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A REVIEW OF THE CORPORATE BOND MARKET IN MALTA

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BOX 3: A REVIEW OF THE CORPORATE BOND MARKET IN MALTA

Since the onset of the financial and sovereign debt crises, tighter financial conditions were observed as liquidity dried up particularly in wholesale markets. As a consequence, central banks around the globe responded with the implementation of non-standard monetary policy measures and stricter regulatory requirements. The latter have restricted the banks' willingness to lend, and in turn brought about some tightening in their lending standards. Such developments were also observed domestically; as banks became more cautious in their corporate lending decisions mainly due to concerns arising from the general economic activity and industry or firm-specific developments. At the same time banks had to actively safeguard their capital buffers in anticipation of more onerous regulations. Lower bank credit however also reflected demand-side developments. While the impact of the recession on Malta was less severe and lasted less than in other euro area countries, NFCs have lowered their demand for credit. As the economy recovered, demand for bank credit by NFCs did not return to previous levels as corporates opted to use alternative funding sources, either using own funds or via intra-group lending which grew in relevance compared to bank lending.[1] Furthermore, NFCs tapped other alternative funding sources, namely that of market funding with the issuance of debt securities, enabling them to take advantage of the more favourable funding conditions resulting from abundance in liquidity and a low interest rate environment. The latter was also reported across the rest of the euro area, where issued debt by NFCs increased, noticeably.

Despite this, the share of debt securities in total debt financing of resident NFCs remained more contained in Malta compared to other euro area countries. Results from the Survey on Access to Finance (SAFE) show that domestic small and medium enterprises (SME) remain considerably more reliant on bank funding when compared to firms in other EU countries, though access to finance does not seem to be their main concern.[2] The latter could possibly be due to the number of initiatives to address the barriers faced by SMEs. Banks have collaborated with the European Investment Fund and launched various lending programmes targeting SMEs to obtain easier and cheaper bank credit, which require less collateral requirements. Meanwhile, the MSE launched the National Capital Markets Strategic Plan in October 2016 with the objective to develop a liquid and efficient securities market. The MSE also provided SMEs with the opportunity to issue bonds or equity through the use of the Prospects multi-trading facility (MTF).[3] By end 2017 this platform was tapped by four domestic companies with a total nominal value of €11.7 million in bonds issued. This, however, can be considered to be still in its infancy compared to the size of the regular capital market, representing just 1.0% of total outstanding (non-bank) corporate bonds.

Trends and characteristics of bonds issued on the MSE

In recent years, the number of non-bank companies quoted on the MSE surged with outstanding debt issued doubling since 2011 to just below €1.2 billion (see Chart 1). This trend accentuated the disintermediation process, and is considered to be beneficial for financial stability through the diversification of credit risk among diverse market participants, while at the same time fostering the growth of the local capital market. Nevertheless, concerns for investors still remain as bonds do not carry similar safety nets as in the case of bank deposits and are also subject to market movements and interest rate risks. This is particularly important for retail investors given their significant exposure. The main holders of non-bank corporate bonds listed on the MSE were resident households, with their share in such bond holdings remaining relatively stable since 2011, standing at about 81% of

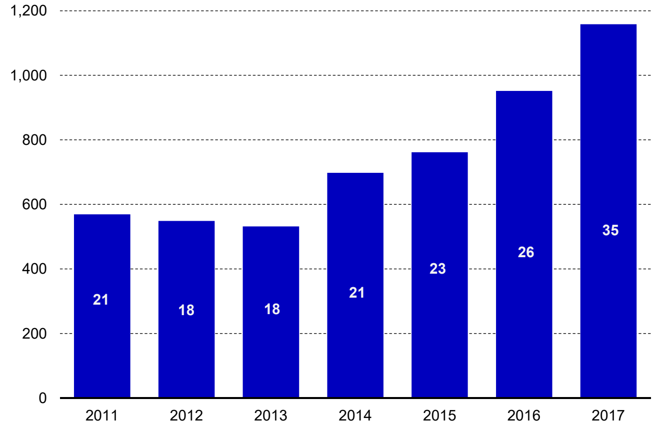
1 J. Darmanin, '*The financing of companies in Malta*', Central Bank of Malta, July 2017.
2 European Commission (2017), '*SME access to finance conditions 2017 SAFE results – Malta*'.
3 https://borzamalta.com.mt/markets-prospectsmtf.

the outstanding NFC bonds as at end 2017. The second largest holders of corporate debt are financial institutions accounting for about 14% of the outstanding bonds in 2017, largely as units in collective investment schemes (non-MMFs) (see Chart 2). The share of non-bank bonds held by non-residents increased over the years but remained contained at 3.4% in 2017.

Out of the outstanding bonds listed on the MSE, only about one-fourth were secured, whereas almost half of the corporate bonds were guaranteed by other related companies or guarantors (see Chart 3). Furthermore, less than 7% of outstanding bonds required the setting up of a sinking fund to support the repayment of these bonds.

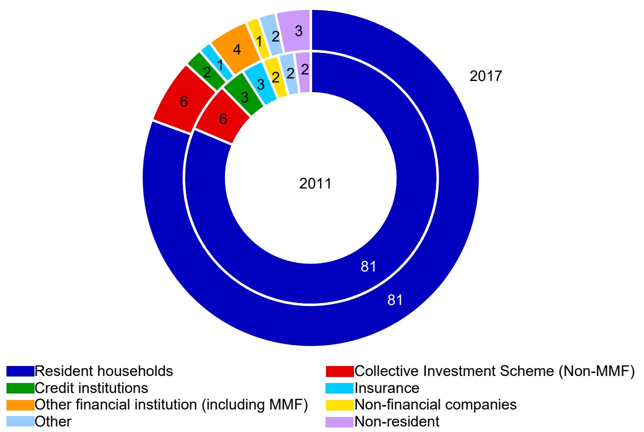
About 4.5% of the outstanding bonds are callable where the issuers may redeem all or part of the debt before the specified maturity date. Typically, the issuer exercises this call when yields fall below the coupon rate. Consequently, the investor will be faced with re-investment risk at the prevailing market rates. Moreover when yields fall, the potential holding gain is not realised if the issuer calls in the bond at par. However, investors are generally compensated through higher yields via a bond premium. The latter could be one of the reasons why this practice is limited; coupled with the fact that around 40% of outstanding bonds issued were specifically to roll-over exiting debt. An additional 22% was used to repay outstanding bank loans or other debt. Consequently, over 60% of issued debt was utilised to refinance existing debt. To date, the market has been rather accommodative to roll over such debt, even at lower yields. However if investors' (which are mainly retail in nature) preferences should change and invest their excess funds in other assets, NFCs may face higher funding costs, which in turn, will hamper their profitability. This risk is particularly relevant for those bonds which do not have underwriters. The remaining 37% of the net proceeds of bonds were used to finance further

Chart 1
BOND ISSUANCE BY NON-FINANCIAL CORPORATIONS
(EUR millions)



Note: Includes also financial holding companies. The figures in the bars refer to the number of issuers.
Source: Malta Stock Exchange.

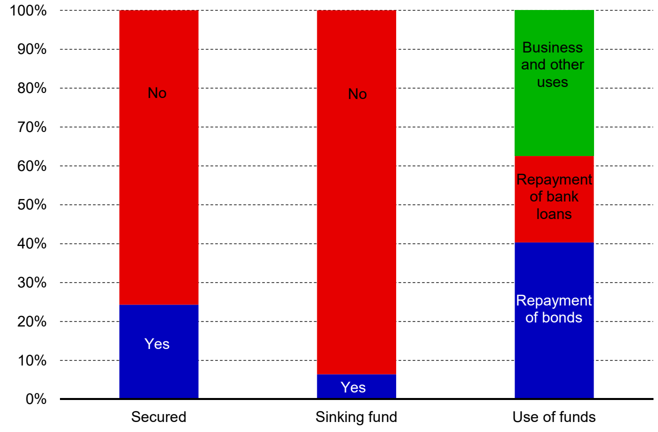
Chart 2
OWNERSHIP OF OUTSTANDING NON-BANK CORPORATE BONDS
(per cent)



Source: Malta Stock Exchange.

business activities or for general funding purposes, including the purchase of real estate for business purposes (see Chart 3).

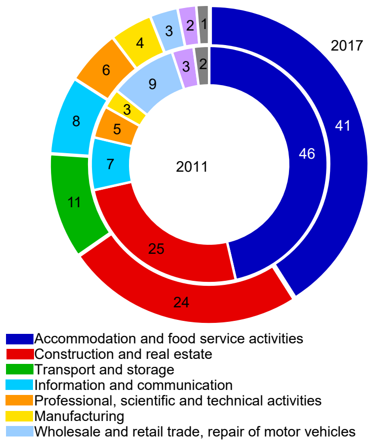
Chart 3
CHARACTERISTICS OF CORPORATE BONDS – OUTSTANDING BONDS AS AT END 2017



Sources: Malta Stock Exchange; Central Bank of Malta workings.

Apart from higher bond issuance, the disintermediation process is clearly visible when identifying trends in bank credit by key economic sectors. The main sectors which reported higher bond issuance are the same ones which reported lower borrowing from banks.[4] Between 2011 and 2017, the accommodation and food and services activities maintained its position as the sector which issued most bonds, up by €210.4million (79.7%), to account for about 40% of the outstanding bonds in 2017 (see Charts 4 and 5). Such increase offsets the drop in bank credit towards this sector which during the same period declined by 34.9%, equivalent to €160.2 million.

Chart 4
OUTSTANDING BONDS BY SECTORS
(per cent)



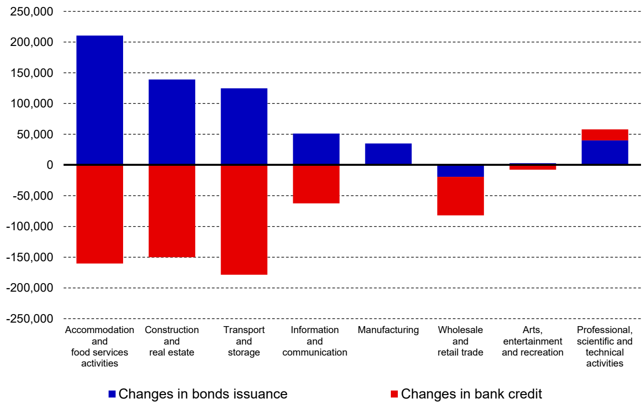
Sources: Malta Stock Exchange; Central Bank of Malta.

Similarly, corporates active in the construction and real estate markets increased their issued debt, up by €139.0 million (97.1%) to account for 24.4% of the outstanding corporate bonds as at end 2017. Meanwhile, resident loans to the construction and real estate sectors declined significantly by about €150 million, or 10.7%. A similar trend was observed in companies operating in the transport and storage, and the information and communication sectors. For these two sectors, outstanding bonds rose by around €125 million and €50 million, respectively, while bank lending declined by about €178 million (-45.6%) and €62.5 million (-54.9%), respectively.

[4] As most bonds are listed by holding companies, which are classified in the 'Financial and Insurance activities' sector, the NACE of the group was used were necessary. When this was not possible, the purpose behind the bond issue was assessed and classified accordingly.

The wholesale and retail trade sector reported lower outstanding bonds and bank lending, while the professional, scientific and technical activities reported increased outstanding debt, both in terms of bonds and bank credit.

Chart 5
CHANGES IN OUTSTANDING BONDS AND BANK CREDIT OF SELECTED NFC SECTORS (2011-2017)
(EUR millions)



Note: Bars show the changes in bond issuance and banks credit between 2011 and 2017.
Sources: Malta Stock Exchange; Central Bank of Malta.

Advantages of disintermediation through higher bond issuance

Both supply and demand factors contributed to the strong growth in corporate bonds issued on the MSE. Such shift to the corporate bond markets gave corporates access to more diverse sources of funding and also offered more investment opportunities to investors. This partly reflected the development of Prospects MTF by the MSE, which created new capital market opportunities for SMEs, with the increased access to the capital market, leading to more efficient utilisation of capital resources by enterprises. In addition, higher reliance on market funding gave NFCs the opportunity to lock-in lower funding costs ahead of a possible turn in the interest rate cycle. The weighted average interest rate for outstanding bonds indeed declined from 6.6% in 2011 to 4.7% in 2017, with all sectors reporting drops. These yields however remained higher when compared to the weighted average interest rate of bank lending. Over this period, however, the spread between the two weighted average interest rates almost halved converging to just 0.7 percentage point in 2017. The spread could also be attributed to the differences in maturity terms.

Debt securities financing however also provided NFCs with longer-term maturities and, possibly, with less conditionality than those imposed by banks when taking up loans. Moreover, the terms of issuance can be customised to the corporates' needs, providing corporate issuers with more flexibility and larger access compared to bank funding. Debt securities financing, relative to bank credit, help issuers to improve their cash flow, although issuers should not rely on the possibility of rolling over debt securities as market conditions may change over time, and therefore should act prudently and build a sinking fund through the life of the security.

At the same time, as NFC funding shifts from the banking to the capital market, risk and rewards are divested amongst a broader base of bond holders. Retail investors are able to obtain a higher return than from bank deposits reflecting differences in relative risk, which are further accentuated in the current low interest rate environment, providing alternative investment avenue other than real estate. Thus, the disintermediation process through the deepening of the bond market addresses concerns derived from tightened bank credit conditions, bringing positive contributions to the economy, and offering various advantages to both issuers and investors.