks have used superior credit ratings to raise funds offshore and then lend to domestic firms.² Perhaps these firms can do with more private equity investment which Australian banks can help to intermediate.

Interestingly, those calling for greater superannuation fund market participation are not SMEs. They are large corporates that expect long-term money to be available at rates not much higher than shorter term commitments. This is a doubtful proposition from a risk and reward point of view. Whether this is in the best interest of super fund members from a fiduciary perspective, is questionable. Ultimately, the capacity of the Australian default superannuation system to support enhanced business lending relies on the growth of contributions from millions of Australian workers. Businesses must be mindful to take steps to support the system which generates a virtuous cycle of member benefits and broader economy wide economic dividends.

1. Introduction

This paper examines the corporate **non-bank lending** market.

We define non-bank lending as NFCs obtaining funding directly from institutional investors rather than via normal credit creation channels through the Australian banking system.

- The debt issuance may occur via private placements (through issuance of bonds or loans) via
 - syndicated business deals where several entities are involved (usually for large amounts); or
 - bilateral business deals where a single borrower and lender are involved (suitable for smaller amounts).
- The demand for this debt issuance may be provided by insurance companies, superannuation funds, family offices, overseas investment banks etc.
- These debt instruments may be short or long duration.

The size and growth of this market is often seen as a barometer of the Australian economy. Increased participation in non-bank lending is a clear sign that capital markets are providing more funding to the real economy; while bond funds are better able to diversify their investments away from the banks.

² These firms may not have any credit ratings, unknown to international lenders or want tickets which are too small.

1.1 The call to vary debt sources

Awareness of the need to facilitate Australian corporate access to deeper and more varied sources of debt is growing. Certainly, Australian based non-financial corporations are keen to source more of their debt locally with the right mix of tenure and yield.

In November 2017 the *Superfunds Round Table*, – an event hosted by Visy and the *Australian Financial Review* in Sydney, brought together business leaders and financiers to examine whether superannuation funds could increase their lending to Australian based companies. It was attended by Visy's executive chairman Anthony Pratt, former Prime Minister Paul Keating, Treasury secretary John Fraser, Hancock Prospecting's chairperson Gina Rinehart, Linfox founder Lindsay Fox AC, banking chiefs Shayne Elliott of ANZ and Nicholas Moore of Macquarie, Scott Barker from IFM Investors, Kristian Fok from CBUS, Mark Delaney from AustralianSuper, among others.

The Roundtable was prompted by a USD150 million, 10-year debt private placement between Visy and AustralianSuper with IFM Investors, initiated and brokered by Westpac. Interest in this deal prompted discussions on the desirability of a large scale, home-grown private placements market, building on the very small domestic market as it now exists.

The Westpac idea was to facilitate direct lending channels between Australian non-financial corporations on the supply side and local superannuation funds or other institutional investors on the buy side of the transaction. The business strategy was to allow a longer tenure and a better matching of assets to the investors' balance sheets.

Since then, follow-up discussions between borrowers, lenders and intermediaries have occurred.

1.2 The market opportunity

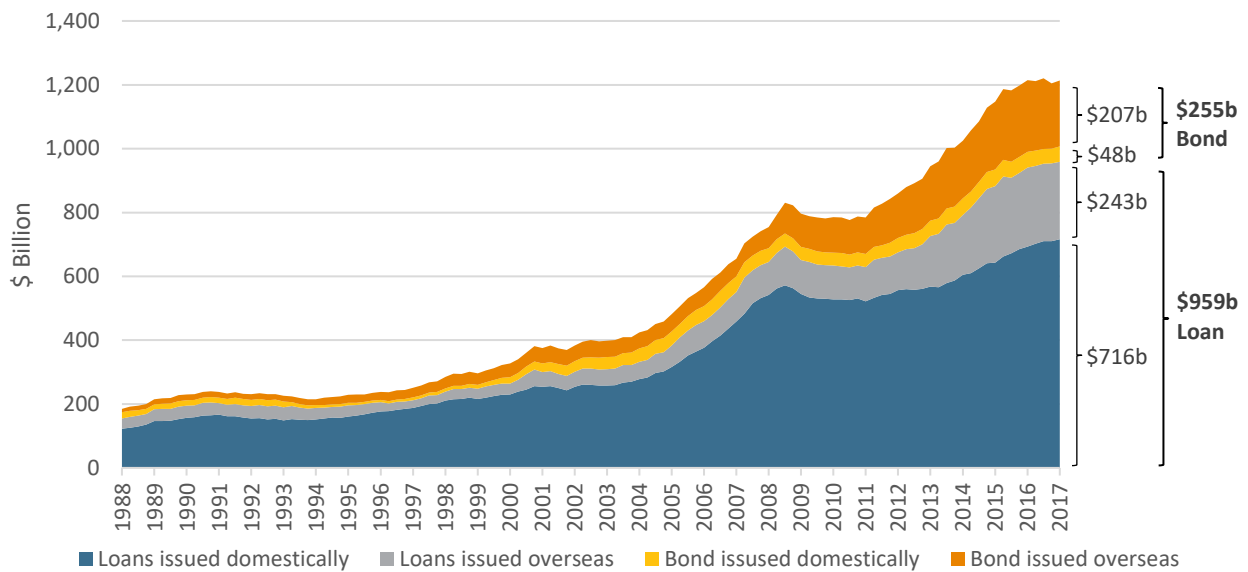
It seems that 2017 was a stellar year for corporate debt markets. Ausgrid, owned by AustralianSuper and IFM Investors, jointly completed a \$1.2 billion dollar seven-year bond issuance, becoming the largest local corporate bond issuance by an Australian company. This was followed by their USD2 billion private placement deal in the United States that became a record for a non-American issuer.

The total Australian non-financial corporate credit outstanding at June 2017 was approximately \$1.2 trillion. This comprised of \$255 billion in bonds and \$959 billion in loans. The majority of bonds issued by non-financial corporations were purchased by overseas investors, while more than two-thirds of loans were held domestically. In total, \$764 billion of credit liabilities were held in Australia and \$450 billion were held by overseas investors.

Since June 2011, the average bond and loan issuance by non-financial corporations in Australia was approximately \$17 billion and \$55 billion per annum respectively.³ The major players in the private credit market on the demand side are the Big Four Australian banks, Macquarie Bank, United States based investment banks and a range of Asian banks. Total loans and placement liabilities held by non-financial corporations are presented by lender over time below (Figure 1).

³ ABS 2017, 5232.0 - *Australian National Accounts: Finance and Wealth - Dec 2017*, Australia, accessed on 25 June 2018, URL: <http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5232.0Dec%202017?OpenDocument>

Figure 1 – NFC liabilities (June 2017)



Source: ABS Cat.5232.0

Note: Long-term loans and bonds issued by non-financial corporations (NFCs) to domestic and overseas investors.

Here was a business worth \$2.8 trillion sitting in private loans on bank balance sheets that superannuation funds (and other non-banks) could contest if they were so inclined. That included \$1.7 trillion in residential mortgages, \$150 billion in personal loans and credit cards,⁴ and approximately \$959 billion in loans to non-financial corporations (Figure 1).

“Banks are tending to step away from structuring smaller more complex loans,” says Joseph Caceres, head of manager solutions and alternative investments at HSBC Private Banking in south-east Asia.⁵

“And while it's typically only been used by institutional investors, there is now an opening in Australia for these lines of credit to extend to good quality mid-sized companies.”⁶

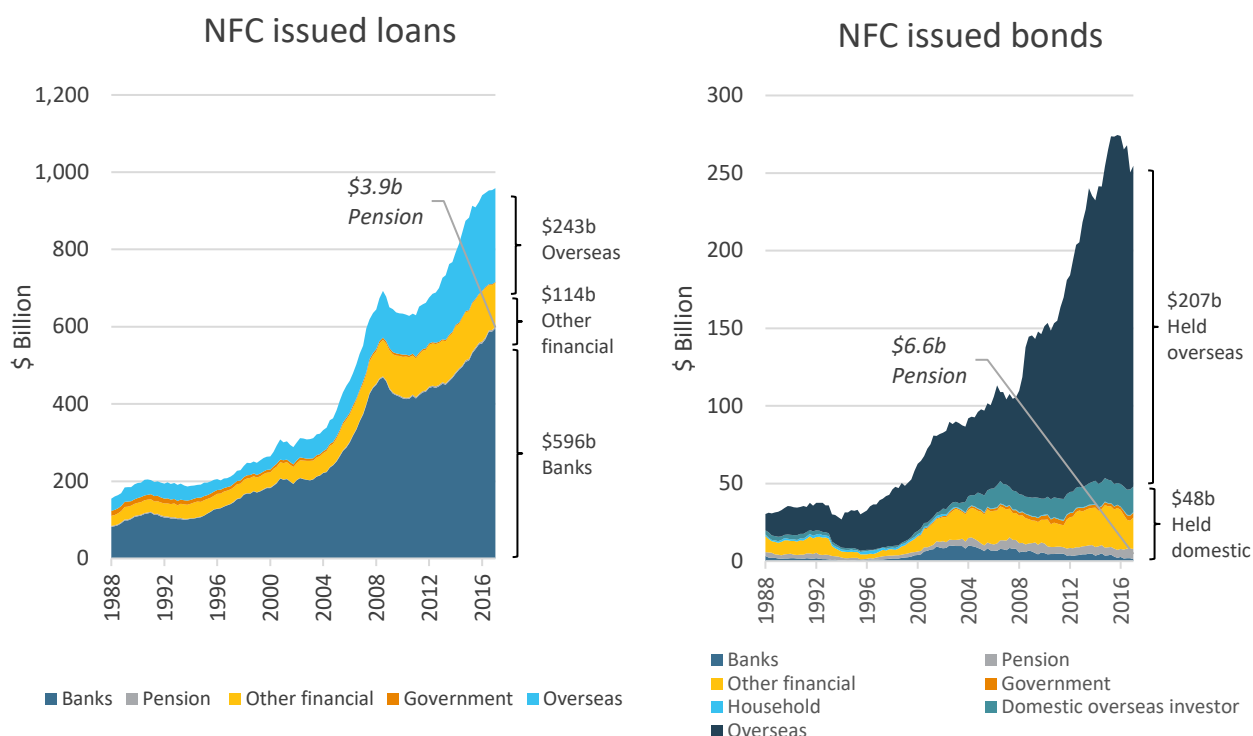
Australian banks have traditionally been the major source of patient credit for local businesses. They currently account for approximately 62 per cent of all commercial lending (Figure 2). This is followed by overseas lenders with 25 per cent. Other financial lenders (including insurance companies, investment funds and central borrowing authorities) account for a minor share of the long-term placements market, with total lending less than 12 per cent of the total market share.

⁴ Joye, C., ‘Why are super funds ignoring the debt market?’, *The Australian Financial Review*, 25 November 2017.

⁵ Sier, J., ‘Lure of private debt markets stronger’, *The Australian Financial Review*, 11 December 2017.

⁶ *Ibid.*

Figure 2 – Diversification in direct lending – sources of credit to NFCs (June 2017)



Source: ABS Cat.5232.0

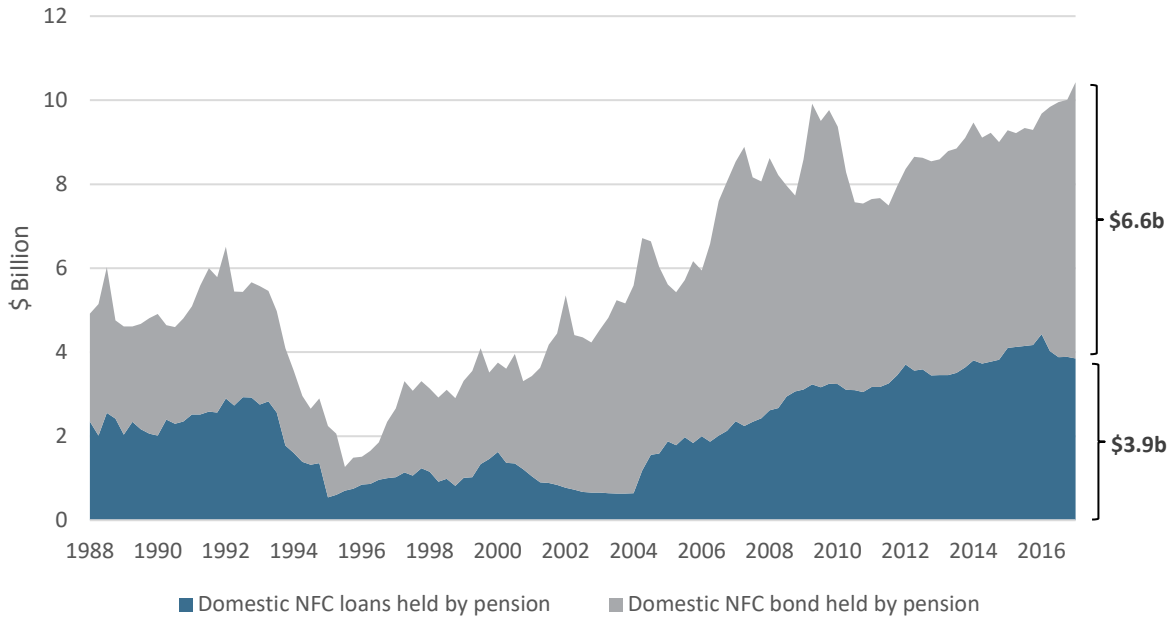
Note: Other financial includes life and non-life insurance companies, money market and non-money market investment funds, central borrowing authorities, securitisers and other financial corporations. Loan figures refer to long-term loans and placements.

However, in recent times it appears an opportunity has arisen for superannuation funds and other non-traditional financiers to lend directly to companies as capital-constrained banks retreat from the market. Currently, superannuation funds (labelled as ‘pension’ in charts) account for only \$3.9 billion of the total domestic non-financial corporate loans market (Figure 3). This figure rises to \$5.5 billion if domestic financial corporations and investment funds are included.⁷ Superannuation funds also hold approximately \$6.6 billion in bonds issued by non-financial corporations (NFCs)⁸. The size of loan holdings by superannuation funds are insignificant when considered against the \$2.7 trillion of total assets held by the superannuation sector at 30 June 2018.

⁷ Pension fund holdings of loans borrowed by domestic financial and non-financial firms were approximately \$5.5 billion (at 30 June 2017) according to ABS Cat.5232.0 Table 18 – *Financial Assets and Liabilities of Pension Funds*. Only long-term debt and placements were included.

⁸ Superannuation funds also hold approximately \$8.5 billion in debt issued by banks and \$2.9 billion from securitisers as of June 2017.

Figure 3 – NFC loans held by pension funds (June 2017)

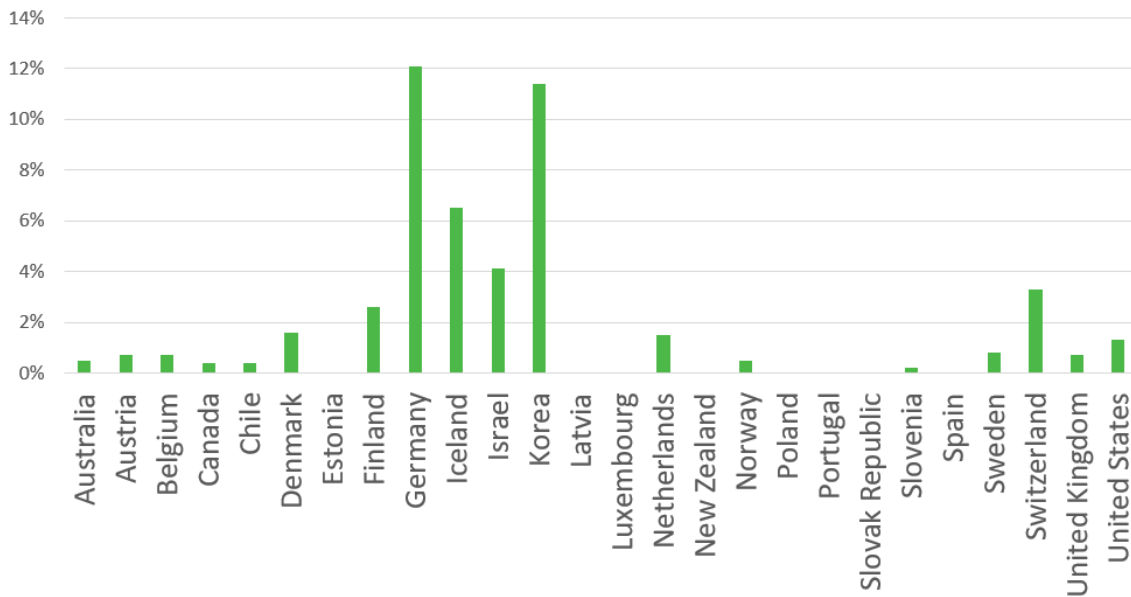


Source: ABS Cat.5232.0

Note: Pension fund holdings of loans and placements borrowed by non-financial corporations (NFCs). All NFC sub-categories have been included – private non-financial investment funds, other private non-financial corporations and public non-financial corporations.

As a proportion of their overall asset allocation Australian superannuation funds have very small holdings of direct loans compared to pension funds around the globe (Figure 4).

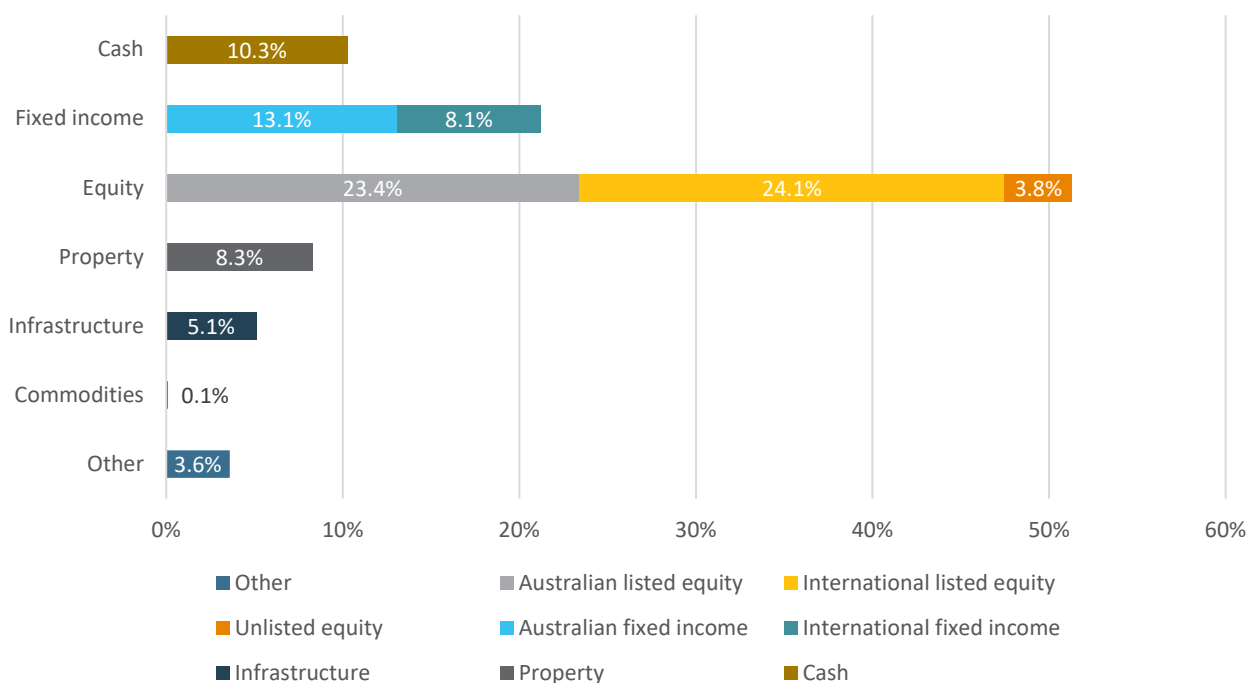
Figure 4 – Global pension system allocation to loans



Source: OCED Global Pension Statistics

While Australian superannuation funds have very small holdings of debt issued by non-financial corporations they do hold significant allocations of domestic and international fixed income assets that constitute more than 20 per cent in total value of the portfolio (Figure 5). It should be noted that some superannuation funds will include exposure to bank loans and other corporate debt within their fixed income allocation, so the true exposure to debt is likely to be understated.

Figure 5 – Asset allocation of the superannuation industry (June 2018)



Source: APRA Superannuation quarterly performance data, June 2018

Note: Excludes SMSFs and the Future Fund.

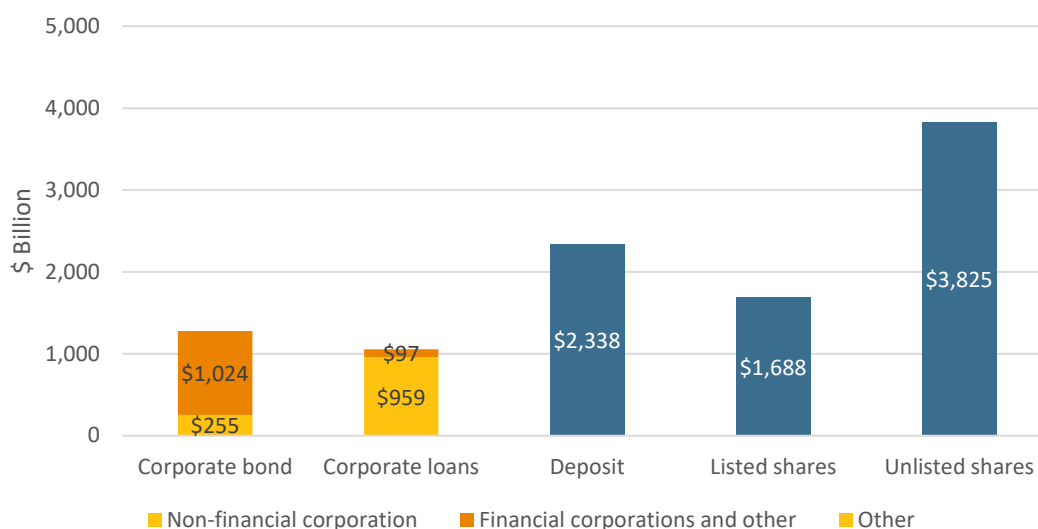
1.3 The demand for debt

Calls for Australian superannuation funds to become more involved in long-term placements partly reflect the relatively small exposure they have to this activity. Some see the small involvement that funds have in the long-term private market as an anomaly in their asset-allocation decision rather than a deliberate choice. They argue that superannuation funds are underweight in debt overall with a 13.1 per cent share of funds under management invested in domestic fixed interest, compared to a 23 per cent investment share in equities via the Australian Stock Exchange (which is 1.7 times the size of their allocation to domestic fixed income). At face value, this is curious as the Australian private debt market is actually larger than the \$2.0 trillion of the ASX.⁹

The private debt market itself is dominated by the big banks and is worth around \$2.3 trillion. It offers higher risk adjusted returns that mostly exceed superannuation funds' performance targets, yet Australian superannuation funds have very low exposure to it. Why this may be the case will be discussed in the following section.

⁹ Deloitte Access Economics 2018, *The Corporate Bond Report 2018 – Australia's growing appetite for corporate bonds*. URL: <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf>

Figure 6 – Comparison of various Australian asset classes (June 2017)



Source: ABS Cat.5232.0

Note: Corporate bond issued onshore by domestic financial and non-financial corporations, and overseas corporations. Corporate loans issued by domestic financial and non-financial corporations. Listed shares are domestic (ASX) only while unlisted shares are both domestic and overseas.

2. Why super funds do little direct lending

This section examines the key reasons why Australian superannuation funds currently have low allocations to direct debt.

2.1 Defined contributions schemes

Typical pension funds in Germany, Iceland, Israel and Korea have significantly higher exposures to corporate loans compared to Australian superannuation funds (Figure 4). However, this is due to the differing nature of their investment mandates and members' retirement needs. These international pension fund systems are typically populated by defined benefit schemes. Investment staff have better knowledge of the timing of future liability outflows and therefore select assets that would most likely to satisfy the income and liquidity needs of their members in retirement phase.

By contrast, most Australian superannuation funds are defined contribution schemes. At the heart of our 'defined contribution' super system, investment risk is borne by the individual rather than the institution.

Therefore, if Australian superannuation funds' allocation to corporate loans is low compared with foreign super funds, it is partly a reflection of the relative differences in investment objectives and performance targets of funds (set out to meet the expected cash flows needed during members' retirement phase).

2.2 Tilt to growth

There is a perception that somehow Australian superannuation funds may be missing out on big opportunities in corporate lending. Anthony Pratt expressed this view in his twitter post, dated 1 June 2018:

“Just refinanced our Atlanta papermill for 20 years at 4 % interest c/o USA pension funds – hope we can get the Aussie super funds to lend too.”

But Australian superannuation funds exist first and foremost to maximise members’ retirement outcomes - not just to provide an easy funding source for corporate Australia.

Individual funds will try to manage their portfolios to maximise returns, although no defined contribution scheme can promise its members a precise monetary outcome. For example, a retiree might expect to receive three dollars in retirement for every one dollar of deferred wages contributed. But that *actual* return could be two dollars or three, depending on a combination of factors, such as investment skill, global growth, financial markets and international policy settings.¹⁰

What helps to maximise member returns is that funds adopt investment strategies that tilt towards growth over the longer term. Return targets are typically CPI+3-4 per cent (i.e. 5.5-6.5 per cent). Funds hold a portfolio of assets designed to generate returns in excess of the fund benchmark over the long-term. Allocations are spread across domestic and global shares, property equity, private equity and infrastructure equity (all bottom-of-the-capital-structure "equity") which collectively account for 63 per cent of the \$2.7 trillion in superannuation savings.¹¹ An aggressive portfolio allocation makes perfect sense where a funds’ membership is still well within accumulation phase with steady positive inflows. A retiree may choose to invest a large ‘bucket’ of their retirement savings in a generic default option of such a fund to achieve a higher capital growth rate than they would do by investing all their retirement funds in defensive assets.

The typical risk adjusted returns offered by direct lending assets are often less attractive than the returns available to long-term listed equity investments, some property assets, and infrastructure and private equity investments. The list of potentially more attractive Australian dollar credit investment opportunities, than direct loans, is long. These are generally shorter in tenure and higher yielding for a comparable rating/credit risk.¹² For this reason, fund managers usually prefer other options.

But it is important to acknowledge all dimensions of risk, not only maturity. Loans are often secured, equity is not. There is a legal obligation to repay a loan, there is none for equity. Interest must be paid, but not dividends. So some direct loan opportunities are likely to represent value on a risk adjusted basis. That said, perhaps these broader risk attributes can be purchased elsewhere for less cost.

So, a ‘growth’ portfolio allocation for a superannuation fund may still include some debt and direct lending assets. This is true even if they are used as some form of cheap portfolio insurance for hedging purposes. There may also be a portfolio diversification benefit from having an allocation towards direct lending within the alternative debt bucket. However, the direct lending allocation’s risk-return characteristics need to be

¹⁰ Three dollars is just an estimate based on the lower growth environment we now inhabit, assuming that a fund avoids poor performing investments. Cooper, J., ‘Why super funds need to look more like banks’, *The Australian Financial Review*, 29 January 2018.

¹¹ Joye, C., ‘Why are super funds ignoring the debt market?’, *The Australian Financial Review*, 25 November 2017.

¹² Some alternative Australian credit opportunities that are not direct lending options may include for example:

- A four-year infrastructure project with a strong BB+ rating at +170bps;
- A 10 year BBB rated infrastructure style public corporate bonds available at +120 to +150 bps;
- Mainstream strong investment grade (BBB/A) corporate bonds are paying +150-200 for five to 10 years;
- Securitised loan/mortgage deals (ABS/RMBS) rated BB to BBB range will pay +300bps to >600bps for three to five years;
- Leveraged Buyout / Private equity sponsored style deals pay ~+400 to +600bps for three to five years, but they are more BB rather than BBB;
- Most large Australian corporates are broadly around a similar rating to these examples (~BBB); and
- Don’t forget equities. For example, NAB shares are yielding 7 per cent.

uncorrelated to other alternative debt assets. Otherwise, such allocation may not bring any diversification benefits.

Figure 7 – Direct Lending – where does it fit – stylised risk and returns



Source: Frontier Advisors

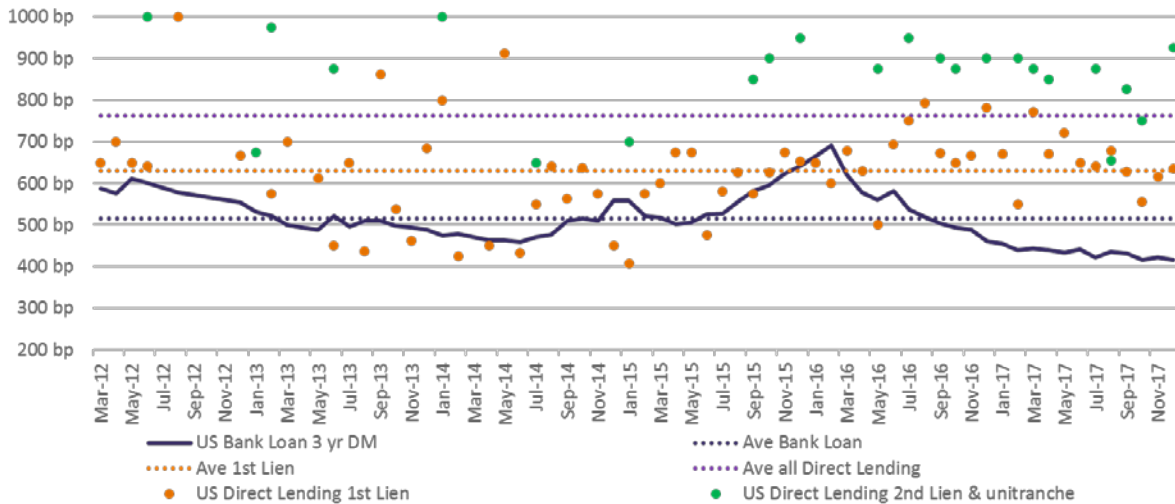
The attraction of owning a privately structured loan is the potential for higher yield or spread relative to the return on bonds and the opportunity to be placed higher in the capital stack in an event of liquidation. However, when lending moves towards higher risk areas (longer term, unsecured, emerging markets etc.) it takes on qualities resembling more equity like compared to debt. Such loans need the right compensation to attract investors (Figure 7).

What risk adjusted returns are required to get Australian superannuation funds investing?

Looking at United States data first, it seems that unless borrowers are prepared to pay a significant risk premium, investors should steer clear of direct lending offerings. This is a point made in Figure 8 which measures the risk premium associated with different grades of direct lending versus a typical business loan in the United States. It shows that normal risks spreads between comparable bank loans and senior direct lends are normally in the vicinity of 250bps to 300bps.¹³

¹³ It is hard to get exact definitions for the overseas markets but roughly in the United States direct lending market is for borrowers who have earnings before interest, taxes, depreciation and amortization (EBITDA) of over \$15 million – with an average of around \$25 million – going up to around \$40 million (all in USD). Debt in those entities is likely to be \$50 million to \$100 million. The direct lending market is illiquid. There is very little trading in the market (like here in Australia) but the returns in that market currently are approximately 6 per cent over the base rate. The Broadly Syndicated Leverage Loan Market in the United States normally kicks in at around \$40 million / \$50 million of EBITDA. At present the credit spreads available in the Broadly Syndicated space are approximately 4 per cent over the base rate. Both Direct Lending and Broadly Syndicated loans are generally senior secured loans.

Figure 8 – Risk spreads associated with direct lending vs bank loans in the U.S.



Source: Frontier Advisers

Looking at the Australian data, the total required premia for direct loans may range from around 200bps for senior private debt (versus bank loans) to around 400bps for subordinated debt (versus bank loans). But the range of credit spread depends on a variety of firm specific idiosyncratic factors (for example, credit risk, illiquidity, complexity, security etc.) and the duration of the borrowing term.

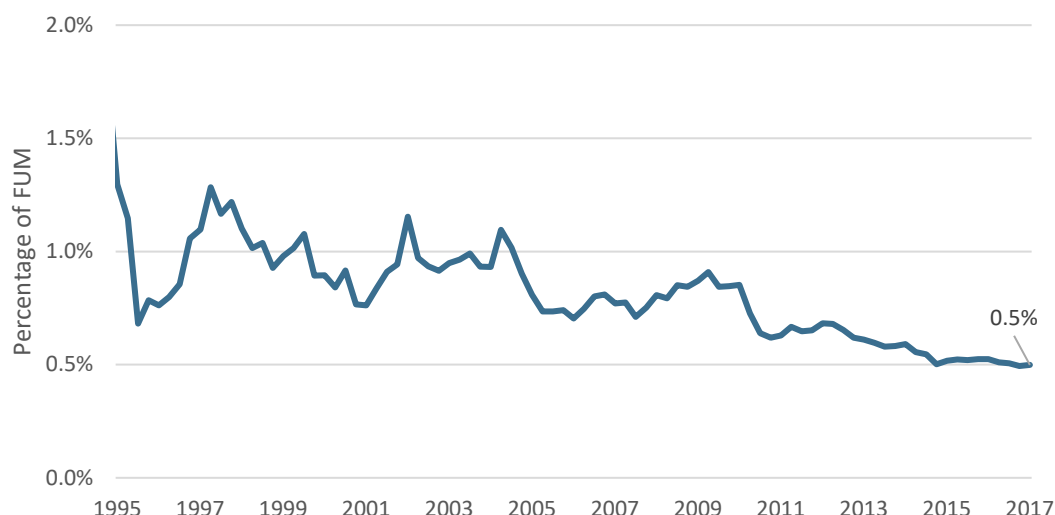
A corporate credit investor such as an Australian superannuation fund may expect to receive a credit spread of 100 bps to a risk free long-term bond. Premiums would have to be added for senior private debt (100bps) and subordinated debt (200bps). These sorts of margins are attractive enough to investment committees.

Direct loans to remain a niche business

It must be noted that while superannuation provides a variety of forms of long-term capital to the Australian economy, without compelling returns, allocations to illiquid assets like direct loans will remain limited.

Some may argue that industry funds are far too conservative in their lending approach. This is a fair conclusion if the benchmark is total credit to domestic non-financial corporations as a proportion of funds under management. With an allocation to NFC credit (loans and bonds) of approximately 0.5 per cent, as of June 2017, it illustrates just how little is invested in these assets (Figure 9). However, perhaps the proposition might be better tested on a case-by-case basis.

Figure 9 – NFC credit as proportion of superannuation total FUM (June 2017)



Source: ABS Cat.5232.0

Note: Superannuation FUM excludes SMSFs and the Future Fund. Credit includes both long-term loans and bonds.

Australian superannuation funds are interested in expanding a sustainable lending business. For example, industry funds have been in the business of lending to non-financial corporations for almost 20 years through their co-owned ('collective') vehicle, IFM Investors. More recently, some funds have taken steps to develop direct lending businesses of their own. This includes: AustralianSuper (Australia's largest superannuation fund with over two million members), Cbus, First State Super, Retail Employees Superannuation Trust, and Telstra Super.

Those Australian superannuation funds with direct lending businesses will still be described as providers of complementary capital to the banking system or a boutique service. Industry funds have targeted no more than 200 to 300 listed companies as potential customers, usually offering a debt tenure in excess of five years. There are many Australian companies comparable to Visy with similar credit profiles and financing needs that would be suited to such transactions in the future.

"It's a conviction play [for the super funds] and you have to be convinced you are getting your money back so you don't want to go too far down the risk curve. Over time, as they get more confident, they will invest further along the credit curve."¹⁴

Westpac's head of loan syndication Russell Sinclair

2.3 The best placed lender

In Australia, pure credit schemes are a difficult business model to make work. They ebb and flow depending on how well individual banking businesses perform, the broader credit cycle and economic conditions.

Currently, Australia's Big Four Banks dominate the corporate lending space. There are major Australian businesses that would only ever deal with between one and three banks for finance. These banks have never needed a top-up from direct lending sources via the superannuation sector. The private loans made to businesses are somewhat smaller than those in the United States or Europe. This is because the

¹⁴Shapiro, J., 'Westpac bankers encouraged by banner year for debt capital markets', *The Australian Financial Review*, 29 January 2018.

Australian banks still have a firm hold on loans to the big end of town. They operate on a three to four-year funding cycle and can cross subsidise this activity against their revenue in transaction banking and other cross selling opportunities. This is possible because the major banks have one portfolio called their “balance sheet” which allows for significant cross subsidisation across various lines of business.

Surely, if there is genuine market failure in Australian financial markets, it is the provision of capital to SMEs.¹⁵ Perhaps superannuation funds might help circumvent that failure somewhere in the smaller cap part of the market. Historically, banks have used their superior credit ratings to raise funds offshore and then lend to domestic firms which do not have a credit rating, are unknown to international lenders or want tickets that are too small. Perhaps these firms could use longer term private equity investments which Australian banks could help to intermediate.

It may be that a significant proportion of the \$959 billion in loans that were made to domestic businesses during financial year 2017 were made to SMEs. These types of businesses provide a number of challenges that make them unsuitable for direct lending by Australian superannuation funds. Often the financial arrangements for smaller businesses are intertwined with personal finances. A mortgage over the family home may also support the business line of credit. In these circumstances, it would be very difficult, and cost prohibitive for an institutional investor to provide funding for a small business.

Medium sized businesses often need the other services that a bank might provide. Examples include transactional banking, payroll facilities, credit card facilities, treasury facilities for FX, trade credit facilities and bank guarantees as well as letters of credit for land lords or other creditors/providers of inventory. There is often a credit risk for the bank in providing these facilities and they will therefore require security if they provide them. If the “core debt” requirement of the borrower is large enough it may make sense to bring in a second lender such as an institution to share the security. However, if the debt is smaller or more cash flow based, it often makes sense for the bank who provides those other facilities to be the sole lender as they then have oversight of all the business’s transactions (and this can be an important input into the credit monitoring of the borrower).

One obstacle to in the development of a lending market, led by the superannuation funds, is a lack of corporate lending experience outside the large banks and investment funds. Whilst there is some awareness in funds, it is not clear whether they possess or even want to develop the internal skill required to accept and reject personal, business and residential credit - something that banks have been honing for years and that is now also subject to competition from fintech businesses.

Another related issue faced by funds investing in corporate credit is that, in some cases, it could be difficult to accurately value private (as opposed to public) debt portfolios over time if no secondary market exists for these assets. This could lead some super funds to underestimate their risk exposures until such a time as their full extent becomes suddenly apparent. We saw this with certain industry super fund exposures to illiquid infrastructure equity during the global financial crisis.

Banks can also make provisions because they have an equity buffer (in terms of shareholders’ money) thus allowing them to adjust the rate of return expectations. In contrast, superannuation funds, through their trustees, are required to maximise returns on members’ savings invested in discrete ‘portfolio allocation’ pots for which there is no scope for cross subsidisation.

Taking these factors into account, superannuation funds are likely better served outsourcing this activity to banks or non-banks and specialist investment managers acting on their behalf or investing in other

¹⁵ Since the GFC, borrowing rates for large portion of companies, particularly for those that are smaller and riskier have remained high. Hambur, J. & La Cava, G., 2018, ‘Do Interest Rates Affect Business Investment? Evidence from Australian Company-level Data’, May 2018, *Reserve Bank of Australia*, page 6, accessed on 25 September 2018, URL: <https://www.rba.gov.au/publications/rdp/2018/pdf/rdp2018-05.pdf>

structures (such as RMBS or ABS securitisation) that provide them with exposure to the small business sector. They might also consider letting banks play a greater role in establishing the *bona fides* for equity provision. Superannuation funds might consider paying banks (and possibly others) to do the fundamentals analysis, leveraging banks' extensive experience in this field lies.

If regulators make it hard for banks to lend to small businesses, superannuation funds might be able to lend more cheaply. This presumes that the regulators are overly conservative and that funds could sensibly hold fewer reserves than the banks. Certainly, since the GFC, banks around the globe are more constrained due to regulation and requirements for stable funding ratios imposed under Basel III.¹⁶ Banks are now, more than ever, less inclined to provide longer term funding, especially for periods out to 10 or 15 years as the regulatory cost of capital increases.

The absence of bank competition at the long end of the market creates an opportunity for longer term investors in the superannuation sector to provide long-term vanilla credit. Supporting this notion, a superannuation fund has considerably lower liquidity needs than a bank does and is in a vastly superior position to commit to long-term loans.¹⁷

In summary, going forward it is envisioned that the Australian superannuation fund direct lending business model will develop in line with the historical pattern; leaving the capital requirements of smaller enterprises to the banks (with shorter three to four-year debt profiles) and equity markets. Larger Australian businesses should be able to borrow the funds they need from the international capital markets with maturities of 10 years or more or obtain financing from the Australian superannuation sector provided they appropriate risk adjusted returns that reflect the illiquidity of the investment.

3. Should super funds do more direct lending?

We have seen Australian superannuation funds allocate relatively little towards direct corporate loans. This section asks whether the funds should raise their currently very low direct debt allocations.

3.1 Dynamic efficiency and capital shortages

To maximise the economic welfare of all Australians we need to see financial capital allocated to its highest bidders here and overseas. This condition is what leads to the highest and most productive intertemporal levels of business investment that maximise total factor productivity and per capita living standards through time. If businesses cannot obtain capital for a competitive price then they are constrained. Similarly, if lenders (in our case superannuation funds) charge too little for their loans they will undermine members savings objectives.

Some high profile Australian business owners are urging superannuation funds to provide debt for 10, 20 or even 30 years to fund domestic and overseas expansions. Often these business owners want fixed rate funding to take advantage of current low interest rates. Superannuation funds have CPI plus targets and a

¹⁶ Pratt, A., 'Harness our super trillions to make Australia grow', *The Australian Financial Review*, 3 April 2018.

¹⁷ The biggest bank killers over time are "asset-liability mismatches". Banks borrow very short-term deposits (liabilities) with and when they fall due, and is therefore trading insolvent given it has committed this money to the multiyear loans it has advanced. This is why we have a central bank, which serves as a lender of last resort, furnishing emergency liquidity support to banks running massive disconnects between the tenure of their assets and liabilities that can trigger crises under the definition of solvency in the Banking Act. Joye, C., 'Why are super funds ignoring the debt market?', *The Australian Financial Review*, 25 November 2017.

natural bias towards floating rate assets. As such, if superannuation funds are providing longer term loans they must also consider their interest risk. The combination of illiquidity, interest rate risk and credit risk, results in superannuation funds expecting higher returns than borrowers often expect to pay.

Are returns from direct lending compelling enough for Australian superannuation funds? We have seen many alternative risk adjusted investment opportunities across asset classes that may outperform the typical direct lending proposition.

So, while the idea of direct lending may look 'simple, obvious, compelling and great value' from the borrowers' perspective, from the investors' perspective there are certain obstacles that need to be overcome before it finds traction with superannuation funds. However, when appropriately rewarded, direct lending could be very attractive for them.

3.2 Resilience – a financial backstop

It is argued that a vibrant domestic debt market, led by superannuation funds, will enhance Australia's standing in the international financial sector and make the economy more resilient to external shocks. This was certainly a point made by the nation's top bankers at the Superfunds Round Table hosted by Visy and *The Australian Financial Review* in November 2017.

JP Morgan chair, Sir Rod Eddington, and Macquarie's chief executive, Nick Moore, have previously argued that renewed efforts to encourage superannuation funds to expand their lending to local companies would not only elevate the nation's standing internationally but increase the resilience of the Australian corporate sector. "The credibility of our financial institutions would be enhanced if we could make this work not only for our own corporates but for others as well," Sir Rod told the Superfunds Round Table.¹⁸

Macquarie's Nick Moore stated that building up more credit skills in Australia to make sound lending decisions was a "huge endeavour" but would strengthen the financial system. "We do need to change the mix of where the money is being invested - right now 25 per cent of assets are in fixed income, that's half the rate internationally," he said.

Nick Moore argued that one of Australia's strengths during the GFC in 2008 and 2009 was, "the way our equity markets could recover and allow many corporations to recapitalise... that came as a result of the depth of our superannuation system and their ability to respond quickly, whereas in many countries they raised capital in a very delayed and drawn-out process."¹⁹

The financial crisis exposed shortcomings in that some Australian companies had too much short-term debt, denominated in foreign currencies. When the Australian dollar took a hit, this accentuated the adjustment pressures faced by these borrowers. The capacity to borrow long-term debt in AUD would prove "powerful" in making Australian companies more resilient and lower their cost of capital, Mr Moore said.

With so many Australian companies looking to the United States market for funding it is clear there is a market for long-term debt in Australia for banks that have funding in local currency.

¹⁸ Shapiro, J., 'Super loans for business would boost economy', *The Australian Financial Review*, 25 November 2017

¹⁹ It is often argued that government support to the major banks helped the Australian economy weather the GFC storm. While from a solvency standpoint the major banks were and remain among the most profitable and well capitalised in the world, they did require extraordinary government support during the GFC. Some of the support was direct in the form of explicit guarantees of bank bonds and deposit liabilities. Some of the support was implicit because the capital markets perceived the major banks as being 'too big to fail' and therefore viewed the major banks as certain to receive government support in times of stress. Finally, some of the government support was indirect, in the form of broader fiscal stimulus measures which benefited their customers and so reduced the credit risk of Australian consumers and the default risk of bank assets.

Some have argued this is not a funding gap that can be breached by Australian banks. Lyn Cobley, the chief executive of Westpac Institutional Bank, has said it is becoming more punitive for banks to "borrow short and lend long" and that it would be necessary for banks to work closely with superannuation funds seeking reliable returns from corporate debt. She said the banks had an important role to "facilitate the placement of appropriately evaluated credits to institutions".²⁰

Westpac bank brokered a \$150 million debt placement for Visy to large Australian superannuation funds.

It is worth noting that some superannuation funds actually played a significant stabilising role during the GFC via their strong cash positions which helped to recapitalise Australian banks and operating companies. The ASX has established that superannuation funds provided the backstop during the crisis.²¹

*"The ability for the superannuation system to underwrite the Australian corporates shouldn't be forgotten. That was testament to the fact we had the liquidity on the equities side, we might not have had it from the credit markets globally, but the Australian banking system could do heavily discounted rights issues through that March quarter of 2009."*²²

WaveStone's principal Catherine Allfrey

Certain not-for-profit institutional investors used wholesale business models and asset allocation to enable speedy engagement in 'off-market' private placements over short time periods. The major banks were significant beneficiaries by being able to recapitalise quickly via this funding channel.

In addition, superannuation funds were an important source of direct equity capital for non-financial corporations during the GFC and were an important stabiliser for secondary listed markets.²³

Nevertheless, superannuation funds face liquidity constraints too. This is especially so where they have many members close to or in retirement phase, or where members are free to choose their investment option and their fund. When a superannuation fund invests in Australian bank loans it is often the lowest earning illiquid asset class within the fund.

3.3 Retirement - capital buffers?

The superannuation system and the retirement living standard boost it has given to retirees is undoubtedly a success story. This is especially true for working Australians. Super funds have helped 14.8 million people build \$2.7 trillion in retirement savings. The system contributes to a virtuous circle of better retirement outcomes for individuals and a stronger and more productive economy financed by equity and debt capital

²⁰ Shapiro, J., 'Super loans for business would boost economy', *The Australian Financial Review*, 25 November 2017.

²¹ Australian Securities Exchange 2010, Information Paper – Capital Raising in Australia: Experience and Lessons from the Global Financial Crisis, 29 January 2010. URL:

https://www.asx.com.au/documents/media/20100129_asx_information_paper_capital_raising_in_australia.pdf

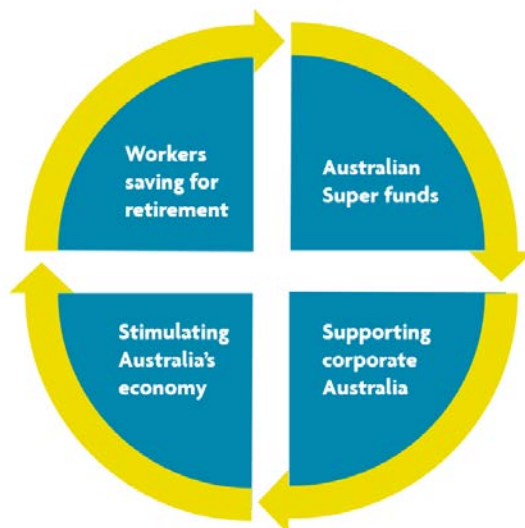
²² Polak, V., 'WaveStone's Catherine Allfrey on the day the GFC arrived in Australia', *The Australian Financial Review*, 12 September 2018.

²³ Australian Securities Exchange 2010, Information Paper – Capital Raising in Australia: Experience and Lessons from the Global Financial Crisis, 29 January 2010. URL:

https://www.asx.com.au/documents/media/20100129_asx_information_paper_capital_raising_in_australia.pdf

(Figure 10). Where superannuation funds are well managed and invest for the long-term they benefit their members and help to build growth and resilience into the domestic economy.

Figure 10 – Virtuous savings and lending cycle



Source: AIST

The need for a more capital-intensive retirement phase has led the superannuation industry to examine various product alternatives to better manage member retirement needs. Some argue that the superannuation system needs to deliver, with greater certainty, the income cash flow its members are expecting in retirement. Some even call for Australian funds to become more like banks, in the sense that retirees can cash out a 'retirement pay cheque' for the rest of their lives.²⁴ However, such promises are difficult to guarantee unless funds have a pool of reserve capital to meet cash flow requirements if investments unexpectedly turn sour.

One approach to better guarantee retirement income is for superannuation funds to hold either member capital, shareholder capital or third-party capital to back retirement promises. Currently, funds are successfully building up the retirement savings pool. However, longevity risks are still present and most retirees are not well-resourced enough to fully self-insure their retirement risks. The argument is that if buffer stocks were held for this purpose, presumably by grossing up superannuation fund portfolio with debt, then they would have more capacity to manage these retirement risks.

The cost of 'grossing up' is moving away from the first best 'growth' portfolio allocation that has worked so well for superannuation funds, encouraging them to hold a greater proportion of assets with lower risk adjusted returns. There is a definite trade-off here between shorter liquidity management and longer-term wealth creation.

3.4 Summing up

Why do Australian superannuation funds have little exposure to longer term direct credit market, especially when compared with their overseas counterparts?

²⁴ Cooper, J., 'Why super funds need to look more like banks', *The Australian Financial Review*, 29 January 2018.

First, larger Australian non-financial corporations have historically been able to access relatively cheap funding from offshore, for example the United States, just not in AUD. At the same time Australia's major banks have historically taken care of the business banking needs of SMEs.

Second, most domestic funds are classified as defined contribution rather than defined benefit schemes; the latter view a substantial allocation towards corporate credit much more favourably given the more predictable nature of their future liabilities and their desire to match portfolio assets and liabilities.

Third, many individually defined contribution funds are tilting portfolios towards growth assets, which makes sense where a funds' membership is still in accumulation phase with steady positive inflows. This makes direct lending assets relatively less attractive on a risk adjusted basis.

Fourth, funds have to manage individual investment options as separate 'profit centres' whereas banks which dominate corporate lending can cross subsidise this activity via other cross selling opportunities.

Fifth, funds have little internal experience in writing and managing loans to corporations, although this can be mitigated by outsourcing this activity to specialist non-banks and investment managers acting on their behalf. Alternatively, there may well be an opportunity for partnering with banks in the future given their well established and relatively deep credit assessment capabilities.

Sixth, in terms of maximising portfolio performance returns, other assets that offer similar risk-return characteristics on fund balance sheets currently exist. These assets are well understood by fund investment staff and have proven track records.

Australian superannuation must continue to innovate. So, engaging in long-term credit provision is a desirable activity where the rewards are appropriate for this class of risk asset. However, to make such long-term investments, superannuation funds need a pay-off that is much closer to an equity return. Unfortunately, some participants expect longer term money to be available at rates not much higher than shorter term commitments. Providing cheap long-term debt doesn't make sense from a risk and reward point of view unless returns compensate for risk, lower liquidity and longer tenures. It is only then that superannuation funds may become interested in lending to corporate Australia.

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