This article draws heavily on presentations made at Finsia's Australia's Corporate Lending Landscape seminars in Sydney (7 May 2009) and Melbourne (20 May 2009). The author gratefully acknowledges the contributions of all presenters.

Australia's corporate lending landscape

The corporate sector's ability to access finance for new and ongoing projects will be a key determinant of the depth and duration of the current crisis enveloping the global economy and financial markets. How has the Government Guarantee affected corporate lending and what alternatives to bank credit are emerging in the current environment?

IN THE PAST 18 MONTHS, the global financial crisis has developed into a global economic crisis as the impacts of financial market instability have flowed through to the real economy, and the situation is still evolving.

Both credit and liquidity are tight as banks have scaled back their corporate lending portfolios and some foreign lenders have begun to back out of the Australian market. This could significantly affect the prospects for recovery, with the accelerator effect of a downturn in business investment a very powerful force.

The ACCI-Westpac Survey of Industrial Trends for the March Quarter 2009 reported that 'continued constraints in credit markets have seen 40% of manufacturers rating finance as "harder to get" – the highest level since the September quarter 1974'. This view was borne out by the May 2009 RBA *Statement on Monetary Policy*, which indicated that total business debt grew by only 1.5% annualised over the March quarter. During the quarter, only 19 syndicated loan approvals with a total value of $10.5 billion were recorded compared with $17 billion in maturities in the same period a year earlier (RBA 2009).

Impact of the government guarantee

A remarkable outcome of the GFC has been the relative strengthening of Australian banks on the world stage. Sound regulation and the intervention of the Rudd Government with a bank guarantee have strengthened the banking sector.

Under the bank guarantee scheme announced in November 2008 (following the initial blanket guarantee announced in October), a Commonwealth Government Guarantee is available on deposits over $1 million and debt raising for a specified fee, based on the risk-rating of the institution. AA-rated major banks can raise guaranteed funds for a fee of 70 basis points (bps) over the cost of funds, A-rated banks such as Suncorp pay a fee of 100 bps and the BBB-rated Queensland and Bendigo Banks, building societies and credit unions incur a fee of 150 bps. This has been a favourable rate for the AA-rated banks,

PROFESSOR DEBORAH RALSTON F Fin is Director, Melbourne Centre for Financial Studies and Professor of Finance at Monash University.

deborah.ralston@melbournecentre.com.au

especially when compared with guarantee fees required by member nations of the European Commission, which have tended to set a fee equivalent to the average credit default swap spread over the prior year plus a premium of 50 bps.

While initially it was envisaged that the bank guarantee would be in place for three years to November 2011, the re-emergence of a non-guaranteed debt market, the strength of the major Australian banks and the unintended consequences flowing from the bank guarantee on competition make it likely that the Government will move to exit the bank guarantee earlier than planned.

In recent months there have been signs of a re-emergence of the non-guaranteed debt market as major banks have begun to successfully issue non-guaranteed debt. The spread between guaranteed and non-guaranteed debt is starting to narrow. According to the RBA's May 2009 *Statement on Monetary Policy*, spreads on five-year bank bonds including the cost of the guarantee have narrowed to 170 bps above Commonwealth Government securities (CGS), 30 bps below the level in January, similar to recent three-year non-guaranteed bond issues. The guarantee also allows the banks to raise longer-tenor funds, that is, with a term of over three years, which would not otherwise be available in the current market.

Key impacts of the GFC on corporate lending

Despite the major banks' ability to raise funds internationally and their healthy capital levels, considerable uncertainty remains in the bank debt market, which is reflected in the fall-off in corporate lending, the reduced tenor of loans and the increased use of restrictive loan conditions.

In March quarter 2009, the volume of Australian business loans dropped by 74% and the number of deals fell by 60% (see Figure 1). Loan volumes, which averaged around US$20 billion for the first three quarters of 2008 fell to US$9.5 billion in the December quarter and to US$6.5 billion in March quarter 2009 (Thomson Reuters 2009).

While the volume of total business loan transactions has dropped substantially, new transactions have suffered the most. As Figure 2 indicates, by December quarter 2008, the vast majority of loans written in the corporate market were for refinancing purposes, at the expense of new loans.

While initially it was envisaged that the bank guarantee would be in place for three years to November 2011, the re-emergence of a non-guaranteed debt market, the strength of the major Australian banks and the unintended consequences flowing from the bank guarantee on competition make it likely that the Government will move to exit the bank guarantee earlier than planned.

At the same time, the tenor of loans has been reduced and financing for more than a three-year term has become very difficult to procure. Whereas in 2006, just over one-half of all loans had a tenor of more than three years, by 2008, only one-third of loans had a tenor of over three years. In mid-2009, longer term funding is almost unprocurable.

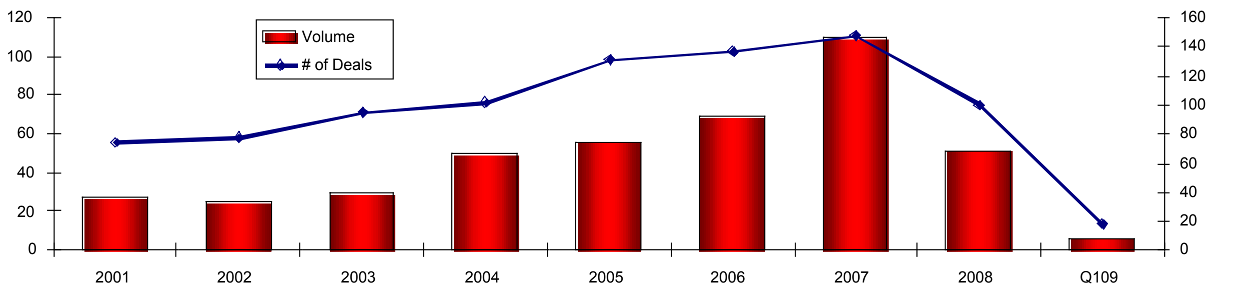
Loan terms are under close scrutiny with banks focused on ensuring that terms are satisfactory and reflective of the current environment. Terms include tighter covenant packages, an increasing number of secured facilities and other items like market disruption clauses.

Legal conditions increasingly restrict access to bank credit. As banks strive to readjust the pricing of risk, material adverse conditions (MAC) clauses, thought to be 'toothless' in the past, are being monitored assiduously, and flexible conditions apply to both structure and pricing of new loans. Similarly, financial covenants are, once again, a central part of lending, with headroom reduced and definitions being tightened.

In such a tight lending environment, the market is looking for alternatives to bank credit such as a retail bond market. The proposed Australian Business Investment Partnership (ABIP) represents a government-backed alternative for the construction industry, with joint funding from government and the major banks.

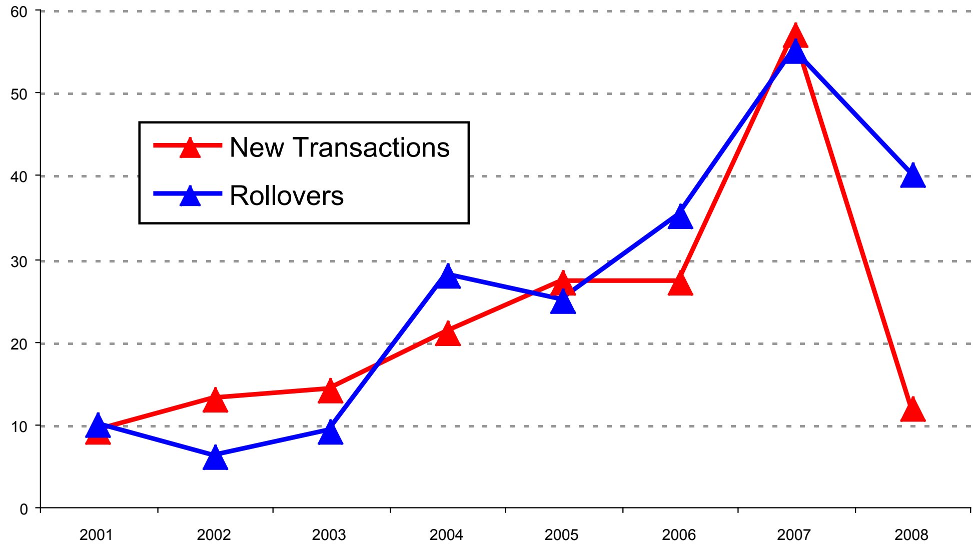
With the property sector one of the hardest hit by the withdrawal of credit following the GFC, there is an argument for government intervention both in terms of potential market failure and to protect the public interest due to implications for employment and economic growth.

Figure 1. Volume and number of business loans deals in Australia ($US bn)



Source: Thomson Reuters, 2009.

Figure 2. **Volume of business loans in Australia by new transactions and rollovers ($US bn)**



Source: Thomson Reuters, 2009.

Under this proposal, ABIP would act as a 'lender of last resort' assisting in the refinancing of construction projects that are viable but otherwise cannot access funding. At the time of writing, however, the proposal had been defeated in the Senate.

Alternative funding sources

Lending has changed in the post-GFC environment in terms of the sources of funds, the size and the structure of deals. As credit has tightened and lending institutions have become risk averse, there is now extreme competition for funds.

A measure of the reduction in liquidity is the margin on short-term funds. The spread between the three-month BBR and the overnight swap rate peaked at 92.5 bps on 7 October 2008 and eased to 22 bps by end-March this year, remaining relatively stable since. Reflecting the level of cautiousness within credit markets, credit spreads have been slower to respond.

There is no sign of a similar recovery in the securitisation market. Of the $8 billion made available through the Australian Office of Financial Management (AOFM) to put liquidity into the securitisation market, only $3.5 billion was taken up by May this year, and there had been only $30 million in non-government activity.

On the other hand, there has been greater usage of the bond market by the non-government sector. From January to April 2009, $28 billion in bonds were issued (up from $23.9 billion a year earlier), of which $8.7 billion were non-government guaranteed private sector bonds.

With the closure of the wholesale market to corporates, falling share prices and dividends in equity markets and with ADIs restructuring their balance sheets through the conversion of deposit liabilities into capital base, there has also been renewed interest in a private bond market with successful retail bond issues being made by Tabcorp and AMP in recent months; the first retail corporate bonds issued in Australia since the 1990s.

These issues highlight the need for an established retail bond market in this country, both by investors (providing attractive returns, a reliable income stream, relatively low risk and a liquid asset) and issuers (allowing a more diversified and flexible funding source, fewer covenants than are applying through credit markets and a funding stream that is typically unsecured).

Conclusion

As banks write off bad debts and focus on deleveraging their balance sheets in the post-GFC environment, access to both international and domestic sources of credit has become more difficult. And, with tight liquidity and expensive credit subject to strong loan conditions, borrowers are looking to new alternatives for funding.

The Government's responses to these adverse conditions (through initiatives such as the bank guarantee, the AOFM support for securitisation markets and the ABIP proposal) have also produced major changes in financial markets.

The GFC has highlighted the reliance of Australian corporates on credit markets and their need for a more diverse range of funding options, as well as the fact that certain structures which appear robust during periods of economic growth may not stand up well when conditions deteriorate. In light of this, it is important to now reconsider the breadth and depth of Australian funding markets in relation to the overall need for credit, debt and capital. ●