Why a corporate bond market: growth and direct finance

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In my remarks today, I provide a brief overview of the role of direct corporate borrowing versus bank loans in the process of economic development. In the earliest stages of economic development, firms finance investment by building up savings from internally generated funds. Self-funding is supplemented by loans from close relatives, extended family members, friends in the community and the like. Such “inside” funding overcomes information and credibility problems, and provides an incentive for owners to use the funds energetically, as promised. The borrower is bonded by its close relationship to family and community. Indeed, close relationships monitor the borrower’s behaviour and can enforce discipline on the borrower if need be.

As an economy develops, self-funding and inside funding become insufficient to finance firms that must manage complex production processes and serve broader markets. Firms must attract additional financing from external sources. Banks arise to provide information-intensive external funding, and, in effect, recreate the kind of information, bonding and monitoring that come with family relationship lending, only with more funding. The cost of external funding through banks involves credit evaluation, loan monitoring, and a component to allow for the risk of default and the cost of managing a default if it occurs. These costs of external finance create an external finance premium that a borrower must pay over and above the opportunity cost of self-funding or funding from close associates.

As an economy continues to develop, some firms need increasingly large external funds. Firms that are widely known can bypass information-intensive bank lending and access lenders directly with corporate bond funding. In the 19th century, railroads were among the first large-scale enterprises in the United States to borrow directly with long-term corporate bonds. Railroads were able to utilise direct bond finance because they had a relatively transparent public image and a physical capital structure (railroad tracks and cars) that was relatively easy to monitor. Hence, railroads reduced their external finance premium by borrowing directly from the public. More generally, firms with a good public image, which produce a product that is widely used and easily monitored, have an incentive to bypass bank loans in order to exploit their transparency to lower their external finance premium.

Nevertheless, firms with direct access to the bond market continue to fund themselves in part with bank loans because banks provide a number of other financial services. These include: backstop financing with a line of credit; access to debtor-in-possession borrowing in the event of bankruptcy; customised borrowing (as opposed to standardised debt instruments used to access the credit market directly); and confidential borrowing, for instance when secrecy is needed for a borrower to appropriate the returns to investment financed with external funds.

In addition, a firm that chooses to access the credit market directly with bond finance also needs investment banking services. For instance, bonds sold by railroads in the 19th century United States were underwritten by elite Wall Street investment banks. Investment bank services include: an endorsement of the creditworthiness of corporate bonds; the pricing and sale of initial public offerings; the marketing of bonds overseas; a market in which the corporate bonds can be bought and sold; the leadership of a creditor committee in the event of a default; and the leadership of equity receiverships in judicial reorganisations during bankruptcy.

Too much reliance on bank loans or direct bond finance, however, exposes a firm to excessive risk of bankruptcy in the event of default. Hence, in developed economies firms have come to rely on a portfolio of external finance that usually includes substantial equity, as well as bond and bank loan finance. Equity finance gives a firm financial flexibility in the choice of the payment of dividends -

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flexibility that a firm can utilise to avoid default on bank loans or bonds. Outside equity, however, involves a cost of its own: too much of it blunts the incentive of managers to run a firm efficiently because external ownership allows managers to retain only a fraction of every dollar of value they create for the firm above revenue needed to pay off fixed obligations, which include debt and fixed salaries. Therefore, equity, bank loans and bonds generally coexist in the capital structure of modern corporate borrowers.

A market for direct debt also improves the incentive for banks to remain efficient and to innovate. A market for short- and long-term corporate debt disciplines and ultimately strengthens the banking system by providing competition for information-intensive bank loans at the margin. Banks have an incentive to be efficient in order to retain clients with actual or potential access to direct finance. A market for direct debt encourages banks to innovate because products initially created and customised by banks often have the potential to be commoditised, standardised and moved from banks to capital markets, which provide them at lower overhead cost. In the United States, bank loans and bankers' acceptances predated commercial paper and other direct money market debt. More recently, banks helped to create money market mutual funds, futures markets, junk bonds and asset-backed securities, all of which then moved outside the banking system to a large degree. By encouraging innovation, competition among banks and non-bank financial markets helps to improve the distribution of financial risk in the economy and lower the cost of external finance.

The growth of non-bank debt finance also improves the resilience of the financial system. Chairman Greenspan has emphasised this "spare tyre" role of the capital market - direct, non-bank bond finance - in cushioning the effect of financial distress on the macroeconomy. In a well-known 1999 speech, Chairman Greenspan emphasised that "[m]ultiple alternatives to transform an economy's savings into capital investment provide back-up facilities for credit flows should primary intermediation fail".[2] He noted, for instance, that the 1990 collapse of real estate collateral that hurt bank lending in the United States did not interrupt mortgage lending much because of the deep market in mortgage-backed securities. He also pointed out that the protracted banking crisis in Japan hurt the macroeconomy more than might have been the case if non-bank capital markets had been widely developed in Japan.

I would like to conclude by emphasising that long-term, local currency corporate bonds can efficiently hedge real future retirement, pension, life insurance and entitlement commitments. However, such bonds can do so only if the purchasing power of the currency is preserved over long periods of time. A credible domestic monetary policy is necessary for long-term, local currency corporate bonds to be demanded domestically as a hedge against long-term commitments. The demand for local currency corporate debt abroad also depends in large part on confidence in a stable purchasing power of local currency. In the 19th century, US railroad bonds were marketed successfully in Great Britain in large part because the United States was on a gold standard.

On the other hand, the public is greatly disadvantaged if it must hold retirement savings in short-term bank deposits. Households forced to save in bank deposits earn relatively low interest on average, and they are exposed to the risk that short-term interest rates might fall to very low levels for long periods of time. So, bank deposits are a poor hedge against retirement needs. If the government stabilises the purchasing power of the currency credibly, and households can hold their savings in a diversified portfolio of high-grade, local currency, long-term corporate bonds, they can earn a higher stable real return with relatively little credit risk.

[2] Greenspan, A (1999): "Do efficient financial markets mitigate financial crises?", speech at the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, 19 October.