ATCHISON
CONSULTANTS

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Financial System Inquiry

Private Capital Markets: Cost of Capital

Continued sound real growth in the Australian economy would be enhanced by reducing the cost of capital in the country. A lower cost of capital would be reflected in both the debt and equity markets. Opaque private capital markets prompts high cost of capital. Enhancement and extension of the capital markets into private markets would contribute to a lower cost of capital.

Exchanges which meet the highest standards of disclosure of key market information on an economical basis should be encouraged for all capital markets including private markets.

- Encourage public clearing markets for transactions in securities and assets for each sector of the capital markets
- Establish rigorous standards for information disclosure by companies and funds raising capital
- Enhance dissemination of market information and company disclosure
- Stipulate regulator role of oversight on a collegiate basis and not discretionary powers over innovation and developments
- Establish an efficient clearing process for all markets including private markets.

It is proposed that frameworks be established for information and transaction exchanges in each component of the private capital markets:

- Loans and debt
- Private business
- Commercial property
- Residential property
- Infrastructure

Comparative Cost of Capital

Analysis of the status of the cost of capital in Australia has been undertaken starting with a comparison between countries.

Table 1 below shows the range of long term 10 year government interest rates in Australia compared with selected OECD countries.

Table 1 - Long Term Interest Rates - 20 years to December 2013

Date	Australia (%)	Canada (%)	France (%)	Germany (%)	Japan (%)	Korea (%)	UK (%)	USA (%)
1994	9.0	8.3	7.2	6.9	4.4	-	8.1	7.1
1995	9.2	8.2	7.5	6.9	3.4	-	8.2	6.6
1996	8.2	7.3	6.3	6.2	3.1	-	7.8	6.4
1997	7.0	6.2	5.6	5.7	2.4	-	7.1	6.4
1998	5.5	5.3	4.6	4.6	1.5	-	5.6	5.3
1999	6.0	5.5	4.6	4.5	1.8	-	5.1	5.6
2000	6.3	6.0	5.4	5.3	1.7	-	5.3	6.0
2001	5.6	5.5	4.9	4.8	1.3	6.9	4.9	5.0
2002	5.8	5.3	4.9	4.8	1.3	6.6	4.9	4.6
2003	5.4	4.8	4.1	4.1	1.0	5.1	4.5	4.0
2004	5.6	4.6	4.1	4.0	1.5	4.7	4.9	4.3
2005	5.3	4.1	3.4	3.4	1.4	5.0	4.4	4.3
2006	5.6	4.2	3.8	3.8	1.7	5.2	4.5	4.8
2007	6.0	4.3	4.3	4.2	1.7	5.4	5.0	4.6
2008	5.8	3.6	4.2	4.0	1.5	5.6	4.6	3.7
2009	5.0	3.2	3.7	3.2	1.3	5.2	3.7	3.3
2010	5.4	3.3	3.1	2.7	1.2	4.8	3.6	3.2
2011	4.9	2.8	3.3	2.6	1.1	4.2	3.1	2.8
2012	3.4	1.9	2.5	1.5	0.8	3.5	1.9	1.8
2013	3.7	2.3	2.2	1.6	0.7	3.3	2.5	2.4
Average	5.9	4.8	4.5	4.2	1.7	5.0	5.0	4.6

Source: OECD Statistics

Table 2 below shows the range of short term 90 day government interest rates in Australia compared with selected OECD countries.

Table 2 – Short Term Interest Rates - 20 years to December 2013

Date	Australia (%)	Canada (%)	France (%)	Germany (%)	Japan (%)	Korea (%)	UK (%)	USA (%)
1994	5.7	5.5	5.9	5.4	-	13.3	5.5	4.6
1995	7.7	7.2	6.6	4.5	-	14.1	6.7	5.9
1996	7.2	4.5	3.9	3.3	-	12.6	6.0	5.4
1997	5.4	3.5	3.5	3.3	-	13.4	6.8	5.6
1998	5.0	5.1	3.6	3.5	-	15.2	7.3	5.5
1999	5.0	4.9	3.0	3.0	-	6.8	5.5	5.3
2000	6.2	5.7	4.4	4.4	-	7.1	6.1	6.5
2001	4.9	4.1	4.3	4.3	-	5.3	5.0	3.7
2002	4.8	2.6	3.3	3.3	-	4.8	4.0	1.7
2003	4.9	3.0	2.3	2.3	0.1	4.3	3.7	1.2
2004	5.5	2.3	2.1	2.1	0.1	3.8	4.6	1.6
2005	5.6	2.8	2.2	2.2	0.1	3.7	4.7	3.5
2006	6.0	4.2	3.1	3.1	0.3	4.5	4.8	5.2
2007	6.7	4.6	4.3	4.3	0.8	5.2	6.0	5.3
2008	7.0	3.4	4.6	4.6	0.9	5.5	5.5	3.0
2009	3.4	0.7	1.2	1.2	0.6	2.6	1.2	0.6
2010	4.7	0.8	0.8	0.8	0.4	2.7	0.7	0.3
2011	4.9	1.2	1.4	1.4	0.3	3.4	0.9	0.3
2012	3.7	1.2	0.6	0.6	0.3	3.3	0.8	0.3
2013	2.8	1.2	0.2	0.2	0.2	2.7	0.5	0.3
Average	5.4	3.4	3.1	2.9	0.4	6.7	4.3	3.4

Source: OECD Statistics

Table 3 below shows the earnings yields for the Australian share market compared with selected OECD countries.

Table 3 – Earnings Yield - 14 years to December 2013

Date	Australia (%)	Canada (%)	France (%)	Germany (%)	Japan (%)	Korea (%)	UK (%)	USA (%)
2000	5.4	3.6	-	6.4	1.4	-	4.8	4.1
2001	5.2	3.6	0.4	1.3	2.8	-	1.6	3.7
2002	6.6	4.8	2.5	0.4	1.3	14.9	2.0	5.2
2003	5.8	5.1	4.5	2.3	2.3	9.3	3.5	4.9
2004	5.8	5.7	8.4	6.4	6.3	14.0	6.5	5.4
2005	6.0	5.3	7.7	6.8	3.7	9.2	5.1	5.9
2006	6.6	5.7	6.9	7.2	4.3	8.0	6.4	6.0
2007	7.1	5.6	6.9	7.3	5.7	6.6	7.6	5.8
2008	11.1	7.7	7.5	5.0	3.8	6.5	3.0	6.5
2009	6.4	4.7	4.9	4.8	4.7	5.8	5.1	5.5
2010	6.3	5.1	8.3	7.9	5.4	6.9	7.5	6.6
2011	8.3	7.0	9.2	9.1	4.5	5.5	9.2	7.8
2012	6.5	6.4	6.1	7.3	4.8	4.7	5.6	7.0
2013	5.9	5.3	4.5	6.6	4.5	6.5	6.0	5.9
Average	6.6	5.4	6.0	5.6	4.0	8.2	5.3	5.7

Source: Bloomberg, IRESS

It is clear from the analysis that the cost of capital for debt in Australia is consistently higher than other developed countries. Equity cost of capital measured by earnings yield is also higher.

Factors which influence the cost of capital can be categorised into two segments:

- Macro-economic factors
- Capital market factors

Maco-economic Factors

Macro-economic factors fall into the political realms and would be incorporated as policy of the elected government. The extent of private sector influence on the size of the public sector in Australia is exercised through elections. Policy factors which are relevant are:

- Fiscal policy
- Monetary policy
- Exchange rate management
- Labor market structure
- Taxation policies

Government policy does influence other factors through tax concessions and grants. The Henry Tax Committee has addressed these issues and identified the distractions and inefficiencies which emanate from these policies.

Capital Markets

Capital markets can also be enhanced and extended through policies which can reduce the cost of capital. Features which would enhance capital markets have been addressed in particular reduction of the opaque nature of private markets.

At the outset the size of the financial markets are needed as a perspective. In Table 4 the key components of financial markets are identified:

Table 4 – Financial Markets – December 2013

	Australia ($b)
Commercial Loans	720
Residential Loans	1,200
Personal Loans	1,300
Debt Market	1,200
Share Market	1,500
Private Business	4,800
Property - Residential	4,200
Property - Commercial	700
Infrastructure	1,200

Source: RBA, Deutsche, NAB, CBA, Iress, Australian Centre for Financial Studies, Ibis

It highlights the dominance of bank lending, private businesses and residential property in Australia. Other than the share market all components of capital markets are private markets.

Further development of capital markets through removal of the veil over private markets would have a beneficial impact on the financing arrangements. Shallow capital markets result in domestic companies beyond the largest 100 – 150 listed companies being the captive of short term loans from local banks as the primary source of capital. Short term loans for long term business growth introduces uncertainty regarding the continuing supply of capital which reduces the extent of business growth and leaves vulnerability in time of credit squeeze.

When capital markets are further developed prospectively sustained equity and debt capital would be available both from domestic and international sources. Forms through which capital markets would be expanded are addressed after considering the key factors for their development. In this analysis derivatives, including over the counter contracts, are considered as part of each component of capital markets. A response from the global financial crises was that all derivatives should be traded on electronic platforms, recorded in central clearing houses with centralised reporting.

The factors affecting further development of capital markets include the following components:

- Transparency
- Information disclosure
- Liquidity
  - Transaction costs
  - Bid/offer prices
  - Turnover
- Regulatory regime
- Clearing houses

Transparency

Inefficiency of the capital markets through lack of transparency exists in the loan and debt markets. There is no transparency regarding prices being interest rates or yield in these markets. Loan terms are provided privately by lenders. It is a private market operated largely by an oligopoly of the major banks in Australia under the four pillars policy with some boutiques. Provision of open clearing market information platforms would reduce this flaw. Loan and debt markets in aggregate are the largest capital markets in Australia. Securities exchanges do not necessarily increase transparency although they do represent a step in the desirable direction. Public clearing markets require buyers, sellers and market makers with disclosure of prices and volumes of transactions. This provides price discovery for participants. Debt markets are the subject of greater transparency than loan markets but are also opaque.

A monopoly, effectively through the ASX, limits expansion of activity and transparency. Regulations are correctly focused on ensuring system stability. Unfortunately they apply a perspective that perceives innovation as introducing instability thereby reinforcing the monopoly.

In an era of industry specialisation it is unlikely that a securities exchange would be proficient in all components of capital markets. ASX is excellent in shares. Specialist capabilities are required in each of the components of the financial markets.

Information Disclosure

Publication of key information would enhance disclosure. Key information in the debt markets surround the factors which include interest rates/yields, maturity/term and credit.

Information can be provided through a public disclosure mechanism which in an electronic environment is readily achieved. Disclosure must be meaningful in terms of the understanding by the general public not solely professional participants. Standards for research would be established as part of enhanced disclosure.

Stipulation regarding disclosure of relevant information is the essence of increasing the enhancement of the debt capital markets.

While credit assessment is a science the basic proposition of gearing is clear. A debt is a debt. Priority security of debt is clear. Accounting standards which stipulate the loan to value ratio, interest cover ratio and long and short term liabilities should be feasible and should be available for public disclosure.

Private debt markets currently are hidden from efficient capital markets by lack of disclosure of relevant terms of issues. A requirement for public disclosure by information providers as a requirement of any capital raising under clear guidelines would enhance this market. It would not be a discretionary decision whether an applicant for capital raising should be approved. Rather it is whether the disclosure standards have been meet.

Within equity capital markets the primary source of capital are the security exchanges. The role of an exchange is as follows:

- Facilitate capital raising for primary issuers
- Provide liquidity for secondary issuers
- Provide pricing for capital raisings
- Ensure financial disclosure standards
- Enhance corporate governance

Certainly the publicly listed companies have access to equity capital raising with the pricing of the capital determined through the public market. Manipulation may be possible but regulatory oversight will ensure that it is not sustained.

Private equity is a much larger part of the market place. Private market disclosure is limited and leads to inefficiency and higher cost of capital. A requirement of high standards of public disclosure by information providers would enhance this market. Information required would be on both the demand and supply side of any investment proposition.

On the demand side business financials and plans would be disclosed. On the supply side the structure of a financial arrangement being equity, convertible debt or debt would be stipulated.

Private markets can result in the illinformed being at risk from poor practice by capital providers or seekers. Second tier exchanges have emerged in the past. They have generally disappeared. The role of information disclosure and the pricing of capital through secondary market transactions are significant. In an electronic environment information dissemination can be provided readily.

Real assets including property and infrastructure suffer from the same lack of information as private equity. Provision of information disclosure standards and data for capital pricing can be provided through electronic systems. Requirements in Australia for raising infrastructure capital are inhibited by the lack of transparency. Private markets can provide advantage for informed participants at the expense of the uninformed.

A regulator such as ASIC can provide oversight over standards of disclosure as an extension of current practice. Standards for research would also be established.

Liquidity

Liquidity in investments being securities or assets impacts on the cost of capital. High liquidity reduces the cost of capital. As liquidity reduces the cost of capital will increase. Real assets are particularly illiquid.

Components which impact liquidity include transaction costs being brokerage, commission, fees and government charges. Bid/offer price spreads are higher with less liquidity and where underlying transaction costs are high. The impact reflects the need for a buyer or seller to cross the spread before transactions can occur. Greater public information about pricing and business information will reduce bid/offer spreads. Lack of information and lack of analysis of information leads to imbalance in market knowledge and liabilities in transaction activity.

Turnover and liquidity is a virtuous circle. Increased turnover means greater liquidity and prospectively lower cost of capital. High turnover reflects participation by traders on the market. Traders are dependent on public disclosure of pricing. Electronic systems which provide this information can be developed readily. High frequency trading systems on security exchanges provide enhanced liquidity with possibly the consequence of excessive short term volatility. Dark pools are the antithesis of public disclosure

Regulators

Roles of regulators would be directed at applying public policy of ensuring stability of the operators in the financial system. Encouragement of consolidation in industry is not necessarily sound public policy. Discouragement of innovation which ensures continuation of monopoly or oligopoly is not sound public policy. Principles of quality regulations are well outlined by public policy groups globally. Stimulation of competition is a strong basic principle.

The principal role of regulators is oversight of the system ensuring stability. A collegiate basis of oversight is encouraged. Discretionary power over innovation and development are not desirable.

Clearing House

In the electronic environment available enhancing all factors can be achieved by encouragement for new participants rather than protecting the current state.

One monopoly that requires change is the clearing house. There is a need for a system where changes in ownership of investments can be facilitated. Registers of owners exist but a common clearing house mechanism is essential in an efficient market. By its nature it is a monopoly or oligopoly unless common protocols by all ownership registers is developed.

A clearing house is a financial institution that provides clearing and settlement services for financial and securities transactions. These transactions may be executed on a futures exchange, securities exchange or over the counter.

Once a trade has been executed by two counterparties, a clearing house assumes the legal counterparty risk for the trade. This process of transferring the trade title to the clearing house is called novation. It can take seconds in highly liquid markets; or days, or weeks in some private markets.

Comment

Enhancement of the capital markets resulting in lower cost of capital can be achieved. The factors involved are:

- Increased transparency of market pricing
- Increased information about securities and assets
- Enhanced liquidity
- Marginally extending the existing regulatory regime and limiting the role
- Establish an efficient clearing process for private capital markets