

The Role of Corporate Bonds for Finance in Austria

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With corporate bond issuance having grown at a fast pace in Austria in recent years, bonds have become firmly established as a pillar of the financing structure of the domestic corporate sector. More and more issuers are smaller firms, and they come from a broad range of industries. Bond financing allows companies to diversify their financing sources and to broaden their creditor base beyond the banking industry. Rather than drive up corporate debt, bonds have become an alternative to bank loans as a borrowing instrument. Compared with loans, bonds allow companies to borrow money over longer horizons, but high upfront costs make this instrument more attractive for companies that need to finance large volumes. Moreover, bonds are not equally appropriate for all financing requirements, which is why they will never fully replace loans in the long term. Finally, more stringent requirements implicitly apply to the quality of a company's credit ratings when companies intend to issue bonds than when they apply for a bank loan. So far, there have been very few cases of bond defaults in Austria.

1 Introduction

Bank loans have typically been the single most important source of external financing for Austrian companies. Bonds, by contrast, would for a long time play rather a minor role. In recent years, however, bond issuance has taken off as a means of financing also for domestic companies. In the euro area, issuance activity rose sharply immediately after the introduction of the euro in 1999. In other words, the disintermediation trend in external financing observed in international financial markets for a number of years emerged also in Austria.

Raising funds through the issuance of bonds differs from borrowing from banks in a number of ways: with regard to maturity profiles and underlying costs, but also with regard to the basic design of payment flows. It follows that bonds are not equally appropriate for all companies (and investment projects). When companies opt for bond financing, this has also impli-

cations for financial stability, as credit risk and the associated chances and risks are no longer taken by banks specifically equipped to deal with such challenges but by a broad range of bond creditors.

The aim of this paper is to look into the implications the changing funding trends have had for corporate finance in Austria. The starting point is a comparative analysis of developments in the euro area and in Austria from 1999 to 2003 and of the major underlying factors on the supply and demand side. The subsequent section provides an analysis of the role corporate bond financing plays in Austria in comparison with bank lending. These findings are then assessed from a financial stability perspective. The final section offers conclusions.

2 Data and Definitions

For the purpose of this paper, a corporate bond is a debt instrument issued by a nonfinancial corporation² in return for which the investor receives

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² Nonfinancial corporations (S. 11) as defined in ESA 1995, i.e. all institutional units of the economy that are market producers whose principal activity is the production of goods and nonfinancial services. Consequently, bonds issued by banks or other financial institutions do not qualify as corporate bonds, even though banks and financial institutions are also business undertakings. Some papers on this issue have, therefore, treated bank bonds as corporate bonds (e.g. de Bondt and Lichtenberger, 2004).

interest and the promise that the capital will be repaid. Bonds are subject to fewer legal provisions and constraints than shares. They do not require the issuing company to have a particular legal form, and they may be tailored to the requirements of the issuing entity or to capital market conditions in terms of maturity, interest rates, coupon payments, currency, asset securitization and the like (Zuffer, 2003). Depending on the placement strategy, there are basically two types of bonds. In a public placement, a given bond is offered to a broad range of investors and subsequently as a rule listed on an exchange. In a private placement, bonds are sold directly to a limited number of specific institutional investors. This paper covers both types of issuance but, to economize on space, does not elaborate on the differences.

Data on outstanding corporate bonds are contained in a number of data sources. First, there are the OeNB's securities issues statistics, for which domestic banks regularly report the amount of securitized liabilities of non-banks (together with their own stock of debt securities).³ These statistics are available from 1999 onward⁴ and are comparable across the euro area as they are compiled on the basis of reporting guidelines established by the European Central Bank (ECB).⁵

Second, the Oesterreichische Nationalbank operates a securities database capturing information supplied by the Austrian banking sector and the two data providers Oesterreichische Kontrollbank (OeKB) and Frankfurt-based Wertpapier-Mitteilungen. This database comprises the profiles of all securities publicly issued at a stock exchange both at home and abroad. The findings of this paper are derived primarily from the data stored in this database. This database, incidentally, also provides input for the OeNB's financial accounts statistics, which, among other things, are used to break down outstanding amounts (available from 1995) and transactions (available from 1999) by investor sectors.⁶

Bonds are valued at nominal prices⁷ in the OeNB's securities issues statistics and at market prices in its securities database (and in the financial accounts). Because of these valuation differences, data from the individual statistics do not fully match. For instance, the total value of corporate bonds outstanding at the end of 2003 was EUR 19 billion according to the securities issues statistics, but more than EUR 20 billion according to the securities database and the financial accounts.⁸

³ Reporting agents provide the stock of all listed and unlisted debt securities denominated in euro and in foreign currencies (including private placements).

⁴ In addition, there are the capital market statistics, for which longer time series are available, but only with a view to bonds issued on the Austrian bond market, excluding placements in international markets and issues denominated in foreign currencies. Given that in recent years the bulk of corporate bonds has been placed abroad, issuance activities are reflected only incompletely by the capital market statistics.

⁵ For a broader international perspective, we used data of the Bank for International Settlements (BIS) for the United States, the United Kingdom and Japan, which are, however, not fully comparable.

⁶ The analysis of the investor pattern is based on financial accounts data. Comparable financial accounts data for a number of European countries can be obtained from Eurostat's NewCronos database.

⁷ Except for data on zero coupon bonds, which reflect actual payments.

⁸ This difference basically reflects the drop in interest rates in recent years, which pushed up the prices of fixed-income bonds.

3 Corporate Bonds in the Euro Area and in Austria

3.1 Corporate Bond Market Structure and Developments since 1999

Between 1999 and 2003, the volume of bonds issued by nonfinancial corporations resident in the euro area

almost doubled, after having grown by a mere 10% over the period from 1993 to 1998. The period from 1999 to 2001 stands out with annual growth rates of approximately 20%. In 2002, growth decelerated to about 2%, but rebounded to 8% in 2003.

Table 1

Outstanding Volume of Corporate Bonds in 2003

	EUR billion	% of GDP
France	306	19.6
Germany	96	4.5
Netherlands	52	11.3
Italy	38	2.9
Belgium	34	12.8
Austria	19	8.5
Finland	17	11.8
Portugal	16	12.1
Spain	16	2.1
Greece	1	0.4
Euro area ¹	594	8.2
U.S.A.	1,992	25.9
Japan	578	19.2
United Kingdom	268	21.3

Source: OeNB (securities issues statistics), ECB, BIS.

¹ Excluding Ireland and Luxembourg, for which data were not available.

This dynamic expansion notwithstanding, at the end of 2003, corporate bonds issued in the euro area corresponded to less than one-third of bonds issued in the United States, and the euro area just barely outpaced Japan. In relation to economic output, bonds outstanding in the euro area accounted for 8% of euro area GDP, which is significantly below the corresponding ratio for the United States, and also below the ratios for both Japan and the United Kingdom (see table 1). Within the euro area, however, there are large differences between individual countries. The GDP ratios of the United States and of the United Kingdom were not reached by a single country. France, which accounted for more than half of all bonds outstand-

ing in the euro area, was on a par with Japan with a GDP ratio of 19.6%. Germany, by contrast, which is the second biggest market in the euro area in absolute terms, posted a ratio of just 4.5% of GDP.

The Austrian ratio – 8.5% of GDP – was the sixth-largest in the euro area and thus slightly above the euro area average. Austrian issuers had a share of 3.3% in total corporate bonds outstanding in the euro area at the end of 2003. Developments in Austria have lagged developments in the euro area by a few years. Following three years of moderate or even negative growth rates, bond issuance growth rates in Austria exceeded the euro area average in 2002 (just barely at 2.6%) and in 2003 (significantly at 22.5%).⁹

⁹ Up until the 1970s, bonds played a fairly big role in corporate financing, as is evident from capital market statistics. At the time, electric utilities (governed by the Second Nationalization Act of 1947 until Austria's accession to the EU) were the single biggest issuers. They tapped into the bond market to fund the development of the Austrian energy market. Until 1977, the outstanding amount of bonds issued by "other nonbanks" on the Austrian bond market exceeded 3% of GDP, a level not reached again until 2003.

In the past few years, the issuance activity of Austrian companies was heavily influenced by intermediary funding programs. Under such programs, the federal government has since 1998 relented funds raised through government bonds to state-owned companies. This is why such companies, previously relying heavily on the bond market, hardly issued any new bonds between 1998 and 2002. At the same time, bonds they had issued earlier came up for repayment, which further dampened the overall increase in outstanding corporate bonds considerably. Following a Eurostat decision in February 2003, these financings must be included in the general government debt (Maastricht definition). As a result, intermediary borrowing is being phased out and the companies concerned have returned to the general bond market (OeNB, 2004).¹⁰

Mirroring the high share of foreign currency loans, bonds of Austrian companies have to a large extent been issued in foreign currencies. At the end of 2003, Austrian foreign currency issues accounted for more than one-quarter of all corporate bonds, which is significantly above the corresponding euro area ratio of 11%. Consequently, the Austrian “market share” was 2.7% for euro-denominated bonds but 8.0% for foreign currency bonds issued in 2003.¹¹

3.2 Reasons for the Sharp Expansion of Corporate Bonds

The conditions for bond issuance improved significantly when 11 (by

now 12) relatively small and partially underdeveloped markets were integrated to form a broad, deep and liquid bond market. First, chances to sell larger volumes are bigger in a broader market and, second, fiercer competition among investment banks in the euro area has driven down issuing costs. Before the introduction of the single currency, investment banking was very much a national business and experience with marketing and sales of instruments in a particular currency constituted a major competitive advantage. These days, the issuing bank and the issuer often have different nationalities. Santos and Tsatsaronis (2002) show that underwriting fees for euro-denominated bonds sank from 150 basis points in 1997 to 25 basis points in 2000, to a level equivalent with U.S. dollar bonds. In other words, the arrival of the euro led to a significant reduction of issuing costs.

In addition, a number of temporary factors were instrumental in driving up issuance activity from 1999 to 2001. First, the sharp rise in mergers and acquisitions was to a large extent financed by corporate bonds (de Bondt, 2002). Second, the deregulation of the telecommunications market and the need to raise funds to pay for UMTS licenses also stimulated demand for bond financing. Third, in the climate of low inflation and interest rates prevailing at the time, companies more readily opted for long-term financing, including the issuance of bonds.¹² Fourth, following the major setback in inter-

¹⁰ If, for illustration purposes, the total volume of intermediary funding (which would no doubt produce a reverse bias, as bonds were not the only source of funding) is added to the actual amount of bonds outstanding, the imputed outstanding volume reaches 14.5% of GDP; this would be the second-largest figure within the euro area.

¹¹ Thereof, Swiss franc bonds accounted for 58%, U.S. dollar bonds for 25% and Japanese yen bonds for 17%.

¹² In addition to the decline in bond rates, the yield gap between corporate bonds and government bonds narrowed considerably in the euro area in 2003 (OeNB, 2004).

national exchanges from 2000 onward, demand for bonds was also fueled by portfolio shifts from stocks to bonds (Deutsche Bundesbank, 2004). Finally, in the initial years of monetary union, corporate bonds were in bigger demand as the supply of government bonds contracted in a number of euro area countries given decreasing fiscal balances.

However, conditions changed not only on the supply side; on the demand side, the higher demand for corporate bonds following the advent of the euro reflects the elimination of the “regulatory-driven home bias” due to currency matching rules existing in many countries for insurance companies and pension funds (Perée and Steinherr, 2001). In the euro area, portfolio managers no longer had to stick to currency matching rules, which before had limited the possibility of investing in currencies other than those in which liabilities were denominated. As a result, the range of bonds in which investors could theoretically put their money expanded significantly.

At the same time, as the legacy currencies were replaced by the euro, investors lost the possibility of exploiting exchange rate or yield differences to generate profits. The search for new portfolio diversification options and higher yields drove up demand for corporate bonds (Kaiser and Heilenkötter, 1999). The fact that

the expansion of corporate bonds in the euro area from 1999 was largely carried by the lower end of the yield spectrum reflects the increasing attention above all institutional investors were paying to credit risk (de Bondt and Lichtenberger, 2004).¹³

4 Impact on Corporate Financing in Austria

4.1 A Broad Range of Industries Issue Bonds

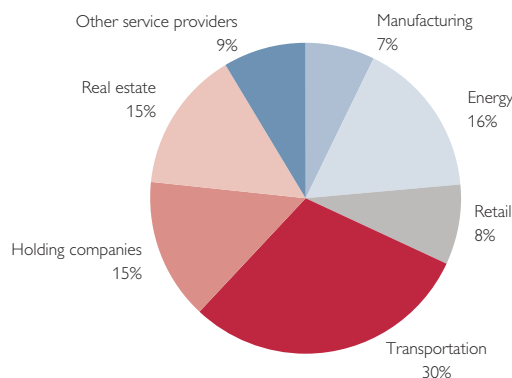
While issuance activity used to be dominated by energy utilities and other quasi-public companies, more recently companies from other industries and, increasingly, smaller firms have also been issuing bonds – the latter typically through private placements.¹⁴ Yet the transportation industry – above all providers of infrastructure – and the energy sector continue to play a big role. The share of real estate companies, including state-owned companies and housing developers, is relatively high. The share of retail companies is larger than the share of manufacturing companies (which is fairly small). At the end of 2003, holding companies, through which a number of companies issue bonds, accounted for a share of approximately 15%. As the funds raised by holding companies are in fact used by companies affiliated with other sectors, the data on the industry structure of corporate bond issuers are somewhat distorted.

¹³ The share of bonds issued within the EU rated speculative grade by Standard & Poor’s was below 10% in the mid-1990s and has since increased sharply, to an average of approximately 30% in the first five years since the euro changeover (Standard & Poor’s, 2004).

¹⁴ Another, innovative form of bonds specifically created for smaller companies is the so-called *Gewinnwertpapier*. From a commercial law perspective, this instrument equals a participating bond, pays a coupon that is based on the issuer’s earnings and does not have to be securitized. *Gewinnwertpapiere* are undated securities but have a minimum redemption period of ten years. In consideration for a premium, AWS (Austria Wirtschaftsservice) offers retail investors a 100% no-loss guarantee (50% for businesses) for bond volumes of up to EUR 20,000. The issuing volume of *Gewinnwertpapiere* is typically in the range of EUR 0.5 million and EUR 2 million. For an overview of these and other types of bonds for medium-sized enterprises, see Haiss and Marin (2002).

Chart 1

Corporate Bonds Issued in 2003 by Industry Affiliation



Source: OeNB (securities database).

As at December 31, 2003, the OeNB's securities database listed 160 companies that had issued bonds. The issuing volume varied significantly, ranging from EUR 0.3 million to more than EUR 3.2 billion; the average outstanding volume totaled EUR 127 million per company. Roughly one-third of the companies had a bond debt of below EUR 10 million; one-third a bond debt of be-

tween EUR 10 million and EUR 50 million; and one-third a bond debt of more than EUR 50 million.

Bond financing is, thus, no longer the prerogative of a small group of large companies; the industry profile of corporate issuers has come to be very mixed in Austria. Large companies do, however, account for the bulk of bonds that are listed on the stock exchange.

Table 2

Outstanding Volume of Corporate Bonds Issued by Austrian Companies

	Number of companies
Up to EUR 10 million	56
Between EUR 10 million and EUR 50 million	51
Between EUR 50 million and EUR 100 million	15
Above EUR 100 million	38
Total	160

Source: OeNB (securities database).

4.2 Additional Source of Funding

In relation to the overall number of businesses established in Austria, the share of companies that have issued bonds to raise funds is rather small at 160. At the same time, the funds thus raised accounted for approximately 7% of the external financing liabilities of the Austrian cor-

porate sector in 2003. This is in fact a high share – surpassed by France alone – when compared with other euro area countries (see table 3). By contrast, the percentage of bank loans replaced by bonds as a source of corporate finance is a lot smaller in Austria than in other euro area countries; the amount of bonds out-

Table 3

Structure of Corporate External Financing in 2003

	Bonds	Loan	Shares and other equity	Other
	% of external financing			
Belgium	3.8	24.3	49.4	22.5
Germany	2.3	43.2	48.0	6.5
Spain	1.1	28.3	24.3	46.3
France	7.3	24.3	38.8	29.7
Italy	2.3	32.1	55.6	10.0
Netherlands	5.5	46.4	37.6	10.4
Austria	7.1	63.6	26.6	2.8
Portugal	5.6	36.4	53.0	5.0
Finland	5.1	30.8	32.0	32.1
Euro area ¹	4.1	33.1	48.2	14.7

Source: OeNB, Eurostat.

¹ Excluding Greece, Ireland and Luxembourg.

standing in 2003 in relation to loans was significantly below the euro area average.¹⁵

Yet the aggregate share of bonds in corporate finance does not say anything about the role bonds play for those companies that have actually issued bonds. Comparing the liabilities of borrowers that use bonds, among other things, as a source of funding with the liabilities of borrowers that finance themselves exclusively through bank loans (using the data of the OeNB's major loans register) provides some insight into this.¹⁶ Among the former group, bonds accounted for about 52% of all funds raised from external sources in 2003.¹⁷ This implies that bond issuance usually does not increase the debt volume of a company but rather tends to replace bank loans as a borrowing instrument.

By issuing bonds, a company may widen its creditor base beyond the range of banks. Bond financing thus complements bank-based financing. A breakdown by investors (based on financial accounts data) indicates that only slightly less than one-fifth of the outstanding volume of corporate bonds was held by (domestic) banks at the end of 2003. This share has risen in recent years, which implies that banks have, in turn, replaced traditional bank lending with securitized lending.

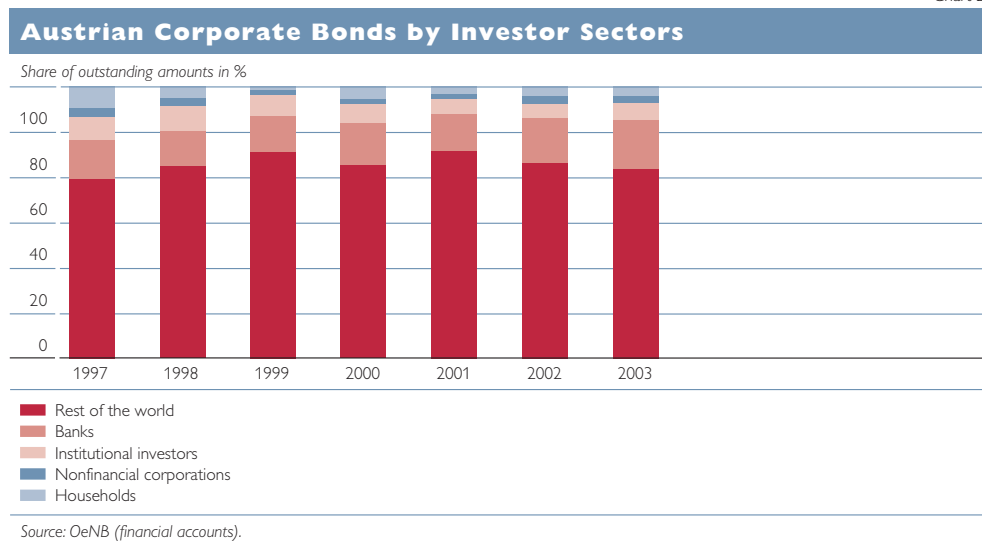
Foreign investors accounted for the single biggest share in a breakdown of Austrian corporate bonds by investors at the end of 2003, namely for about 70% of outstanding amounts. International investors go above all for large and liquid issues for which an external rating is available. For instance, in the category of

¹⁵ In a long-term comparison (based on capital market statistics) bonds are found to have played a major role in the corporate sector's external funding up until the early 1970s (with the qualification that the segment of the economy using this tool was much smaller at the time). Until about 1970, domestic bonds outstanding corresponded to more than 10% of corporate loans extended by banks.

¹⁶ Banks' reports of major loans provide information about the sectoral allocation of loans (or credit lines) that exceed a volume of EUR 350,000. Unlike in the monthly balance sheet reports, banks supply individual data for every single borrower and gross (unadjusted) data. Corporate loans or credit lines at a bank that are below EUR 350,000 are not recorded. As bonds held by investors other than banks are not included in these major loans data, either, the comparison made on the basis of those data underestimates the role of bonds for corporate finance.

¹⁷ By comparison, for companies covered by the major loans statistics, bond financing accounted for 9.6% of external finance.

Chart 2



corporate bonds with outstanding volumes above EUR 500 million, foreign investors had a share of 81%, compared with a share of 34% in the category ranging from EUR 100 million to EUR 500 million.¹⁸ The high share of foreign investors can also be explained with the fact that foreign currency bonds tend to be issued on international capital markets without being offered to domestic retail investors. The latter buy fairly large amounts of smaller bonds issued on the domestic market and tend to keep those bonds until redemption (Marek, 2002). Consequently, the share of households was just 0.6% in outstanding volumes exceeding EUR 500 million but as high as 8% in the category ranging from EUR 100 million to EUR 500 million. With an overall share of 3.4% of corporate bonds outstanding at the end of 2003, households were a minor source of corpo-

rate finance. Similarly to households, domestic institutional investors play a lesser role as buyers of domestic corporate bonds.¹⁹

4.3 Long-Term Financing

As investors may sell bonds on the secondary market, bond instruments can meet the (differing) maturity needs of both investors and issuers, thus enabling companies to borrow over long horizons.²⁰ At the end of 2003, more than 80% of bonds issued by Austrian companies had an original maturity of more than five years; in the case of bank loans the corresponding share was close to 60% (see table 4). Approximately 45% of the overall volume of corporate bonds had a maturity of ten years or more. Some companies have even issued perpetuities (especially Gewinnwertpapiere). Unlike in the case of loans, of which 30% had a maturity of below one year, hardly any bonds

¹⁸ This analysis is based on both financial accounts and securities database figures and does not cover bonds with smaller outstanding volumes because the data for the latter are characterized by a high degree of uncertainty due to valuation problems.

¹⁹ One reason might be that investment funds investing in corporate bonds tend to track international benchmark indices, which include only a small amount of Austrian bonds.

²⁰ This is primarily true for bonds listed on a stock exchange. The fungibility of private placements is more limited, because private issues are not actively traded on the secondary market.

Table 4

**Original Maturity of Corporate Bonds and Bank Loans
as at December 31, 2003**

	Corporate bonds	Bank loans
	Share in %	
Up to 1 year	0.4	30.1
Between 1 and 5 years	18.5	10.7
Over 5 years ¹	81.1	59.2
between 5 and 10 years	36.3	x
between 10 and 15 years	34.3	x
between 15 and 30 years	10.0	x
over 30 years	0.4	x

Source: OeNB (securities database and balance sheet reports).

¹ The design of the balance sheet reports does not allow for a breakdown of loans with a maturity of more than 5 years.

had maturities of less than one year. Commercial paper, i.e. debt securities with short maturities typically issued by large corporations in many countries, plays a minor role in Austria.

As bonds are long-term financial instruments, they provide maturity-matching financing for very long-term investment projects.²¹ Moreover, the principal of bonds is payable at maturity, so that companies may actually use the full amount raised through bonds until maturity.

4.4 High Fixed Costs

Unlike loans, where costs are basically proportional to the amount borrowed, bonds come at high upfront one-off issuance costs. These costs include underwriting fees that banks charge for handling a public offering and for guaranteeing to buy any shares they cannot resell; marketing costs,

such as the costs of producing issuance prospectuses;²² road show costs; and the costs of listing on a stock exchange (which consist of a listing fee payable to the underwriter and the stock exchange listing fee proper).²³ Estimates indicate that, in the case of small and medium-sized bond volumes, these costs may reach between 2% and 3% of the issuance sum (Finanzplatz e.V., 2000). Given the high fixed costs, bonds will thus be used above all by companies with considerable borrowing needs.

Coupons may be fixed or floating, as defined upon issuance for the entire maturity period. In the euro bond market, fixed bonds, which pay a fixed rate of interest and are redeemed at full on maturity (which is also fixed), prevail.²⁴ A considerable amount of bank loans, by contrast, carries variable interest rates.

²¹ See e.g. Hais and Marin (2002), who analyzed a number of bond prospectuses to establish the purpose for which Austrian corporate issuers were raising funds.

²² Publicly issued bonds are subject to the reporting requirements of the Austrian Capital Market Act, which increases disclosure needs and thus costs (Zuffer, 2003). Private placements can be handled more flexibly, namely on a case-by-case basis; moreover, they are not subject to the Capital Market Act, which reduces disclosure requirements.

²³ At the Vienna stock exchange, the initial listing cost is equivalent to 1 basis point for bonds with a maturity of up to 5 years (no less than EUR 1,450, no more than EUR 5,800) in the Official Market; 0.50 basis point (no less than 725 EUR, no more than 2,900 EUR) in the Semi-Official Market and 0.25 basis point (no less than 500 EUR, no more than 2,750 EUR) in the Third Market. For bonds with a maturity of more than 5 years, the basis point values are twice as high (minimum and maximum rates remain the same). In addition, bond issuers pay an annual listing fee of 0.16 basis point in the Official Market, 0.08 basis point in the Semi-Official Market, and EUR 72.50 in the Third Market.

²⁴ This is also true for Austrian issuers: Fixed-rate issues accounted for more than 98% of all bonds publicly issued at the Vienna stock exchange by Austrian companies from 2001 to 2003 (OeNB, 2004).

Corporate bond coupons reflect the current benchmark condition for risk-free investment²⁵ and a premium for the issuer's default risk and credit risk. Furthermore, the issuance volume may affect the coupon, which may contain a premium for a lower degree of liquidity; above all international investors buy high volumes and rate liquidity highly. Again, this means that big companies will be able to borrow at cheaper rates (and that it is cheaper to borrow over longer horizons, when high fixed costs are spread over longer periods of time).²⁶

4.5 High Credit Standards

By raising funds through the issuance of bonds, companies may reduce the risk of suddenly facing liquidity constraints should individual banks refuse to lend to them at some point. Bond creditors may typically not exercise any early redemption privileges; all they are entitled to is receiving coupon payments, repayment of the principal and regular company information. The possibility that contracts are changed after the issuance date (be it by the creditor or by the debtor) is virtually nil, as the issuing company deals with a large number of creditors, whose identities will typically not be

known to them; the sheer number of parties involved would make it difficult to handle any such changes. Credits originated by banks, by contrast, can be renegotiated more easily. In the case of temporary liquidity shortages, it is a lot easier to obtain payment deferrals or bridging loans from a single bank than from bond creditors, who may be scattered all over the world. Given the comparatively lower flexibility inherent in bond financing, potential bond issuers must meet disproportionately high credit standards, or the involved risks must be easily assessable by external investors.²⁷

Moreover, unlike bank lending, securities lending is typically not secured by collateral,²⁸ which is one of the reasons why securities lending is basically available only to companies with a fairly good credit rating.²⁹ This ties in with evidence from the OeNB's major loans register on borrower ratings.³⁰ A comparison shows that companies that have also issued bonds have a significantly better rating than companies that have taken out only loans. More than three-quarters of all corporate bond issuers, but a mere quarter of all companies indebted to banks were classified in the highest two rating bands at the end of 2003.

²⁵ In most cases, the swap interest rate applied for the given maturity period is used as a benchmark.

²⁶ There is a lack of meaningful data that would allow comparisons of bond coupon payments with loan interest rates. The volume of the Austrian market is too small at present to generate meaningful data on corporate bond coupons. At the euro area level, disaggregated coupon data are available for different credit quality categories and maturity sectors, but loan statistics distinguish only between maturities of up to 1 year, between 1 and 5 years, and more than 5 years.

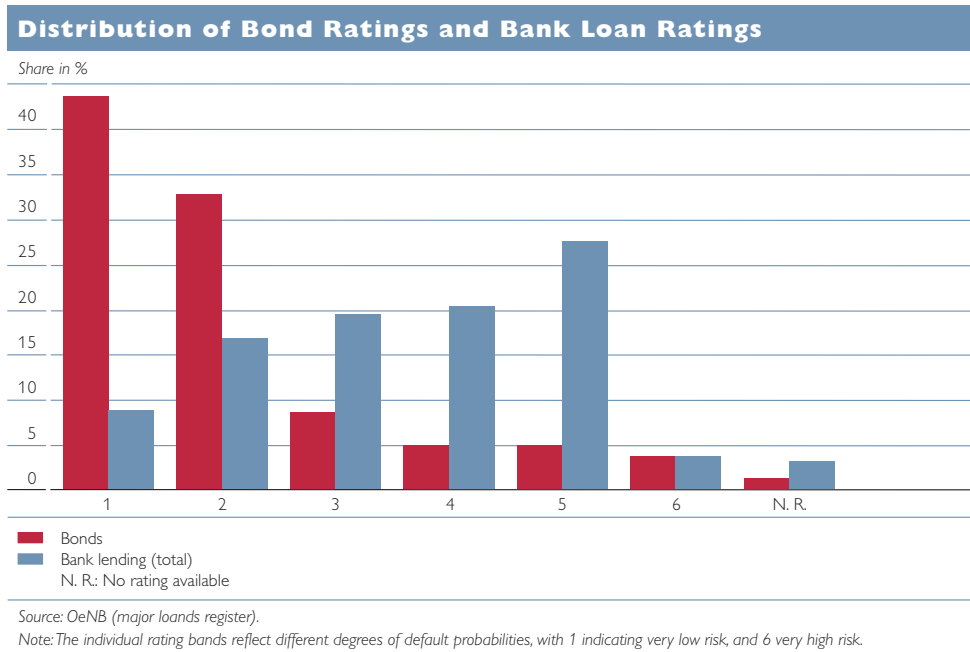
²⁷ This is true, for instance, for energy utilities, above all, when they have a monopoly, as used to be the case in the past.

²⁸ However, the terms and conditions for bonds may include covenants specifying legal requirements and performance indicators that need to be met (Zuffer, 2003).

²⁹ The avenue of bond market financing is open also for companies with lower credit ratings, but the latter face higher risk premia.

³⁰ Banks are required to report outstanding volumes of "major loans," including securitized lending, and indicate how they rate individual borrowers internally. This rating reflects only the financial health of the borrower; it does not take into consideration specific loan conditions, such as collateralization or claim subordination. The OeNB maps these risk estimations into a uniform master scale, recently adjusted in August 2004 to contain seven notches plus a default category.

Chart 3



5 Implications of Corporate Bond Financing for Financial Stability in Austria

As mentioned above, through the issuance of corporate bonds credit risk is being diversified beyond the banking system. When mutual funds or insurance companies buy corporate bonds, professional investors take over the associated risks, and they can be expected to have implemented an adequate risk management system. Retail investors, by contrast, cannot be expected to be similarly equipped. To begin with, they will not be able to diversify their risks broadly, because of the smaller amounts they invest in the first place.

Banks are typically in a better position to assess the underlying risks of

investing in corporate bonds. Through credit assessments, banks will often have access to more comprehensive information than is disclosed in bond prospectuses. In addition, they will be better informed about recent developments through regular contacts, reports, etc.³¹ Given these information asymmetries and the fact that bond creditors typically have a worse bargaining position, the risk of a change in creditworthiness is particularly relevant for bond investors.³²

In Austria, only minor incidents of credit risk have materialized in recent years. Since – as indicated above – the instrument of bond issuance is typically used by companies with a good credit rating, there have been few cases of corporate bond defaults (see table 5).³³ A total of 2.4% of all

³¹ At the same time, investors are better off if these information costs can be allocated to a bigger financing volume, which will typically be the case with larger companies.

³² In addition to credit risk, bond subscribers also incur price risk (above all when they do not intend to keep the instrument until maturity) and liquidity risk (above all in the case of smaller bond volumes and private placements).

³³ Data on bond defaults could be found for listed bonds only.

Austrian corporate bonds newly listed on the Vienna stock exchange between 1990 and 2003 defaulted.³⁴ Adjusted for repayments (but excluding forgone interest income), the default volume corresponded to 1.9% of the

underlying issuing volume, which is significantly below loan defaults; the latter amounted to 3.3% of banks' claims on nonbanks in 2003 (OeNB, 2004).

Table 5

Bonds Issued by Austrian Companies That Have Not Been Completely Repaid

	Maturity		Face value EUR million
	Begin	End	
4% Heid warrant bond 1989–1999 ¹	19.12.1989	19.12.1999	29.1
4% Maculan convertible bond 91–96 ²	07.10.1990	07.10.1996	48.0
Axioma participation bond with BÜRGES guarantee 2000 ³	01.10.2000	perpetual	0.7
Cymantix participation bond with BÜRGES guarantee 2000 ³	01.04.2000	perpetual	0.6
SHOPtoSHOP participation bond with BÜRGES guarantee 2000 ³	01.11.2000	perpetual	0.7
Educell participation bond with BÜRGES guarantee 2001 ³	01.12.2001	perpetual	1.6
6% Adcon convertible bond 02–07/Tranche A/PP ⁴	13.11.2002	14.11.2007	1.0
6% Adcon convertible bond 02–07/Tranche B ⁴	09.12.2002	09.12.2007	3.0

Source: KSV, AWS, APA, Wiener Börse.

¹ Heid offered to buy back outstanding bonds at a rate of 40% of the face value in 1997; at a rate of 28% of the bond price in 1998, and at 24% in 1999.

² Creditors were supposed to receive 40% of their claims in the bankruptcy distribution, but actually received only a rate of 10% (with the approval of the Supreme Court).

³ AWS offers natural persons a no-loss guarantee of 100% of the face value of participation bonds.

⁴ Bankruptcy was filed on September 16, 2003.

These small figures would indicate that at least the major Austrian underwriters exercise a high degree of caution in selecting bond issuers; at the same time, large issues can only be placed successfully with the involvement of a major bank. At any rate, no speculative developments have been observed on the Austrian bond market to date.³⁵

This might be taken to suggest that as the volume of bond financing grows, and since this is typically only an option for companies with a fairly good credit rating, higher risk would tend to become concentrated in banks' lending books. One factor that speaks against this assumption is that banks, too, have invested more heavily

in corporate bonds. The latter accounted for less than 2% of the volume of loans outstanding to companies at the end of 2003, however. Moreover, the risk position of banks may even improve if companies that have issued bonds put up more collateral for loans, which are typically unsecured.³⁶ The crucial point, though, is that there is a de facto limit up to which loans may be replaced with bonds; after all, as has been shown, the two types of instruments have different functions in the financing process.³⁷ A case in point is the fact that the volume of outstanding bonds does not exceed the volume of outstanding bank loans in a single country analyzed here. Furthermore, a poten-

³⁴ In addition, Omni-Holding ceased to service its Austrian schilling-denominated bond in 1991; creditors received only a small portion of their monies back. This bond had not been issued by an Austrian, but by a Swiss company - an issuing vehicle based on the Cayman Islands.

³⁵ As a result, there is no market for Austrian high-yield bonds.

³⁶ Unless specifically excluded through covenants.

³⁷ In the short-term financing category, a substitution potential may evolve should a market for commercial paper develop in Austria.

tial accumulation of higher credit risks in banks' balance sheets would only pose a problem for financial stability if such risks were not offset by corresponding risk premia.³⁸

Owing to the stepped-up issuance of corporate bonds, the risk sensitivity of external financing has improved, as corporate bond prices usually reflect the inherent risk appropriately. It is indeed possible that the better management of risk aspects in Austrian bank lending may have boosted bond financing in recent years. Bond issuance by Austrian companies may become even more attractive should risk considerations in lending continue to gain in importance.

6 Conclusions

Through the integration of the Austrian bond market into the euro bond market, which gained in liquidity and market depth thanks to the introduc-

tion of the common currency, raising funds through the issuance of bonds has become an option for an increasing number of domestic companies. Given the dynamic development of bond financing in Austria in recent years, bonds should be here to stay as an instrument of corporate finance. While the range of corporate debt financing instruments has thus broadened, bond financing is unlikely to replace loan financing even in the long term, as bonds are not equally appropriate for all borrowing requirements. Bonds are adequate for investment projects with relatively large and long-term financing needs, but will only be an option for companies with a high credit rating. Overall, bond financing should contribute to the stability of corporate finance, as it smooths access to external debt by broadening the creditor base.³⁹

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³⁸ After all, the fungibility of bonds facilitates risk allocation in the market. Investors intending to eliminate a particular risk from their portfolio may sell the corresponding bond in the secondary market; loans are a lot more difficult to transfer (even though differences in the fungibility of the two instruments are beginning to blend as the trend toward securitization continues (see Lumpkin, 2003).

³⁹ Davis (2001) has found U.S. companies to have regained access to funding, following a period of crisis, more quickly via bond financing than via bank loans.

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