COMMENT ON CURRENT FINANCING TECHNIQUES

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As indicated by Elizabeth Nosworthy in the main paper presented on this topic, the development and either continuing viability or continued availability of financing techniques and sources relevant to the mining and energy sector, is being impacted both by regulatory changes and broader economic/financial developments in the Australian and overseas capital markets.

The regulatory changes involve primarily taxation changes impacting on various forms of tax effective financing which have been utilised in the financing of mining and energy projects. Also under the heading of regulatory change, and somewhat in parallel with development of a more restrictive tax environment, one can see a similar desire to look more closely to the overall substance of transactions in the interpretation of accounting standards directly relevant to certain financing techniques such as leasing. This is a subject on which the writer will comment later, as the changes are not confined to interpretation of existing standards. New standards relevant to financing are also being introduced such as in the area of defeasance (AAS23) and balance sheet consolidation (ED40), although the latter remains in draft form only at this stage having met resistance from a number of quarters.

OFFSHORE CAPITAL MARKETS ISSUES

One of the suggested financing approaches for discussion was access to overseas capital markets issues. This avenue of financing was not developed in Nosworthy's paper which expressed the view that this market may not be as readily available for borrowers in the industry. In commenting on the main paper the writer would first like to explore the question of access and availability which is one of relative importance and not of course a black and white issue. Clearly certain borrowers are continuing to access offshore capital markets. However, what the writer's comment does intend to convey is a couple of thoughts which are worthy of expansion:

— firstly, access to international capital markets issues is more restrictive than may sometimes be thought, and certainly greater volatility exists in certain markets today that have seen very rapid growth over the last few years (for example — developments in the EuroA$ Bond market which will be elaborated on later); and
— secondly, developments in the Australian market that perhaps make medium to long term domestic borrowings relatively more available and attractive.

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Offshore borrowings will usually require addressing a number of risk management considerations related to foreign currency exposure: hedging through the foreign exchange forward market, availability of natural hedging, currency and interest rate swaps, tax and accounting treatment of foreign exchange gains and losses, and withholding tax. It is intended to elaborate on interest withholding tax only. The mechanism and motive for interest rate and currency swaps is discussed in the main paper and in any case, most borrowers today are more aware and competent at managing interest rate and currency risk. In the mining and energy industry where sales contracts may be export oriented, foreign currency earnings will provide a natural hedge and motivation for an offshore borrowing. In fact, over the past six months the impact of currency risk has not been felt on borrowings, but an appreciating Australian dollar has certainly impacted on those with an unmanaged position on sales contracts written in US dollars.

Traditionally, the source of offshore funding sought for major financings has been international syndicated loans incorporating, where applicable and available, sources of export credit financing. Conventional one bank or syndicated loans have tended to move out of favour over the past five years. This has reflected firstly a world trend away from balance sheet/margin lending to a greater emphasis on creating various forms of securities that are able to be distributed to a wider group of lenders/investors. The motivation for the banks has been an escape from harrowing lending margins achieved on conventional facilities through competition, as well as constraints on balance sheet capacity to hold on to assets. The appeal of securities issues from the borrower's perspective has been access to a wider source of funding and from an eligible Australian borrower's perspective a potential avenue around interest withholding tax.

The withholding tax consideration is the second factor that has influenced the attraction of conventional sources of offshore funding. Avoiding a withholding tax liability has always been an overriding concern for Australian borrowers. Currently, very few banks will absorb withholding tax and those who will generally will not provide a long term absorption commitment. The Japanese banks are now virtually the only banks who will. An alternative source through Belgium seems likely to close as anticipated tax changes in that country will not make it attractive for Belgian banks to absorb withholding tax in the future.

The alternative to finding a lender who will absorb withholding tax, is to source funding through an offshore securities issue which satisfies the exemption provisions under section 128(f) of the current taxation legislation. Essentially, the only exemption available under section 128(f) is for a widely distributed securities issue such as the following:

- US$ Eurobonds
- US$ Note Issuance Facilities
- A$ Eurobonds
- US$ ECP
- US$ Bankers Acceptances
- US$ Domestic Commercial Paper
- A$ ECP

A number of these avenues to offshore funding are only available to government authorities, major financial institutions or major corporates who directly — or by way of a parent company guarantee — have the necessary US market rating from Standard & Poors or Moodys (as required for a US$ domestic CP issue).

From the viewpoint of Australian corporate borrowers in the mining and energy industry, the best known but not easily accessible sources of funding through overseas securities issues would be: US$ Note Issuance Facilities (Euronotes or NIF's) and A$ Eurobonds.

Euronotes are accessible by all large Australian corporates and provide a medium to long term (five years, and longer for top credits) commitment usually by a group of banks providing or guaranteeing to provide funds to the borrowers. Against the commitment given, these issues allow the borrower to issue short term (three to six month maturity) Euronotes. These Euronotes are issued through a number of alternative marketing structures, such as tender panels or a placing agent. The participating banks act as underwriters, being committed to purchase Euronotes that either cannot be placed with final investors, or, cannot be placed at or below an agreed upon interest rate. These notes are normally priced at a margin relative to LIBOR (a floating rate benchmark for pricing of US$ facilities). The presence of the underwriting banks thus serves to guarantee that the borrower can always raise funds up to the full amount of the facility at known interest costs over its full term. In addition to the interest on actual funds being raised, the borrowers usually have to pay an underwriting and arrangement fee. Additional utilisation and/or commitment fees may be payable depending on the structure of the individual facility.

Over the past five to seven years an avenue to securing medium term fixed rate A$ funding through offshore markets has existed through the A$ Eurobond market, although particularly since the stock market crash the reliability of, and access to, this market has become more restricted.

Nevertheless, it is a market that has developed strongly over five years to mid 1987. A feature of this market is that it is essentially retail based meaning that A$ paper on issue is ultimately held not by institutions but by European (Benelux, German and Swiss) investors whose return and thus enthusiasm for the paper is sensitive to prevailing interest rates and A$ exchange rate outlook at the time of issue.

A large part of the growth in the market has also been accounted for by 'swap driven' issues by non-Australian borrowers, particularly European banks and international corporations such as IBM. The motivation of these borrowers in undertaking an A$ issue is not to secure A$ debt, but rather to access through the subsequent swap, say, floating rate US$ funding at pricing superior to what they could achieve from a direct US$ borrowing, with this advantage achieved having regard to interest and exchange rate differentials. For the Australian counterparty, a source of fixed rate A$ funding is obtained at a cheaper rate than could be raised domestically. Again, the nature of this swap arrangement shows the sensitivity of this market to any volatility in interest and exchange rate movements, and thus there tend to be windows of opportunity for accessing this market which come and go. Very often the Australian counterparty in these swap driven issues is a financial institution, having the acceptable credit standing and happy to access a source of fixed rate A$ funding to be utilised in subsequent lending activities.

The retail investor base to this market perhaps adds to its sensitivity. This will also tend to limit eligible issuers because investor familiarity with the borrower's name is an important component for success. Thus, it can be seen that while figures quoted for growth of this market are very large (reportedly some A$12 billion in 1987), this is not indicative of wide access by Australian corporates.

DOMESTIC CAPITAL MARKETS ISSUES

A principal factor responsible for the past growth in markets such as the A$ Eurobond market as a source of medium term fixed rate funding has been the relatively cheaper cost against a domestic borrowing of similar term and the virtual absence of any corporate bond market in Australia.

In any case, as indicated, the offshore market has been relatively restricted. There is no doubt that this access has become even tighter because of the stock market crash and the resulting so called 'flight to quality' by investors. Those borrowers looking to more traditional sources of offshore funding suitable to project financing requirements have needed to manage the additional considerations of currency risk and added cost borne through interest withholding tax. At the same time, the capacity of Australian banks to deal with the size of major project and equipment financings has undoubtedly been growing. In addition, the source of domestic funding for such financings has widened by reason of Australian banks and financial institutions being able to participate in forms of tax effective financing such as leveraged leasing and unit trust arrangements described in the main paper. The cost of financing achieved through these arrangements has been competitive with traditional sources of offshore funding.

However, if the scale of tax effective financing is now likely to reduce and borrowers required to return attention to more conventional sources of funding, what will be the domestic capital markets environment available to support this? As an added factor in this equation, the capacity of project sponsors to look at the equity markets in the short term has obviously been impacted by the stock market crash, and certain industries such as gold, which particularly benefited from the strong equity markets of one year ago, are now required to focus on other alternatives and, hence, the relevance of the discussion on gold loans covered in the main paper.

AUSTRALIAN CORPORATE BOND MARKET

One of the possible consequences of the share market crash and the associated reduced access to and interest in equity markets by borrowers and investors respectively, has been considerable discussion of the possible re-emergence of a corporate bond market in Australia. To this point there have only been a limited number of issues, but these have been successfully placed and it remains to be seen how far and fast this market will develop.

While the share market crash has no doubt been a factor providing an impetus to this market, it is not the sole consideration. As indicated above in the discussion on A$ Eurobonds, one of the reasons that this offshore market was able to develop so rapidly has been the relatively high level of interest rates in Australia over the past several years. The past six months has seen a sizeable fall in medium to long term bond rates in Australia at the same time that increased volatility and unpredictability has come into the A$ Eurobond market.

An additional key impetus from the investor end has been a growing shortage of fixed interest paper from Commonwealth and semi-government securities issues, a reflection of the dramatic reduction in the public sector borrowing requirement. Total Commonwealth, State and local government borrowing requirements in 1988–89 are expected to decline to something like 1.4 percent of GNP compared to a 1984–85 figure of 5.1 percent. As a consequence of this reduced availability of government paper, domestic institutions have shown greater interest in taking up prime corporate paper.

For the present, with somewhat reduced exposures to major corporates that institutions have through the equity market, institutions appear to be prepared to take up and hold fixed interest corporate paper. Partly for this reason but more because there has only been a limited number of primary issues to date, there has not to this point been any effective secondary market developed for this corporate paper which will probably be a necessary step if the market is to fully develop, attracting broad institutional investor support including from overseas.

What are the characteristics of corporate bonds — sometimes described as unsecured notes — and what issues have been undertaken? Medium term fixed rate unsecured notes is a more meaningful description as issues to date have been three to five years with the fixed interest cost priced at a margin over Commonwealth bonds of equivalent term. Some premium is reflected in this margin for the unsecured nature of the notes (ranking them behind secured borrowings) and lack of liquidity in the market at present. Stated margins have varied between 85 basis points for an $80 million underwritten issue for BHP Finance (arranged pre October crash) and 140 basis points for $75 million issue for Shell. Other issuers have been Australian Industry Development Corporation, State Bank of Victoria and Pioneer Concrete. A number of these issues have been sold as virtual private placements, but even so the range of pricing achieved is competitive with the A$ Eurobond market and compares with pricing achieved by semi-government authorities at a margin over Commonwealth bonds of 90 to 115 basis points. Finally, the unsecured notes taken to the market to this point have not been in the form of bearer instruments but registered and would likely attract interest withholding tax for overseas investors which may prove a constraint to development of this market. However, the writer believes this is a constraint that can be readily overcome as the market develops.

A$ PROMISSORY NOTES

This is an A$ domestic market facilitating the issue of short term securities broadly in an equivalent manner to the Euronote market described earlier; that is, a group of Australian banks commit to a medium term facility against which short term promissory notes are issued usually by way of tender panels. Again, pricing — which in this case is expressed as a margin over the domestic Bank Bill Rate — is usually capped at an underwritten rate and the group of underwriting bankers will be obliged to take up paper at this price if it is not able to be sold at the underwritten or better price through the tender panel process.

The promissory note market has been available to a broader range of corporates, and pricing was usually quite competitive to comparable Bank Bill funding prior to October 1987. The impact of the stock market crash was followed by an immediate period of uncertainty in the promissory note market and while there has been some correction of this situation, access to the market is not as widely available as before. For those issues that have proceeded, margins sought have tended to be higher than pre October 1987 and some corporates may no longer find it cheaper than funding on a Bank Bill basis.

A further issue of a regulatory nature that threatens to impact on the promissory note as well as certain other markets, is the whole question of capital adequacy requirements which the Reserve Bank of Australia (RBA) is presently working to see introduced. Presently, the underwriting commitments that banks take on in supporting a promissory note issue are not counted for purposes of capital usage and thus effectively represent off-balance sheet business. The RBA proposals for capital adequacy would change this situation and apply a 50 percent capital usage factor to underwriting commitments on facilities such as promissory notes and Euronotes. These arrangements, if implemented, will make banks more selective about underwriting commitments and/or increase pricing on such facilities as they compete for balance sheet space.

OFF-BALANCE SHEET FINANCING

The writer would like to touch briefly on this subject which is mentioned in the main paper in the context of trusts and has been the subject of previous papers to this conference.[1] Increased pressure on balance sheets and gearing has been a consequence of the events of October 1987 for some corporates. The capacity to readily source equity to support new funding ventures has reduced, pushing forward consideration of debt and pseudo equity funding (*e.g.* preference shares and convertible notes). Given a concern in these circumstances to maintain or rebuild balance sheet strength, there is apparently some increased interest in opportunities to secure off-balance sheet sources of funding, either to remove existing assets off-balance sheet or as a basis for participation in or support a new venture.

1 [1984] *AMPLA Yearbook* 255 ff.

The problem is that this heightened commercial desire to see funding achieved off-balance sheet is coinciding with a more rigorous regulatory environment governing the relevant accounting standards. Just as is now apparent in the tax arena, the present environment is one in which the accounting profession is encouraged to look beyond the technical application of the rules to the overall substance or purpose of the transaction undertaken.

An illustration of this situation may be provided in the present application of AAS17 — the accounting standard dealing with leasing, which is very often a feature of a transaction structured to achieve an off-balance sheet financing. AAS17 seeks to establish the distinction between an operating lease and a finance lease, and requires that the borrower's liability in the case of the latter be disclosed on the balance sheet. While specific criteria are set down for establishing what constitutes an operating lease, there is also a somewhat more subjective judgment to be made as to whether the lease is one 'in which *substantially all* of the risks and benefits incident to ownership of the leased property effectively remain with lessor'.

It is in making this judgment that the inclination today is to stand back and look at the overall substance rather than the form of the transaction. Thus, certain considerations will be taken into account such as:

- how real is the capacity of the lessee to 'walk away' from the leased asset at the end of the lease term — put another way, if an option exists to consider purchase of the asset, is it just that (an option) or is repurchase an absolute must;
- what risk falls back on the lessee in the event that a sale of the leased asset proves insufficient to meet outstanding borrowings by the lessor; and
- to what extent do the lessor participants in fact participate in sharing of risk and reward — if this is not in proportion to interests held in the lessor or joint venture vehicle, what commercial rationale exists for the divergence.

Structuring of suitable arrangements to the satisfaction of the external auditors is, therefore, not particularly easy but is achievable with the right participants (including lender), including in the resources development sector.

Similar judgments about sharing of risks and reward where support is provided for other 'off-balance sheets' arrangements such as trust arrangements discussed in the main paper or various forms of non-recourse or limited recourse financing. The options available to a borrower on how such financings may be treated, have been further restricted by a small inclusion in the new defeasance standard (AAS23) that will effectively outlaw certain types of set-off arrangements. What this means is that project financing aimed at limiting lender recourse to the project assets, is not necessarily off-balance sheet financing.

A further limiting of the scope for off-balance sheet financing will follow should a Standards Board exposure draft on consolidation (ED40) come into force. Whereas consolidation to this point has largely depended on the level of shareholding in an associated company (over 50 percent requiring consolidation), the proposed standard would seek to assess whether the parent entity has 'effective control' regardless of the shareholding held. There is resistance from some quarters to the standard as proposed, the impact of which would be widespread including application to the public sector and all manner of entities including trusts — which presently provide a useful form of intermediary vehicle for shareholding purposes because interests in trusts are not presently consolidated or equity accounted.