

Deloitte Access Economics

Out on a limb?

Domestic fixed income assets
in Australia

Australian Securitisation
Forum

16 October 2012

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Glossary

ABS	Asset-backed securities
ADB	Asian Development Bank
APH	Australian Parliament House
ASF	The Australian Securitisation Forum
CCCR	Counterpart Credit Capital Risk
CLF	Committed Liquidity Facility
CVA	Credit Valuation Adjustment
DAE	Deloitte Access Economics
EIB	European Investment Bank
FCS	Financial Claims Scheme
FI	Fixed income
FoFA	Future of Financial Advice
GFC	Global Financial Crisis
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
RBA	Reserve Bank of Australia
RMBS	Residential mortgage-backed security
SMSF	Self-managed superannuation fund
UK	United Kingdom
USA	United States of America

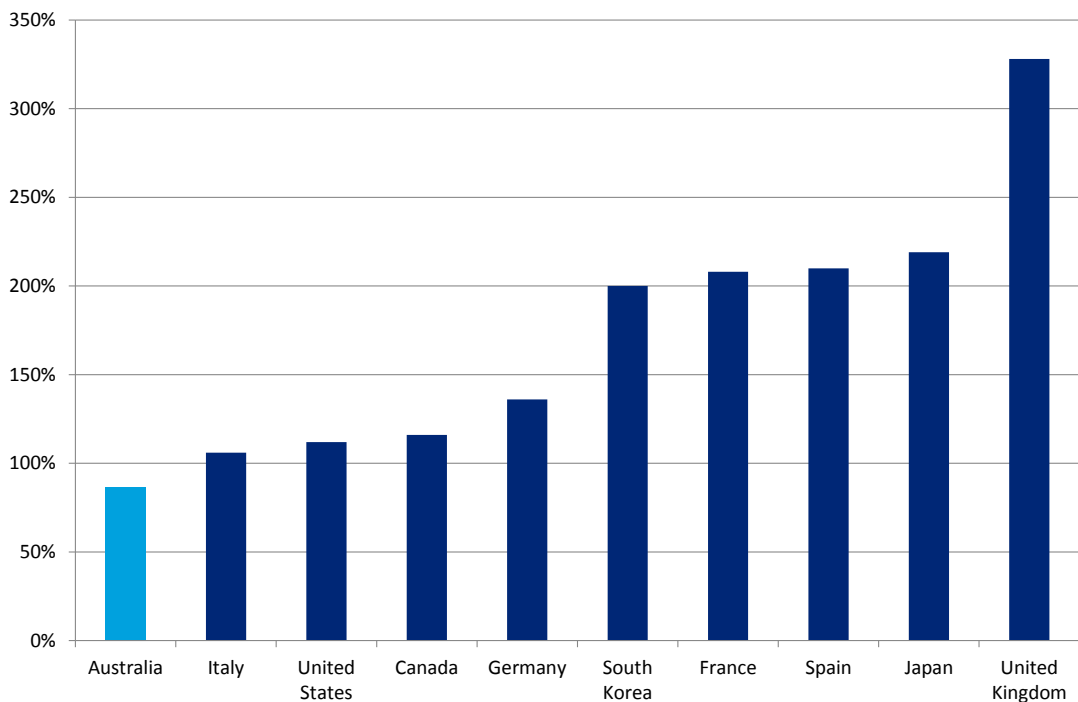
Executive Summary

By comparison with other developed economies, Australia has both a small corporate bond market and a low pension fund asset allocation to fixed income (FI) securities, including domestic FI securities.

Specifically:

- i. relative to GDP, the value of corporate debt outstanding in Australia is low compared with that in other developed economies (Chart i) and much of this is issued by financial corporations; and
- ii. Australian superannuation funds' allocation to FI assets stands at about 9%, well below the average for the 29 OECD countries of 52.3% (Chart ii).

Chart i: Corporate debt outstanding (% of GDP)*



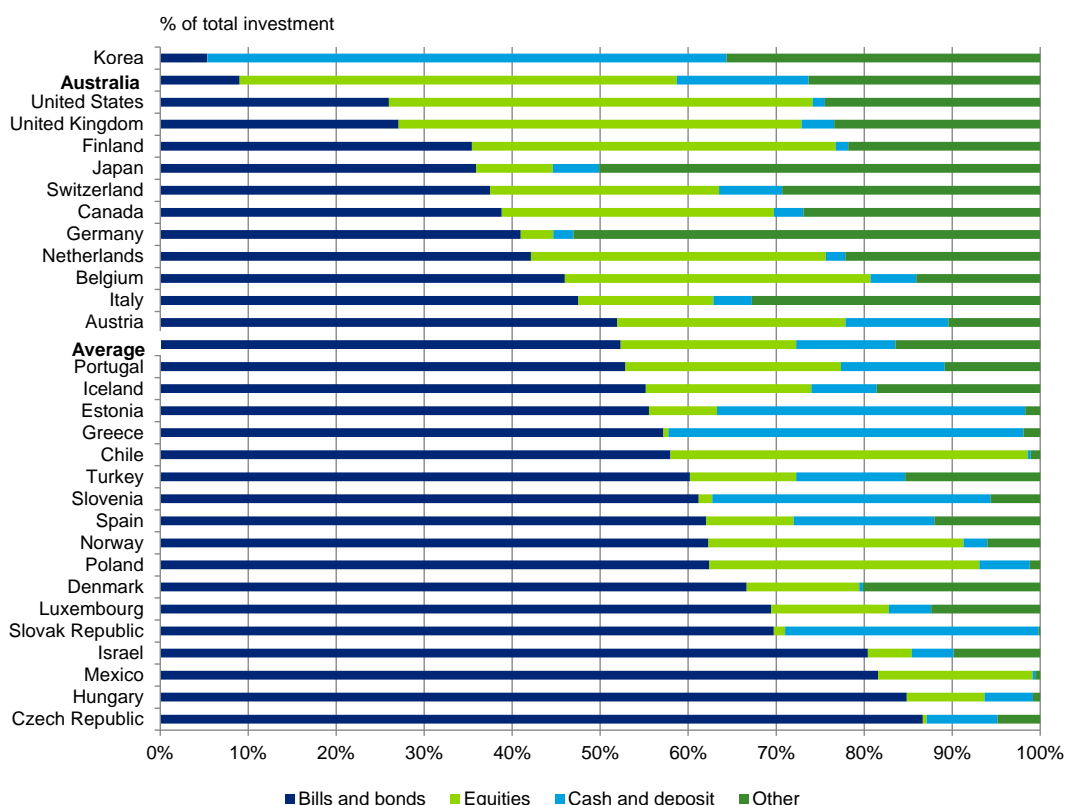
Source: Reserve Bank of Australia, Global Finance Magazine

* Includes non-resident issuers

Numerous explanations have been offered for these features of the Australian financial system, including:

Small corporate bond market:

- the price of issuing debt relative to bank credit;
- inadequate liquidity, scale, depth and the absence of longer-dated bonds;
- execution risk;
- the need for credit ratings;
- competition with overseas distribution networks; and
- regulation.

Chart ii: Pension fund asset allocation for selected OECD countries, 2011

Source: OECD Global Pension Statistics, 2012.

Note: Data for the United Kingdom refer to 2008.

Low FI asset allocation:

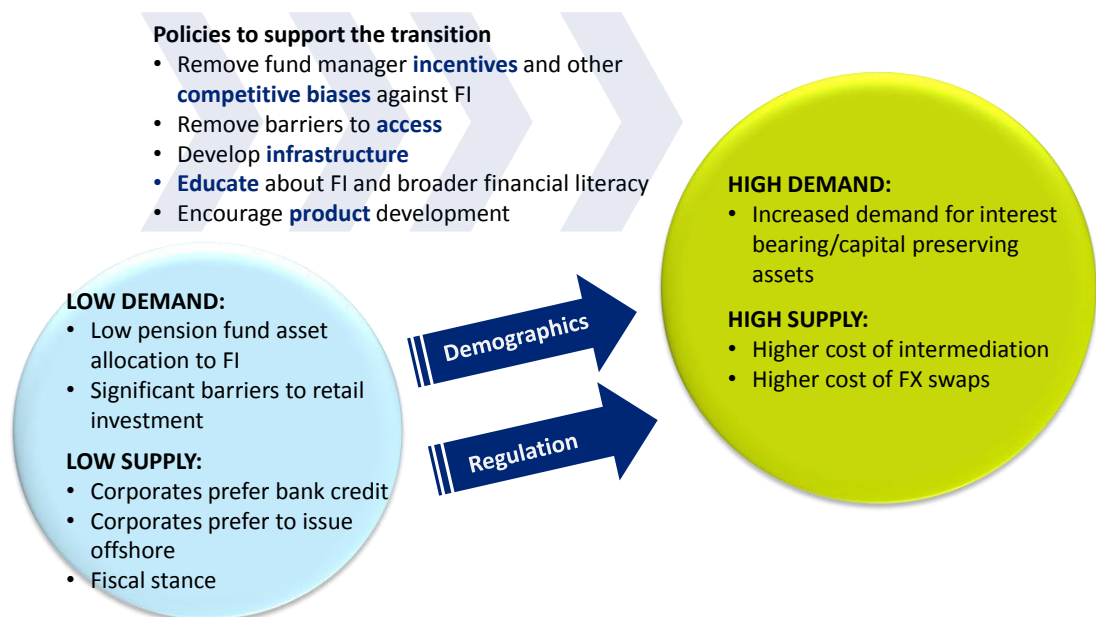
- demographics (i.e., Australia's relatively young population);
- adverse incentives for financial planners and portfolio managers;
- an embedded bias towards equities;
- lack of financial literacy;
- limited access to bonds for retail investors and SMSFs; and
- competitive non-neutrality between FI and other asset classes, reflecting differences in their regulatory and tax treatment.

Investigating these possible causes reveals that neither low demand nor low supply is responsible by itself for the current "low equilibrium" outcome in FI markets. Rather, both demand and supply interact to produce the observed outcome.

Moving Australia's FI markets away from their low equilibrium presents a challenge. Intervention on either the demand or supply side of the FI markets could, in principle, induce movement towards higher equilibrium levels of both demand and supply, but the choice of policy instrument matters.

Imminent developments in demographics and bank regulation in Australia may serve, in any case, to catalyse change and enhance the potential effectiveness of policy interventions aimed at shifting the current low equilibrium in Australian FI markets to one characterised by higher volumes.

Figure i: Nudging the system away from a “low” towards a “high” equilibrium



Possible policy interventions include:

- correcting the competitive bias against FI caused by regulatory, tax and remuneration incentives by, for example, introducing a fee for deposit insurance and/or “too big to fail” status, eliminating adverse incentives in funds management, and allowing mutuals to access franking credits;
- improving access to the market and reducing the regulatory burden associated with FI by, for example, standardising terms and conditions for corporate issues—particularly for ‘vanilla’ bonds;
- developing infrastructure to facilitate the market for FI assets, including an online trading platform similar to the London Stock Exchange Order Book for Retail Bonds (ORB), or listing bonds on the ASX;
- educating investors and other market participants, using mechanisms like an online central repository for debt instruments where circulars and prospectuses can be accessed, and enlisting the support of governments, training institutions, employers, consultants and fund managers; and
- encouraging and supporting product developments such as a municipal bond market, a deeper annuities market, and a wider range of securitised products, including master trusts.

Figure i illustrates how emergent forces for change could catalyse policy interventions aimed at fostering a higher allocation to FI assets. While governments can prepare the way for such a transition, market participants must also engage if movement beyond the status quo is to occur.

Deloitte Access Economics

1 Introduction

By comparison with other developed economies, Australia has both a small corporate bond market and a low pension fund allocation to fixed income (FI) assets, including domestic FI securities.

Numerous explanations have been offered for why this might be the case, and the likely implications have long been debated. However, interdependence of cause and effect complicates the issues and makes it hard to identify remedies, even to the extent these are considered necessary.¹

The Australian Securitisation Forum (ASF) engaged Deloitte Access Economics (DAE) to work with industry experts to investigate perceived impediments to the demand for and supply of domestic FI assets in Australia. A Steering Committee for this project was established, the members of which are listed in Appendix A.

The chief objectives of the project were to:

- investigate whether Australia’s low pension fund allocation to FI assets and the small corporate bond market are related and, if so, in which direction causation might run (i.e., is the low demand for FI assets the result of low supply or *vice versa*?); and
- investigate and assess whether these features of Australia’s financial markets are a problem and, if so, formulate cost-effective, practical policies to remedy them.

Agreement was quickly reached within the Steering Committee that neither low demand nor low supply is responsible by itself for the current “low equilibrium” outcome in Australia’s FI markets. Rather, both factors interact to produce the observed outcome.

Consequently, breaking away from the current equilibrium—to the extent this is considered desirable or necessary—requires intervention to disrupt mutually reinforcing tendencies. Absent intervention, current outcomes are likely to persist.

Intervention on either the demand or supply side of the FI markets could, in principle, induce movement towards higher equilibrium levels of both demand and supply, but the choice of policy instrument matters.

Imminent developments in demographics and bank regulation in Australia may serve, in any case, to catalyse change and enhance the potential effectiveness of policy interventions aimed at shifting the current low equilibrium in Australian FI markets to one characterised by higher volumes.

This report summarises the findings of our inquiries into Australia’s fixed income markets. The aim is to synthesise and shed light on the forces acting in these markets, and to suggest possible policy interventions.

¹ The discussion in this report focuses on fixed income assets and equity. This is not to imply that other asset classes are unimportant or insignificant (Table iChart ii). However, Australia’s outlier status relates to our low fixed income allocation and relatively high exposure to equities, and this is the focus of our report.

Our report is structured as follows:

- Chapter 2 describes current outcomes in FI markets in Australia and presents suggested reasons for these outcomes as gleaned from a literature review and consultation with the Steering Committee;
- Chapter 3 explores the implications of the low equilibrium in FI markets and identifies underlying forces for change which could catalyse policy intervention;
- Chapter 4 identifies a range of policy interventions that could nudge Australia's FI markets away from the status quo towards a new high demand/high supply equilibrium; and
- Chapter 5 concludes the report.

2 Current state of Australia's fixed income markets

The current state of Australia's fixed income markets could be described as a "low" equilibrium. In other words, by comparison with other developed economies, both the demand for and supply of FI assets are low.

The former is reflected in a low pension fund asset allocation to FI securities (including both foreign and domestic FI securities); and the latter in the small size of Australia's corporate bond market.

These outcomes are regarded as mutually reinforcing—hence the use of the term "equilibrium". Demand for domestic FI assets is constrained by low supply *and vice versa*.

This chapter summarises the evidence for this proposition and explores possible explanations.

As part of this project, a survey of fixed income fund managers was undertaken by Australia and New Zealand Banking Corporation Limited (ANZ). Fifteen responses were received, including 11 from some of the largest fund managers in Australia.

Throughout this chapter, responses from the survey are used to identify possible explanations for the low equilibrium in Australia's FI markets.

2.1 Low supply

Two groups of issuers supply debt to the Australian FI markets:

- **Government issuers:** Commonwealth government and State governments; and
- **Non-government issuers:** financial institutions; other non-financial corporates; asset-backed issuers; and non-resident 'Kangaroo' or \$A-denominated debt issuers.

This report focuses on \$A-denominated debt issued by Australian residents—i.e., *domestic* fixed income securities.

2.1.1 Government debt issuance

Government bills and bonds perform an important role in FI markets, both as a source of supply and as a benchmark for private sector issues. Yet Australian government debt issuance is very low by international standards.

In 2011 the gross stock of general government debt on issue was equal in value to about 24% of GDP (IMF 2012a). This compares to more than 102% in the United States, and an average of about 72% in advanced economies.²

²

www.imf.org/external/pubs/ft/weo/2012/01/weodata/weoselco.aspx?g=110&sg=All+countries+%2f+Advanced+economies

2.1.1.1 Reasons for low government supply

Government bond issuance in Australia is low largely because of prudent fiscal settings applied by governments of both political persuasions, at the federal and State level, over an extended period (Debelle, 2011).

Australia also lacks the range of sub-sovereign bond markets extant in other economies. Notably, Australia does not have a municipal bond market (bonds issued by local governments). This market is popular with retail investors in other countries.

In the USA, municipal bonds account for over 10% of all government debt outstanding (SIFMA, 2012). Table 2.1 shows new security issues for State and local governments in the United States.

Investors in the US municipal bond market benefit from their income tax exempt status. Coupon payments and the original issue discount of municipal bonds issued for public purposes are exempt from Federal and State income taxes.³

In the Euro area, supranational institutions, such as the European Union and the World Bank, issue regularly into domestic FI markets. Indeed, supranational institutions also issue into the Australian market. Bonds issued by entities such as the World Bank, IFC, EIB, ADB and IADB account for 17% of bonds outstanding in the corporate bond market at the present time (Bayley, 2012).⁴ Notwithstanding, the Australian domestic bond market is small compared with international counterparts.

Table 2.1: New security issues, State and local governments in the USA

By type of issuer (US\$m)	2009	2010
State	63,477	55,191
Special district of statutory authority	270,812	294,877
Municipality, county or township	80,518	86,615

Source: Board of Governors of the US Federal Reserve System

2.1.2 Non-government debt issuance

Four types of issuers comprise the supply side of the non-government debt market in Australia:

- financial institutions (such as banks and insurance companies);
- other non-financial corporate issuers;
- asset-backed issuers; and
- non-resident issuers.

Overall, relative to the size of the economy, Australia's corporate bond market is small compared with that in other developed economies (Chart 2.1).

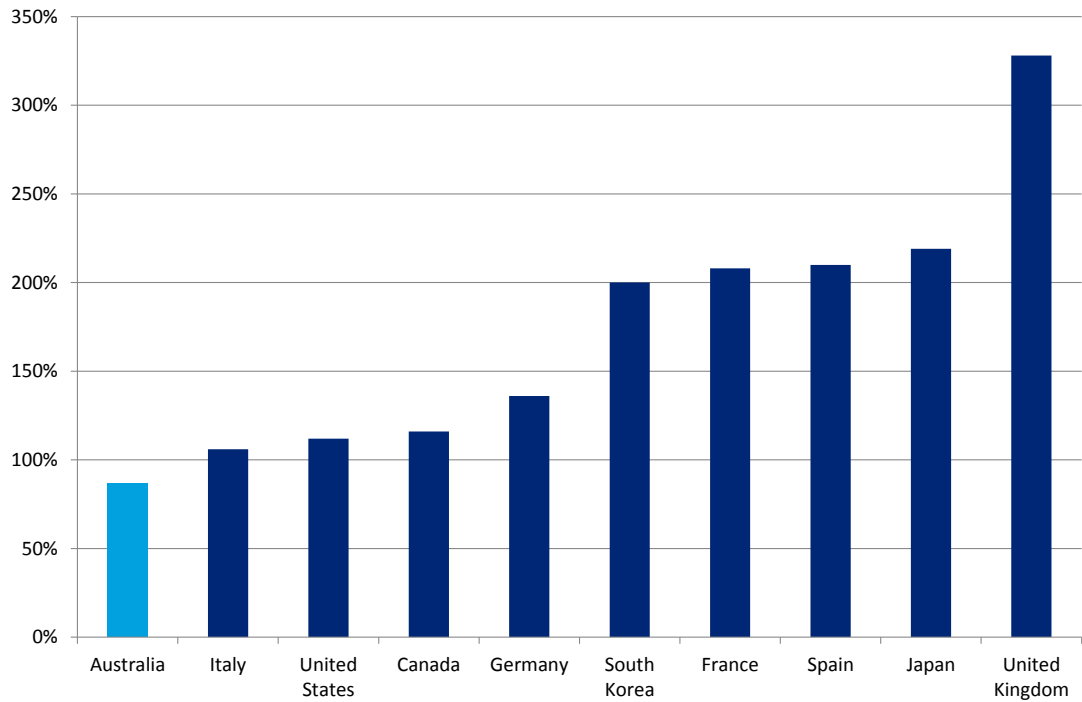
³ Profits from trading municipal bonds and municipal bonds issued for non-public purposes are not tax exempt, however.

⁴ Information supplied by Phil Bayley, Principal, ADCM Services, October 2012.

In addition, non-government debt issuance in Australia is dominated by banks and other financial institutions, which currently account for over two-thirds of all non-government debt outstanding (Chart 2.2).

The dominance of the banks in this market reflects their key role in financing Australia’s current account deficit. In turn, much of this debt is held by non-residents.

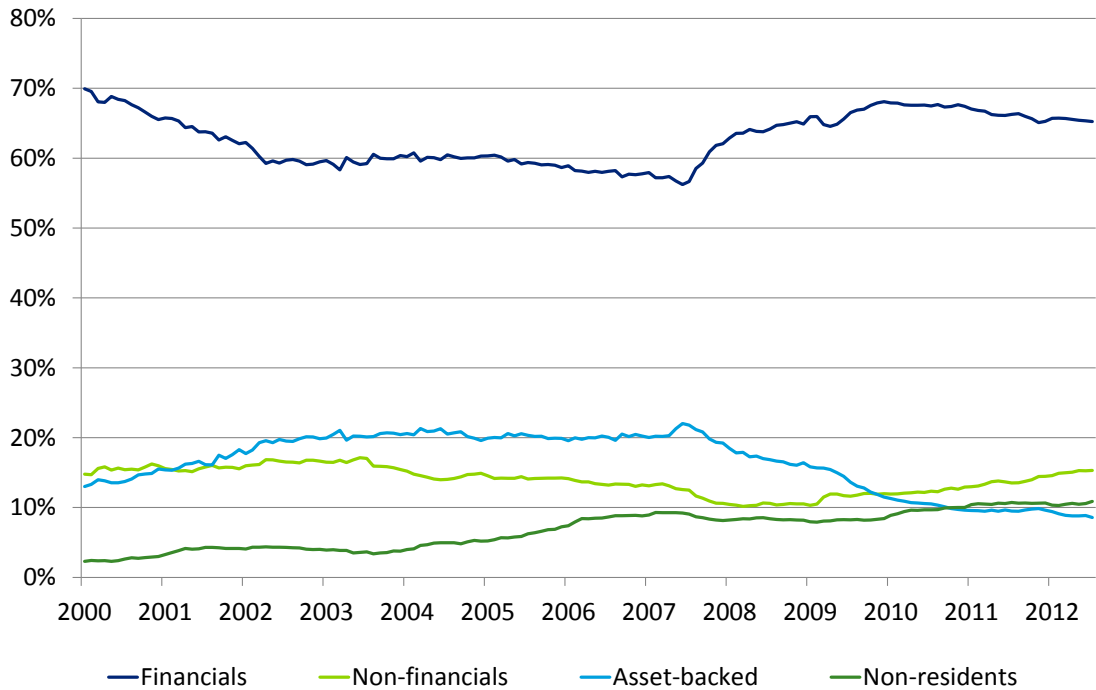
Chart 2.1: Corporate debt outstanding (% of GDP) *



Source: Reserve Bank of Australia, Global Finance Magazine

* Includes non-resident issuers

Chart 2.2: Share of non-government A\$ debt issuance

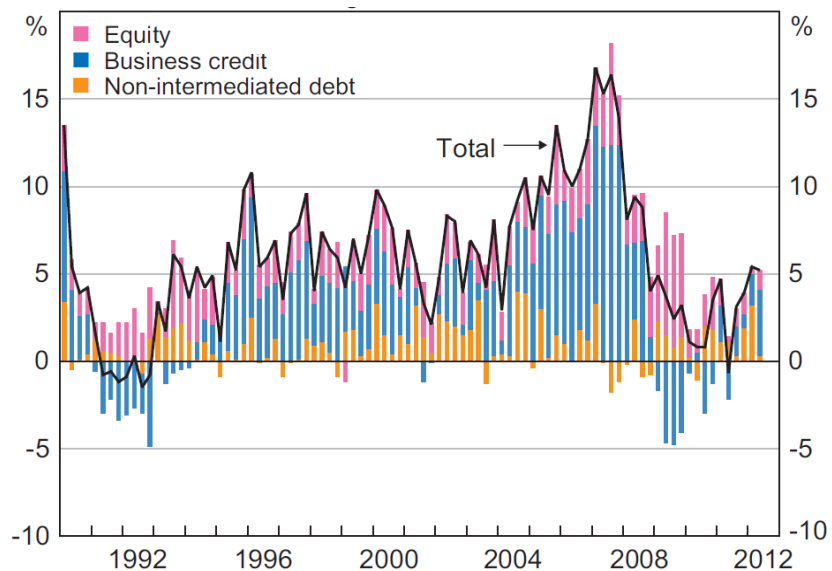


Source: RBA

* Includes offshore issuance and short-term debt securities

Non-financial corporations rely more heavily on bank credit and equity markets for their external funding (Chart 2.3). This is in contrast to the USA, where non-intermediated debt accounts for around 80-90% of corporate finance (Table 2.2).

Chart 2.3: Business external funding, net change (% of GDP)



Sources: APRA; ASX; RBA

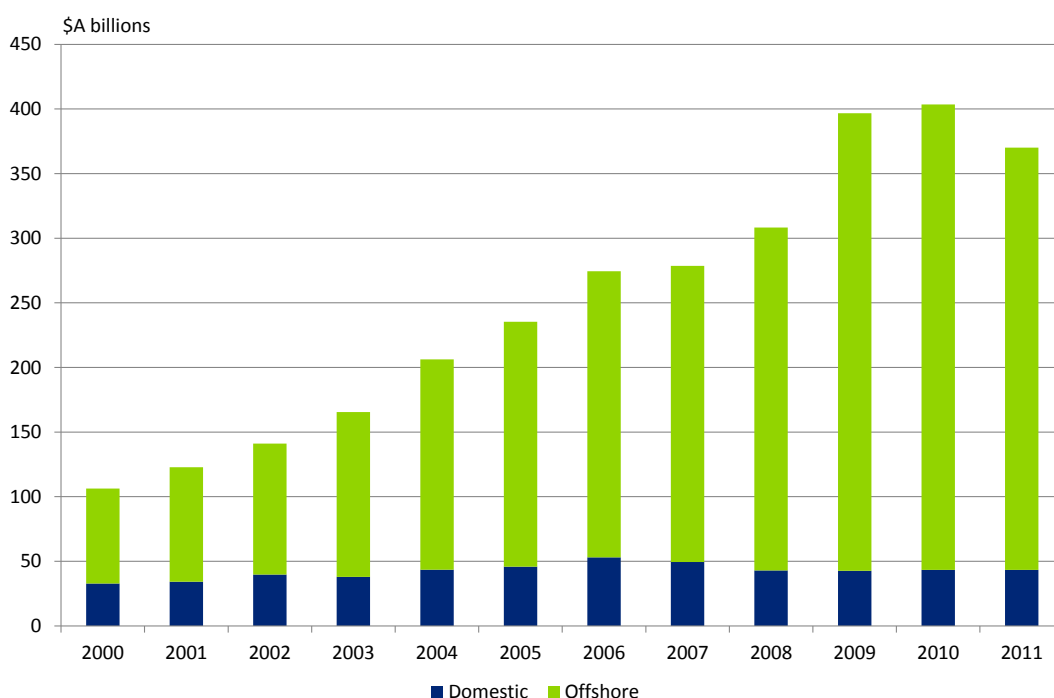
Table 2.2: New securities issues, US corporations

Type of issue or issuer, or use	2009	2010	2011
All issues, new and refunding (\$m)	1,194,985	1,024,709	1,037,231
Bonds	970,694	893,717	909,109
<i>By type of offering:</i>			
Sold in the United States	952,868	879,916	880,674
Sold abroad	17,825	13,801	28,436
<i>Memo: Private placements, domestic</i>	4,526	22,227	17,895
<i>By industry group</i>			
Nonfinancial	497,936	497,673	480,698
Financial	472,758	396,044	428,411
Stocks	233,967	131,135	129,489
<i>By Industry group:</i>			
Nonfinancial	63,043	60,831	58,740
Financial	170,925	70,304	70,749
<i>Memo: Government bonds (all levels)</i>	2,304,607	2,089,583	

Source: Board of Governors of the US Federal Reserve System

Also in contrast to Australia, banks in the USA issue fewer bonds than non-financial corporates (in Australia, domestic bank bonds on issue outweigh non-financial corporate bonds on issue by 10 to 1). This in turn reflects the very different US balance of payments position compared with that in Australia.

When they do issue bonds, Australian non-financial corporations tend to issue in overseas markets. At end-2011 almost 90% of the outstanding stock of non-financial corporate debt was issued overseas (Chart 2.4).

Chart 2.4: Australian non-financial corporate debt outstanding

Source: RBA, 2012

2.1.2.1 Reasons for low corporate supply

As part of this project, the Finance and Treasury Association (FTA) undertook a survey of 25 corporate treasurers. Table 2.3 outlines the factors corporate treasurers reported as important when accessing various markets.

Table 2.3: Key considerations in accessing markets

Factor	Number of times factor appears in top five
Price	16
Tenor	14
Scale and depth of the market	12
Diversification	11
Covenants	8
Currency and interest rate risk swaps	6
Ability to issue without a credit rating	7
Fees paid to intermediaries	5
Cost of legal documentation and tax advice	5
Ease of changing documents or T&C's	5
Legal liability of directors	5
Fixed versus floating rate	5
Secondary market liquidity	2

Source: ASF survey of corporate treasurers

The majority of corporate treasurers surveyed (13 out of 25) do not consider the A\$ bond market a viable funding source.

Instead, corporates generally look to the banking system to raise capital—11 of the 25 (44%) corporate treasurers surveyed stated that they have not raised debt finance outside the banking system over the past 10 years. Only 28% (or 7/25) of those surveyed have ever raised debt finance through an A\$ bond issue.

Commonly cited factors for not issuing corporate bonds include:

- price;
- tenor;
- liquidity, scale and depth;
- execution risk; and
- credit ratings.

2.1.2.2 Price

The margin over benchmark was cited in the FTA survey as the most important consideration for corporates seeking to access debt markets.

This view is echoed throughout the literature, with the instability of pricing in the corporate bond market, and the cost of a corporate bond issue relative to the cost of bank credit, widely regarded as key impediments to the development of fixed income markets in Australia.

Banks can offer more competitive rates on loans to business compared with the cost of capital market raisings because they package loans together with other services, including transactions, swaps and foreign exchange. Banks aim to profit from the full banking relationship with their corporate clients whereas capital market raisings are purely transactional.

Nevertheless, some market participants claim there is no statistical difference between the credit spread on corporate bonds and that on syndicated loans, and that the perception that syndicated loans are cheaper suggests advisor bias (see Section 2.2.3.2).

Table 2.4: Issuance costs by market

Market of issue	Domestic		Euro-market	United States	
	Retail	Wholesale		Trad PP	s144A
Due diligence/Legal	A\$250,000-450,000	A\$75,000-125,000	A\$250,000-400,000	A\$250,000-300,000	A\$600,000-1,000,000
Underwriting	175-300bps	5bps per annum	25-40bps flat	25-50bps*	30-50bps
Road-shows	A\$10,000+	A\$10,000+	A\$100,000+	A\$100,000+	A\$100,000+

* Agent/placement fees apply in this market

Source: Data supplied by ANZ

However, this does not explain why—when they do issue bonds—Australian non-financial corporates tend to issue overseas. It is not clear whether, after adjusting for the cost of FX swaps back into Australian dollars, offshore issuance is cheaper.

Indeed, Table 2.4 (compiled from information supplied by an informed market participant) suggests that domestic wholesale issuance is the cheapest option.

2.1.2.3 Tenor

The FTA survey indicated that the relatively short tenor of fixed income instruments is a major reason why the Australian corporate bond market is not seen as a viable funding source. Similarly, (Lambert, 2012) found the limited number of bonds with longer term maturities is a limiting factor in the development of a domestic A\$ bond market.

The lack of longer-dated bonds is especially relevant for real estate investment companies, whose assets (such as shopping centres and offices) are long-dated. Over 90% of the debt financing of these assets in Australia is bank intermediated, typically characterised by short-duration, floating rate loans.

The short duration of the Australian commercial real estate loan market means that one third of the total outstanding commercial real estate loan book of an REIT or fund must be recapitalised annually.

In response to the lack of longer-dated debt capital in Australia, many REITs choose to raise debt offshore, most notably in the US 144a PP market.

Recently BHP Billiton issued a new A\$ bond, successfully raising \$1 billion in a very short time. This is the company's first domestic issue since 2001, suggesting that some large issuers are reconsidering where they issue (KangaNews, 2012).

2.1.2.4 Liquidity, scale and depth

A further challenge for the Australian fixed income market is its relatively small size. This has both demand- and supply-side implications.

Survey respondents indicated that small numbers of investors willing to invest was an impediment to the development of the Australian bond market.

At the same time, liquidity in the domestic market is low because issuance is small and irregular. Investors require a consistent supply to be willing to invest (Lambert, 2012).

2.1.2.5 Execution risk

Australian corporates have ongoing relationships with banks, which reduce the transaction costs of raising debt through banks relative to corporate bond issuance. Issuing a corporate bond in Australia is difficult; this is particularly true for first-time issuers.

In the FTA survey, execution risk was highlighted as a deficiency of the A\$ corporate bond market. Both investors and issuers are adversely affected by the risk that investors fail to take up the issue and it is withdrawn by the issuer for lack of interest.

2.1.2.6 Credit ratings

Credit ratings were seen as essential for Australian corporates to access funding through the local debt market. By the same token, absence of the need for a credit rating was highlighted as a significant attraction of the US private placement market.

Credit ratings are not required on some forms of private placement. However, credit ratings are required for access to public markets in the USA and Europe. Currently around 60 companies in the ASX 200 have a credit rating. Thus around two-thirds of Australia's largest companies lack the credit rating needed to access most corporate bond markets.

2.1.2.7 Distribution networks

Investment banks generally take new issues to markets where their distribution networks are strongest. For an international investment bank, the distribution network will be strongest overseas, and they therefore have an incentive to recommend distributing overseas rather than locally.

It is also claimed that fees payable for distribution act as a barrier to retail bond issuance in Australia.

2.1.2.8 Regulation—ASIC

It is widely argued that a significant contributor to Australia's undeveloped retail corporate bond market is the regulatory burden imposed on issuers.⁵ Specifically, issuers are required to publish a prospectus providing the same level of disclosure as initial public offerings in equity markets.

Following an initial public offering in an equity market, subsequent share issues require only a short-form prospectus. This is not true of subsequent debt issuance, for which ongoing long-form prospectuses are required.

These prospectus requirements can be onerous and expensive. Moreover, potential investors are required to interpret complex and detailed financial information, which is likely to deter people who are less financially literate.

From a creditor's perspective, in the event of a problem with a company's financial viability, debt ranks higher than equity. Consequently, given its superior status, debt should be at least as easy to issue and to access as equity.

A number of respondents to the ANZ survey highlighted the differential treatment of debt and equity as an obstacle to investment in domestic fixed income assets.

Furthermore, reforms in 2009 have eased regulations on equity issuance, widening the gap between regulatory requirements for corporate bond issuers compared with equity issuers, and increasing the relative complexity of investing in bonds for retail investors.⁶

In 2010 ASIC acknowledged that the regulatory burden on Australian corporate bond issuance may be restricting investment opportunities for retail investors, and has proposed to allow companies offering 'vanilla' bonds a simplified prospectus.⁷

This change is intended to make corporate bonds more accessible to retail investors while still providing an appropriate level of consumer protection.

However, the regulatory relief applies only if specific conditions are satisfied. Among the conditions, the value of the issue must exceed \$50 million. This acts as a barrier to issuance by smaller companies that would still be required to undertake the more onerous disclosure process, regardless of their risk profile.

⁵ http://archive.treasury.gov.au/documents/2266/PDF/Retail_Corporate%20Bonds_DP.pdf

⁶ For example, see Class Order 09/425, Class Order 09/459 and Consultation Paper 105 Facilitating Equity Capital Raisings, issued 24 February 2009. <http://www.mercari.com.au/media/AFCF.pdf>

⁷ For example, CO 10/321 *Offers of vanilla bonds* and CO 10/322 *On-sale for convertible notes issued to wholesale investors*.

Moreover, issuers with greater ability to access offshore markets will generally do so, if only to avoid local regulatory requirements on issuers to retail investors. This leaves issuers without ready access to foreign markets (very likely all of those issuing less than \$50 million of bonds) as the only issuers whose bonds are available to local retail investors.

As a result, the average risk-rating of bond issues available in local retail markets may be lowered by intervention intended to protect retail investors from risk.

Furthermore, the requirement to lodge prospectuses for retail issues may give rise to circumstances where:

- it is easier to issue and buy shares in a company than to issue and invest in plain vanilla bonds issued by the same company; and
- it is easier to issue and buy shares in a highly speculative company than issue and buy the bonds of a small, creditworthy company.

Deemed Director Liability mandates due diligence by company directors for a retail debt issue. For wholesale debt issues, on the other hand, directors enjoy limited liability. Personal liability of directors partly explains why prospectus requirements imposed on retail debt issues are so onerous (Eliakim D. and Harvey P., 2012).

The discussion paper *Development of a Corporate Bond Market* released in 2011 by the Australian Treasury explores ways to streamline disclosure and liability requirements in Australia's retail corporate bond market (Australian Government, 2011). The paper aims to address issues outlined above by streamlining prospectus requirements for qualifying bond offers and modifying the director liability regime.

Partly in response to Treasury's work, the *Personal Liability for Corporate Fault Reform Bill 2012* was introduced into the federal Parliament in 2012 to coordinate personal criminal liability for corporate fault across Australia. The reforms amend existing Commonwealth laws, including the *Corporations Act 2001* and the *Foreign Acquisitions and Takeovers Act 1975*.

The reforms:

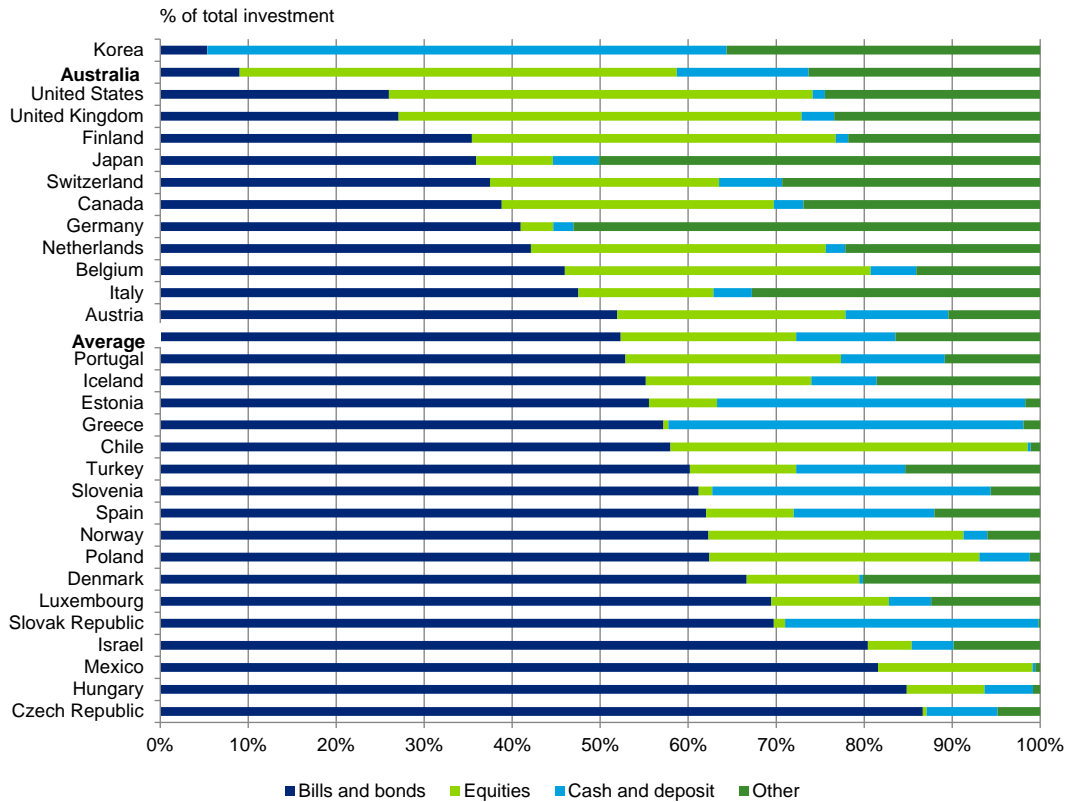
- remove the personal criminal liability of company secretaries for certain offences, replacing it with a civil liability, and impose a penalty for a breach of the civil liability; and
- provide that only an officer of a corporation who authorised or permitted the commission of an offence by that corporation is personally liable for the breach.

2.2 Low demand

2.2.1 Demand from pension funds

In 2011 only 9% of Australian superannuation funds' total assets were allocated to fixed income securities, well below the average for the 29 OECD countries of 52.3% (Chart 2.5).

Chart 2.5: Pension fund asset allocation for selected OECD countries, 2011



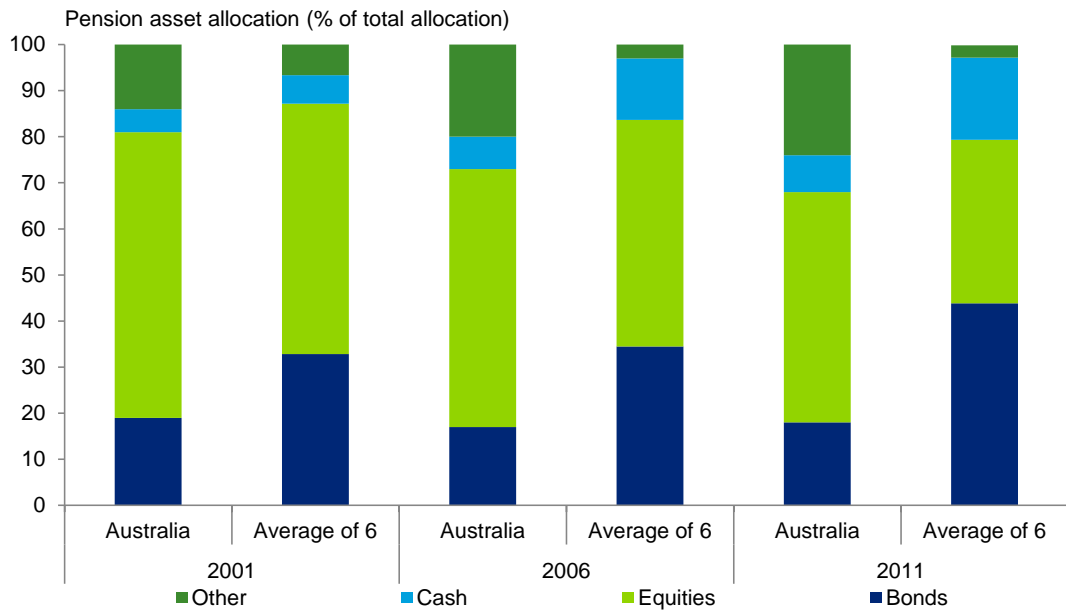
Source: OECD Global Pension Statistics, 2012. Note: Data for the United Kingdom refer to 2008.

Australia’s low allocation to FI assets is not a recent phenomenon, having been evident for at least the past decade. However, the divergence from other countries has widened in recent years, as other countries increase their pension fund allocations to FI but Australia’s remains largely unchanged.

In a study of the world’s largest pension fund markets published by Towers Watson, Australia was the only country not to increase its holdings of bills and bonds between 2001 and 2011 (Chart 2.3).⁸

⁸ The Towers Watson study included seven major pension markets: Australia, Canada, Japan, Netherlands, Switzerland, the United Kingdom, and the United States.

Chart 2.6: Australian superannuation asset allocation

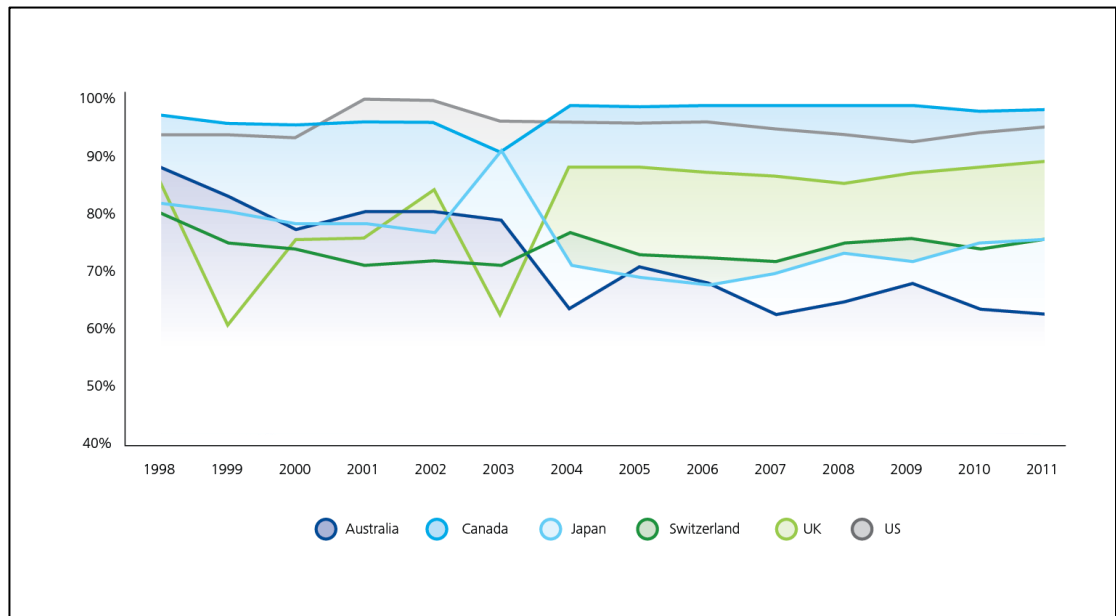


Source: Towers Watson, 2012

Note: Average of 6 countries includes: Canada, Japan, Netherlands, Switzerland, the United Kingdom and the United States.

Furthermore, within the FI asset class, which is already small relative to other countries, the proportion of funds allocated to *domestic* fixed income securities is also low.

Chart 2.7: International comparison of domestic fixed income exposure as a share of total fixed income exposure



Sources: Towers Watson, 2012 and OECD Factbook 2009, 2010

In 2011 around 60% of Australian superannuation funds' FI assets were domestic securities, compared to 75-80% for Japan and Switzerland, and over 90% for the UK, the US and Canada (Chart 2.7).

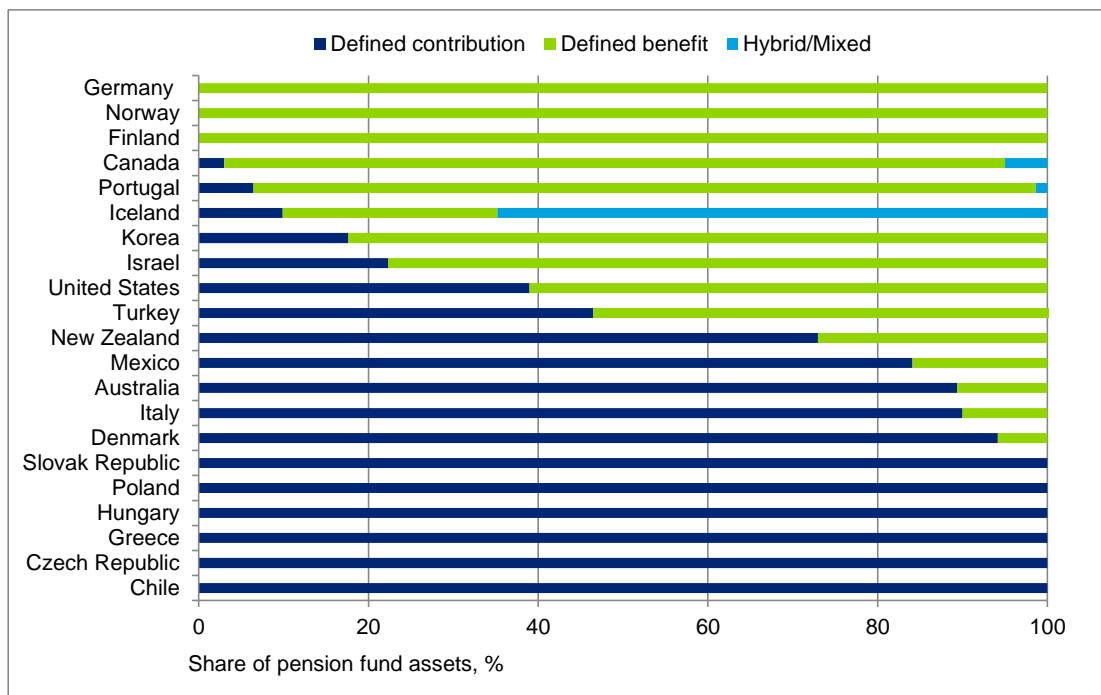
This has not always been the case, however, with Australia’s domestic share of FI assets around 90% as recently as the late 1990s.

2.2.1.1 Are we comparing like with like?

A possible explanation for this outcome is that Australian superannuation funds are predominantly held in ‘defined contribution’ rather than ‘defined benefit’ schemes.

However, even when compared with countries which also have a large share of pensions in defined contribution schemes, e.g. Chile, Denmark and the Slovak Republic, Australia’s allocation to fixed income is still much lower (Chart 2.8).

Chart 2.8: Asset shares of different pension fund types (%)



Source: OECD Global Pension Statistics, 2011

Indeed, countries for which defined contribution schemes account for 100% of pension fund assets, e.g. Hungary, Greece and the Czech Republic, still allocate 50-90% of their assets to the fixed income class (Chart 2.5).

Hence, the dominance of defined contribution schemes would not appear to explain Australia’s relatively low allocation to fixed income assets.

2.2.2 Demand from other investors

Other than superannuation funds, the following groups are potential investors in the Australian bond market:

- **Other institutional investors:**
 - managed funds
 - insurance companies
- **Retail investors:**
 - households
 - SMSFs

The low investment in FI extends beyond pension funds, with other investor types also relatively underweight in this asset class.

2.2.3 Reasons for low demand

The following factors are cited as key impediments to the demand for Australian FI securities:

- demographics;
- adverse incentives for financial planners and portfolio managers;
- an embedded bias towards equities;
- lack of financial literacy;
- limited access to bonds for retail investors and SMSFs; and
- competitive non-neutrality between FI and other asset classes, reflecting differences in their regulatory and tax treatment.

2.2.3.1 Demographics

Australia's superannuation investors are predominantly in the accumulation phase of their retirement savings plans. This has been cited as a possible explanation for the low allocation to FI assets compared with equities.

However, demographically 'younger' countries in the OECD, such as the USA, Canada and the Slovak Republic, have higher FI allocations than Australia.

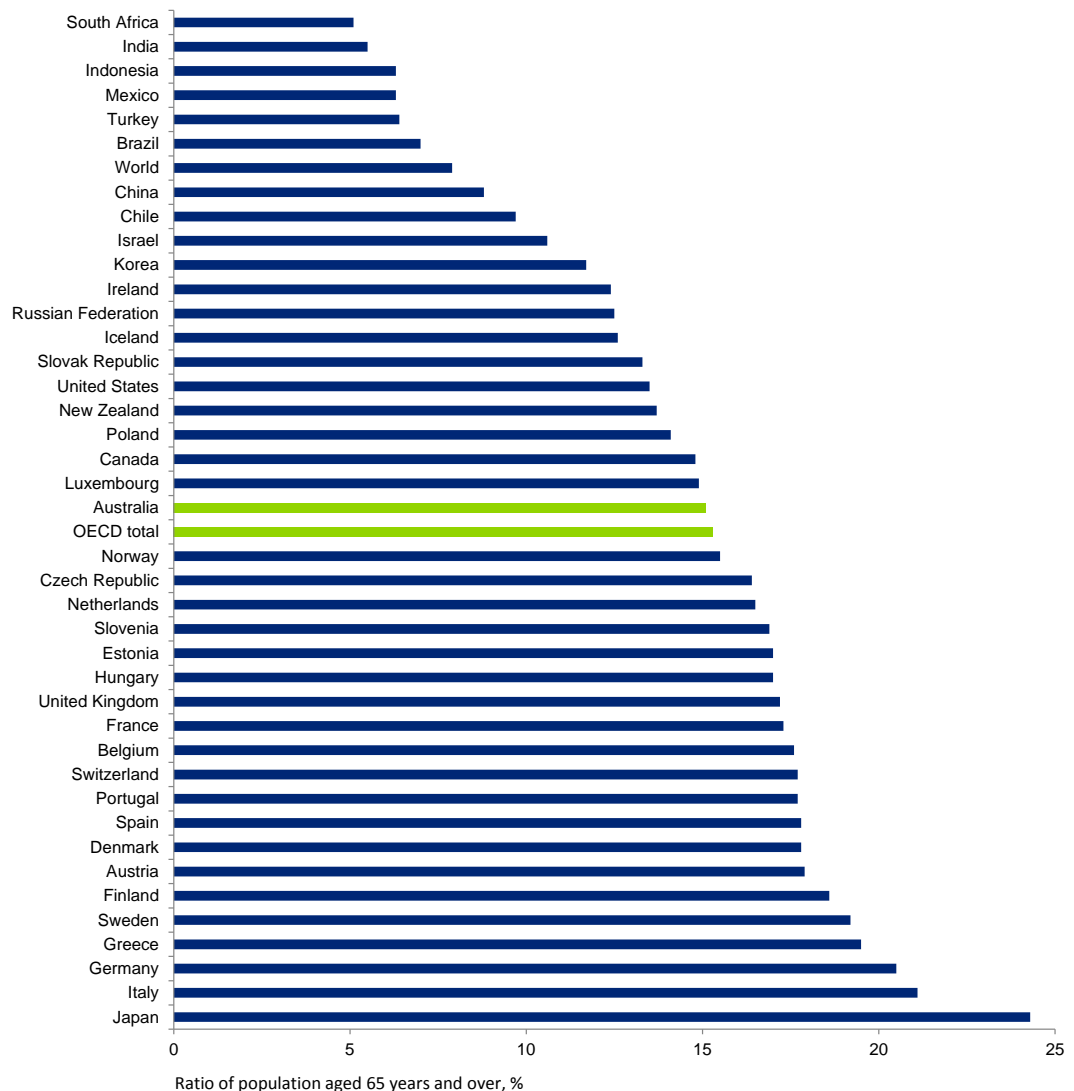
The share of Australia's population aged 65 years and over is almost equal to the OECD average (15.1% compared with 15.3%), and yet the OECD average allocation to fixed income (almost 50%) is much higher than Australia's FI allocation.

Nevertheless, the retirement of large numbers of 'Baby Boomers' over the next decade will shift the balance within superannuation funds away from accumulation and towards pension draw-down.

While something other than Australia's relative youth is determining the current allocation of pension fund assets in favour of equities, the changing demographics of fund membership will potentially catalyse a move in favour of fixed income if other policy settings also change.⁹

⁹ This issue is discussed further in Chapter 3 below.

Chart 2.9: Population of retirement age (%): 2012



Source: OECD Factbook, 2009

2.2.3.2 Adverse incentives

Adverse incentives may explain Australia's low demand for FI assets. There are two potential sources of this effect:

- a **fee structure** or other remuneration incentive (such as management fees or sales commissions) that favours equities or other asset classes over bonds (i.e. managing fixed income assets may not be as remunerative as managing other asset classes); and
- a **market bias** towards equities in 'default option' asset allocations.

Portfolio managers

Fees for managing fixed income products in Australia are low compared to the global average, suggesting that remuneration attached to managing this asset class is low by international standards (Table 2.5).

However, Australian fees are not as low as those in the UK or Canada, and only marginally lower than those in the USA. Yet all of these countries exhibit higher allocations to FI assets.

Table 2.5: Average fee by product group

Region	Equity (%)	Fixed Interest (%)	Differential (%)
Global / international	0.77	0.44	0.33
European	0.73	0.44	0.29
United States	0.75	0.38	0.37
Australia	0.61	0.36	0.25
Canada	0.38	0.24	0.14
United Kingdom	0.69	0.29	0.40

Source: Mercer, 2010

Moreover, the differential between management fees for equities and FI—i.e. the relative benefit of managing equities over FI—is also low relative to that overseas, suggesting that fees are not responsible for the observed bias in asset allocation in Australia.

Furthermore, between 2008 and 2010, average fees paid to fixed income managers increased by 10.9%—more than any asset class in any country. Hence, if management fees induce portfolio managers to favour certain asset classes over others, higher FI allocations should have been observed over these two years.

Financial planners

Commissions paid to financial planners are affected by the product they recommend to retail investors and SMSFs.

Selling hybrid securities is more remunerative than traditional debt. Other things equal, financial planners may be more likely to promote products that carry higher commissions.

Recent changes to the structure of commissions paid to financial planners under *Future of Financial Advice* (FoFA) reforms should mitigate these effects.

Default options

A market bias towards equities in ‘default option’ asset allocations may lead to low demand for FI assets in superannuation portfolios.

Much of Australia’s superannuation savings defaults to predetermined options, which typically involve a low FI allocation.

Moreover, the default investment strategy during the pension phase is the same or very similar to that in the accumulation phase—67% allocation to high growth assets in the pension phase versus 74% in the accumulation phase (Towers Watson, 2012).

2.2.3.3 Embedded bias towards equities

Superannuation funds typically benchmark performance within asset classes rather than across asset classes. The overall asset allocation is determined at board level and is then implemented at the operational level according to the pre-determined asset allocation.

Asset class managers determine the allocation to securities within their asset class but not across the different asset classes. Indeed, their performance and remuneration are linked to benchmarks for their respective asset classes rather than the overall portfolio return.

Hence, embedded preferences at the board level for equities over debt will flow through to the operational level (Schroders, 2012).

One reason for a preference at board or portfolio manager level for equities over debt is the need for liquidity. Members of superannuation funds can transfer their balances in favour of other funds and/or change asset allocations without a mandatory waiting period. Since equities are generally more liquid than FI assets, the need for liquidity can reinforce a bias in favour of equities over fixed income assets.

Another reason, cited by respondents to the FTA survey, is the role of asset consultants to boards and their strong links to the equities market.

Credit ratings also play a role in limiting allocation to FI assets. According to the survey of FI managers, investment mandates often stipulate limits on exposure to FI assets at different credit ratings whereas the same need not apply (or not as strictly) to different grades of equity—even though equity typically ranks lower than FI as a claim on the assets of a company.

2.2.3.4 Financial literacy

Financial literacy has assumed growing importance throughout the developed world as the proportion of defined benefit superannuation schemes has declined, and individuals have been obliged to take on more of the risks and some of the responsibility of investing their retirement savings.

At the same time, the internet has transformed the financial sector, increasing the range of financial products available to retail investors. These issues are particularly pertinent to Australia, where the proportion of employees who are members of defined contribution superannuation schemes is among the highest in the world.

Against this backdrop, there has been an increased focus by Australian governments on the ability of Australians to understand the choice of financial products available, to effectively weigh up their investment options, and to plan for their future financial needs.

Surveys suggest that, despite taking on increased responsibility for their financial future, many Australians do not have a thorough understanding of complex financial issues like investing and planning for retirement.

ASIC is charged with consumer protection in financial products. It is claimed that ASIC 'overprotects' retail investors from fixed income products. As discussed above, this may bias retail investors away from FI securities towards equity and other investment products.

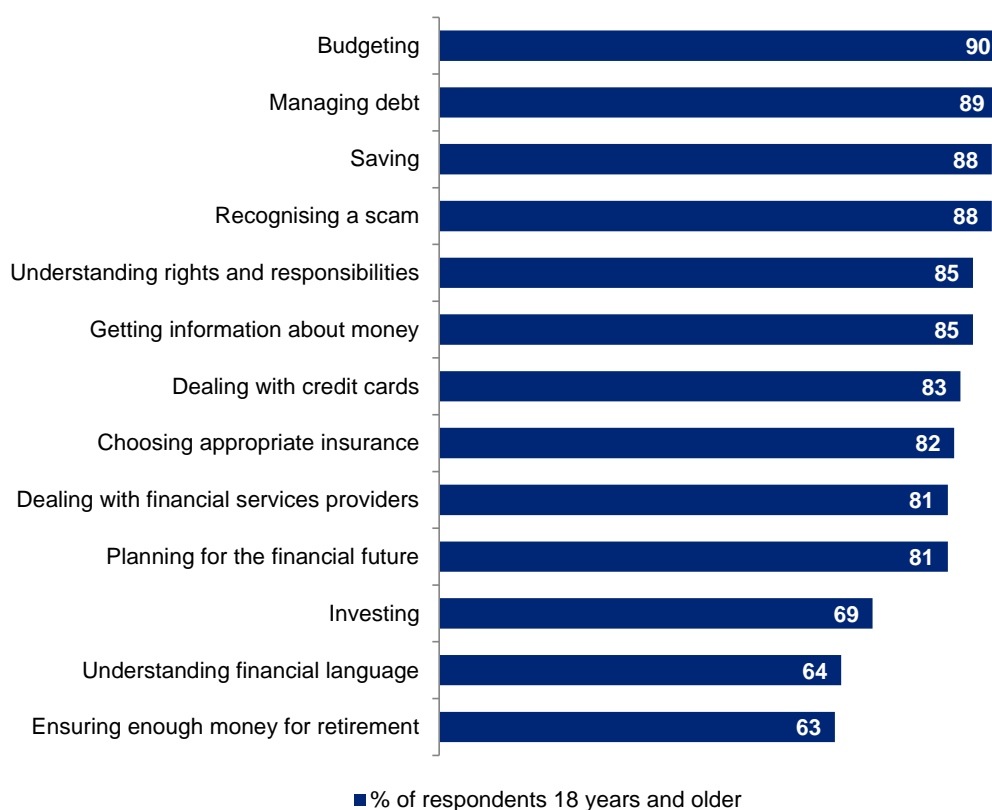
Various surveys of financial literacy suggest that, while Australians are generally confident in managing their day-to-day money issues such as budgeting, saving and taking on debt, they are less confident when it comes to investing and planning for retirement. Across the range of surveys, results are generally correlated with age, gender, education and other socioeconomic characteristics.

An Australian Government publication entitled, *Financial Literacy: Australians managing money* (2007) found that only 69% of Australians were confident that they have the ability

to invest and 63% that they have the ability to ensure that their retirement savings are adequate (Chart 2.10).

Nonetheless, the proportion of adults who recognise the importance of learning more about investing and planning for retirement is higher than the proportion who report having the ability to invest and ensure sufficient funds for their retirement.

Chart 2.10: Ability and understanding of money matters



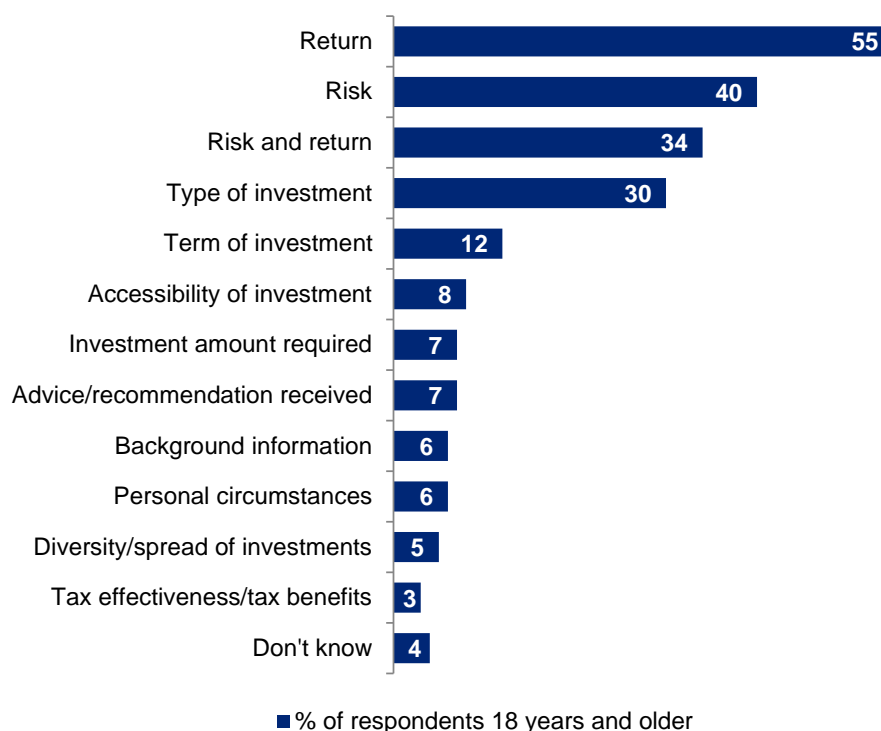
Source: Australian Government 2007

Consistent with a lack of confidence, the survey found that only 34% of adults say they would consider both risk and return when making an investment decision and just 5% would consider portfolio diversification (Chart 2.11).

Significantly, the largest number of respondents listed return as an important consideration for investment decisions. Given the higher average returns on equity markets relative to bond markets over the longer term, focusing on returns without adequate consideration of risk is likely to bias investors towards equities and away from fixed income assets.

A limited understanding of the relationship between risk and return is consistent with the ANZ survey of Adult Financial Literacy (2011), which found that 47% of respondents would consider investing in a product that is “advertised as having a return well above market rates and no risk”.

This confirms a lack of understanding of the relationship between risk and return.

Chart 2.11: Considerations when making investment decisions

Source: Australian Government 2007

Given the complexities involved in investing, individuals are also likely to invest in instruments and companies that are familiar to them.

Share prices attract more attention in the media, including regular reporting on nightly news bulletins, whereas fixed income assets (apart, perhaps, from term deposits) typically have a low public profile.

2.2.3.5 Limited access to bonds for retail investors and SMSFs

Onerous regulatory requirements on issuers to retail investors (see 2.1.2.8 above) restrict access to fixed income securities by retail investors and SMSFs.

Low levels of familiarity with fixed income assets and financial illiteracy more broadly, also constrain investment in fixed income securities. Lack of comfort with the fixed income class can afflict advisers and financial planners as well as retail investors.

Data indicate that retail investors and SMSFs (like superannuation funds more broadly) typically have a low allocation towards bonds and other fixed income assets. Over the four years to December 2011, debt securities comprised less than 1% of SMSF portfolios (Australian Taxation Office, 2011).

2.2.3.6 Competitive non-neutrality between FI and other assets

Certain regulatory and tax interventions distort the investment choice between FI and other asset classes. A key issue is whether the resulting non-neutrality is deliberate or an unintended consequence of the intervention.

Regulation—Financial Claims Scheme (FCS) and deposit guarantees

The explicit FCS guarantee favours investing in term deposits over other non-government fixed income products.

Prior to the introduction of the FCS, Australian depository institutions enjoyed an implicit government guarantee. The RBA recognised this fact in 1997: *'it is hard to believe that ... democratically elected governments will (or should) stand by and watch a large number of citizens (and voters) lose money they thought was relatively safe'* (RBA 1997).

Under the FCS, around A\$620 billion of deposits are subject to an explicit government guarantee for which neither the issuer nor the depositor pays a fee. The ceiling on the guarantee for individual deposits was lowered from A\$1 million to A\$250,000 in February 2012 (APH, 2012).

The FCS guarantee changes the risk-return trade-off for bank deposits, including term deposits, increasing their attractiveness relative to other FI investments such as corporate bonds.

Taxation

Different tax treatment of different asset classes discourages investment in fixed income assets in Australia.

Capital gains

Income earned from both debt and equity investments is taxed at the investor's marginal rate. However, capital gains are taxed at a discounted rate after 12 months—a 50% discount for individuals and 30% for superannuation funds.

This treatment discriminates against assets that only deliver an income stream with no opportunity for capital gains, including bank deposits and FI assets held to maturity.¹⁰

Negative gearing

An asset is negatively geared when the interest paid on funds borrowed to finance the asset exceeds income earned from the asset. The Australian taxation system permits deductibility of losses incurred on negatively geared investments against other sources of taxable income.

Fixed income investors do not have the same opportunity to profit from the tax treatment of negative gearing to the extent that capital gains are not possible or envisaged.

¹⁰ Bonds bought and sold prior to maturity, where there is the possibility of capital gains and losses are not affected.

3 Forces for change

Australia has a low allocation to fixed income assets by international standards and this is reflected in both low demand for, and low supply of, FI assets. Absent forces for change, this “low equilibrium” is likely to persist. Low supply of FI assets in Australia reinforces low demand and *vice versa*.

Yet forces for change are evident. Changing demographics and regulatory developments in banking are likely to boost both demand and supply in FI markets.

Together these forces have the potential to catalyse policy interventions aimed at nudging Australia from a low equilibrium towards a high equilibrium, in which demand for and supply of FI assets more closely resemble levels observed in comparable countries elsewhere in the world.

For those concerned about Australia’s status as an outlier in FI markets, this will be a welcome development. The forces for change potentially disrupt the self-reinforcing nature of the existing low equilibrium, creating the opportunity for policy intervention to nudge the system towards a new high equilibrium in fixed income allocation.

For others less concerned about the current state of FI markets in Australia—i.e., those who do not regard the low allocation to FI assets (and the associated small domestic market for corporate bonds) as a problem—the underlying forces for change imply at the very least a disruption of existing conditions, and the need to review current attitudes.

Those who dismiss the current low equilibrium in FI allocation as a problem (or who regard it even as desirable) typically emphasise longevity risk in their perspective. They point to the marked increase in life expectancy in recent years, and emphasise the need for retirees hoping to avoid dependence on the public age pension to maintain significant exposure to equities in their portfolios well beyond the accumulation phase.

3.1 Longevity risk

Retirees who live longer than expected may exhaust their retirement savings. The risk that a person outlives his or her retirement savings is known as *longevity risk*.

Australians have experienced a steady increase in life expectancy, with the result that they are living longer than ever before and spending more years in retirement. Actuarial estimates of life expectancy are repeatedly confounded by advances in medical technology and healthcare.

Longevity risk has become more of an issue for retirees and those saving for retirement as the length of time spent in retirement has become less predictable. A focus on longevity risk leads to the conclusion that investors should seek to maximise expected return over the long haul—including retirement—in order to mitigate the risk of outliving one’s savings.

Given the established outperformance of equities compared with fixed interest assets over the long term—the so-called ‘equity premium’ (Drew and Sanford, 2002)—investment advisors concerned to minimise longevity risk counsel maintaining an exposure to equities even beyond the accumulation phase of retirement saving.

On this view, a low allocation to FI assets is entirely defensible, and indeed advisable, given the continuing tendency of longevity outcomes to surprise on the upside.

Longevity risk is also a matter of concern for public policy. If large numbers of Australians live longer than expected, outliving their retirement savings, the Commonwealth government will experience additional pressure on age pension outlays, with attendant implications for future taxpayers (IMF, 2010).

On this view, the Commonwealth ought not to intervene to boost demand for FI assets for fear of exposing the budget to greater stress on age pension outlays than is already predicted.

3.2 Sequence risk

An alternative perspective on retirement saving emphasises the sequence in which returns on an investor's portfolio are earned through time. While it may be true that equities earn a premium return compared with fixed income assets over time, they do so only *on average* and not at every point in time.

Accordingly, notwithstanding a higher return on average, a sequence of high returns may be followed by a sequence of low or even negative returns. A retiree's ability to fund retirement income will depend upon where in the sequence of returns the decision to retire is taken.

The risk that retirement occurs in the low or negative phase of short-term returns, adversely affecting a retiree's ability to fund a given income in retirement, is referred to as *sequence risk*.

On average over the past 20 years, equities have outperformed fixed income assets. However, the outcome for an individual investor depends on the timing of the movements of financial markets relative to when they enter and exit their investments. Some investors may benefit from a portfolio that is more heavily weighted towards equities while others may lose (Henry, 2012).

A focus on sequence risk leads to the conclusion that exposure to more volatile assets like equities should be pared back as retirement approaches and in the retirement phase itself.

To avoid capital losses which may not be recoverable within the timeframe available, investors should shift their asset allocations away from equities towards fixed income investments as they near retirement and during the retirement phase—notwithstanding the expected higher average returns on equities over an increasingly lengthy period spent in retirement.

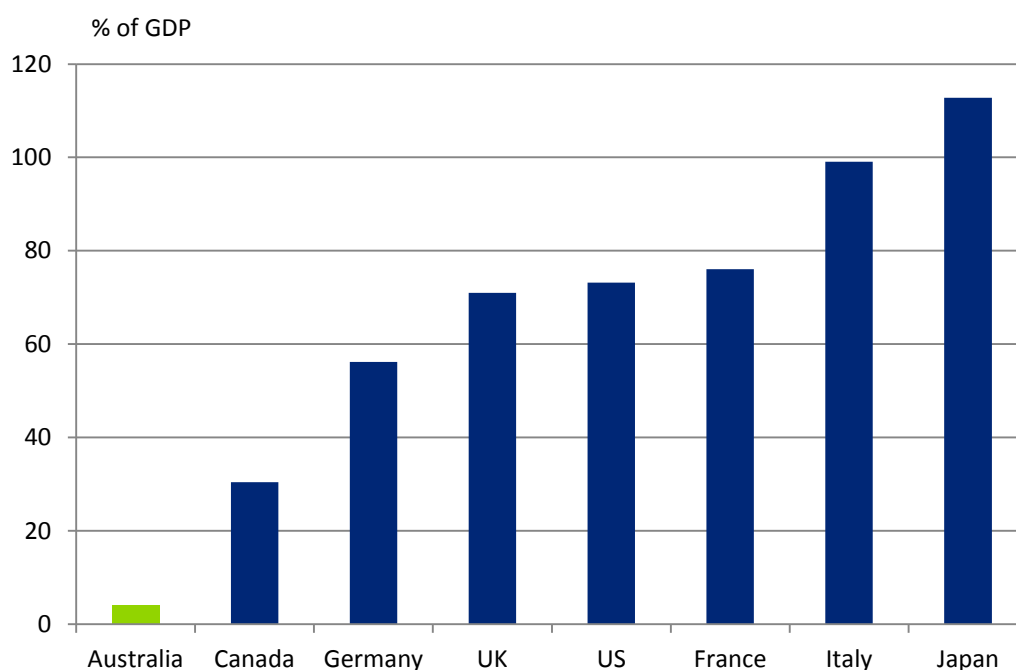
3.3 Exposure to global financial markets

Australian superannuation funds invest significantly in offshore equity, while Australian banks raise significant funds offshore through wholesale borrowing (Henry, 2012). Both investors and borrowers are exposed to developments in offshore markets, raising concerns about the flow-on implications for the Australian economy should these markets become dysfunctional, as they did during the recent Global Financial Crisis (GFC).

Conversely, the larger the domestic corporate bond market, the greater the buffer against adverse global developments.

Japan is a case in point. Net public debt in Japan is more than 125% of GDP (Chart 3.1) yet the Japanese government continues to access funding at low interest rates given the large pool of domestic savings (IMF, 2012b). Japan has insulated itself to a significant extent from adverse developments in global capital markets.

Chart 3.1: General government net debt, selected countries, 2011



Source: IMF World Economic Outlook Database, October 2012.

Note: Japan and the US are IMF staff estimates.

A functioning local debt market is preferable to relying on a government guarantee. During the recent GFC, Australia's triple-A sovereign credit rating assisted Australian banks to raise funds in traumatised global capital markets. However, such funding would be far more difficult to raise in the absence of a triple-A rating.

Recognition of the importance of a strong and diversified financial system for Australia's economic development together with lessons learned from our exposure to dysfunctional global capital markets during the GFC have heightened concerns over the current low equilibrium outcome in Australia's fixed income markets.

The advent of demographic transition and post-GFC regulatory developments in banking has the potential to catalyse change in the FI landscape. Even those who see no difficulty with the status quo should recognise the disruption to established patterns that these forces for change will foment.

3.4 Demographic change

By far the larger part of Australia's pool of retirement savings is held on behalf of those yet to retire. Only 15% of Australians have reached retirement age or older.

Since the numbers of retirees are still relatively small, and those currently in retirement had fewer years in which to accumulate significant savings balances (contributions to superannuation having been compulsory only since 1992), the savings of current retirees represent only a small share of the national retirement savings pool of about A\$1.6 trillion.

With the majority of Australians in the accumulation phase of their retirement savings plans, longevity risk looms larger than sequence risk in the investment plans they are likely to choose or have chosen on their behalf.

Even though, as noted in Section 2.2.3.1 above, countries with younger demographics than Australia still have more substantial exposure to FI assets in their pension fund portfolios, Australia's bias towards equities might at least be excused if not explained by the demographic profile of Australian retirement savers.

However, Australia's retirement demographics are about to change. With a relatively large pool of people approaching retirement (i.e., the 'Baby Boomers'), and steadily increasing life expectancy, more and more Australians are expected to be in retirement over coming years.

Deloitte Access Economics estimates that, over the next 10 years, the number of Australians aged 55 and over will increase by more than 1.8 million, raising the share of the Australian population in retirement by over 3 percentage points.

Furthermore, the average length of time that retirees will have been invested in superannuation will steadily increase. This together with the larger numbers of retirees will raise the share of the national retirement savings pool owned by Australians in the pension or draw-down phase of their retirement savings plans.

With more Australians approaching or in retirement, sequence risk will loom larger in people's minds, even if a significant cohort of investment professionals still emphasise longevity risk in their advice. The strong likelihood is that demand for less volatile assets will grow, and asset allocations will shift away from equities in favour of fixed income assets.

3.5 Government finances

Government debt issuance is likely to increase in future due to the vagaries of the economic cycle and demographic change.

Australia has not experienced a recession in more than 20 years but the likelihood of a significant downturn, possibly triggered by a slowdown in China's development surge, cannot be discounted. Such a downturn will quickly change the outlook for the supply of government securities.

The ageing of Australia's population will also have a significant impact on the Commonwealth's fiscal position through rising outlays on the age pension and aged care.

The old-age dependency ratio in Australia was 21% in 2010.¹¹ This is forecast to rise to 40% by 2050 (Standards & Poor's, 2010).

¹¹ The old-age dependency ratio is the number of people 65 and older divided by the number of those 15 to 64.

There will be fewer workers paying taxes and more retirees with their attendant health costs. For service standards to be maintained during this lengthy period of demographic transition, the federal government will inevitably need to borrow.

3.6 Regulatory change

Regulatory changes affecting the banking industry are also likely to stimulate the supply of fixed income assets to Australian investors.

3.6.1 Basel III

In the wake of the GFC, the Basel Committee for Banking Supervision under the auspices of the Bank for International Settlements has promulgated new rules governing the capital adequacy and liquidity of banks. Australian banking regulators have implemented the new rules with only minor modifications. The new rules are scheduled to take effect from 1 January 2013.

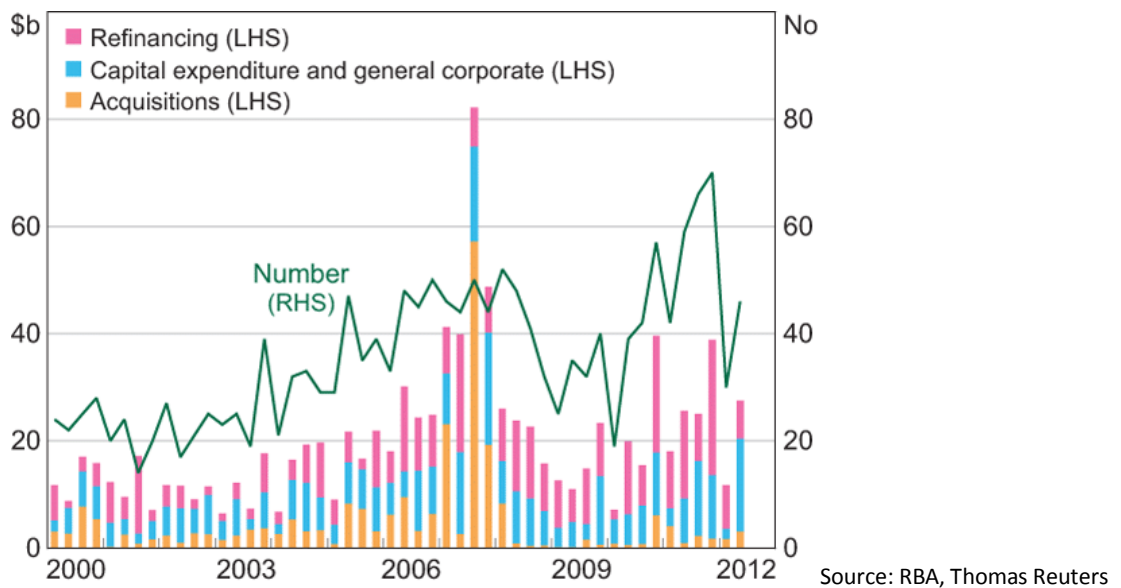
The effect of the new banking regulations (known collectively as Basel III) is to make bank intermediation more expensive. Banks will need to hold more capital on their balance sheets and more liquid assets, including bonds.

Basel III will very likely stimulate disintermediation, i.e., the replacement of bank lending by securities trading at the margin. Rather than borrowing from banks, corporates will seek to raise funds directly from capital markets. In this they will be aided by banks themselves, keen to replace lost interest income with fee income earned on originate-to-distribute capital market transactions and related services.

However, the extent of disintermediation will depend on the cost to banks of implementing Basel III requirements. According to the Australian Prudential Regulation Authority (APRA), Basel III will add only 10 basis points to the cost of bank funding, producing a negligible impact on disintermediation (Littrell, 2011).

Under Basel III Australian banks will need to supplement meagre supplies of public debt with corporate debt in order to meet their new liquidity requirements. Moreover, Basel III precludes them from holding bonds issued by other banks, further stimulating their demand for high quality corporate debt.

Both developments will encourage the issuance of asset-backed securities and other structured products, including through an expansion of the syndicated loan market, adding to the pool of FI assets available for investment. The syndicated loan market is of interest because such loans can be securitised. A majority of syndicated loan funding is approved for capital expenditure and general corporate use (Chart 3.2).

Chart 3.2: Syndicated Loan Approvals: Quarterly

Furthermore, Basel III's treatment of foreign exchange swaps will make issuing corporate debt offshore and swapping the proceeds into A\$ more expensive, thereby encouraging the domestic issue of A\$-denominated corporate bonds (Figure 3.1).

Figure 3.1: Basel III treatment of foreign exchange swaps

Basel III increases the minimum level of capital a bank must hold against the risk of loss from derivative exposures to counterparties.

To cover the potential loss of market value from counterparty exposure, a new Credit Valuation Adjustment (CVA) Risk Capital Charge is being introduced.

$CVA \text{ Risk Capital Charge (new capital charge)} + \text{Default Risk Capital Charge (current capital charge)} = \text{Total Counterparty Credit Risk Capital (CCR) Charge}$.

This new charge will require banks to hold more capital against foreign exchange swaps than is currently the case.

Like the demographic developments described above, changes in bank regulation will stimulate a move away from the current low equilibrium in Australian FI markets. In the case of regulatory change, the stimulus will come predominantly from augmented supply of FI assets as banks disintermediate their corporate lending at the margin.

The additional supply of FI assets will interact with the higher demand for such assets stimulated by demographic developments as well as banks' heightened need for liquid assets to add to their balance sheets in place of illiquid corporate credits.

The interaction of demand and supply has the potential to catalyse policies aimed at nudging Australia's FI markets away from the current low equilibrium towards a high equilibrium.

3.6.2 *MySuper*

New regulations are about to be introduced for default superannuation under the rubric of *MySuper*. *MySuper* products are intended to set a new benchmark for transparency and comparability of key performance information. APRA will collect and publish information on the fees, costs and returns for each *MySuper* product (Parliament of Australia, 2012).

Greater transparency and comparability of returns among different default superannuation products may reduce the inertia experienced to date in the asset allocation of default superannuation funds. *MySuper* may act as a further catalyst towards change in equilibrium demand and supply in FI markets.

4 Options for policy intervention

Imminent demographic and regulatory developments may catalyse policy interventions aimed at changing Australia's fixed income asset allocation. The active support of market participants will also be required if the pace of change is to gather momentum.

4.1 Restoring competitive neutrality

4.1.1 Fees for financial claims scheme and “too big to fail” implicit guarantees

Protection provided to bank deposits in the wake of the GFC was intended to restore investor confidence in the banking sector and encourage investment in deposit products. This was in turn intended to reduce banks' dependence on offshore wholesale funding.

Providing a government guarantee for certain fixed income products and not others distorts competition. The Financial Claims Scheme (FCS) changes the risk/return profile of bank deposits relative to substitute fixed income products (like corporate bonds and asset-backed securities) that have no explicit government guarantee.

This distortion was noted by a number of FI managers surveyed by the ANZ.

The government could impose an explicit charge for the FCS so that the value of this benefit is priced into the terms offered by banks and other insured deposit-taking institutions on eligible deposits.

There is also an implicit guarantee that Australia's major banks are “too big to fail”. This perception affects the prices paid for bonds issued by major banks relative to other deposit-taking institutions that are not perceived in the same light by investors.

Pricing for this additional market advantage would further assist competing issuers of FI securities, including asset-backed securities, and restore competitive neutrality.

4.1.2 Commissions and financial incentives

Performance incentives offered to portfolio managers and other investment professionals have the potential to skew their asset allocation decisions and advice.

Recent reforms under the Future of Financial Advice (FoFA) initiative deal with concerns surrounding the payment of commissions to financial planners.

Consideration could also be given to changing the performance indicators against which the performance of portfolio managers is assessed. This might commence as a requirement for default superannuation schemes which could then catalyse a broader change in the industry.

One such option might be to require portfolio managers to report their performance against absolute return objectives set out in their PDSs, such as CPI plus x%, rather than (or in addition to) their performance against benchmarks for different asset classes.

4.1.3 Franking credits for mutuals

Mutual deposit-taking institutions (i.e., building societies, credit unions and mutual banks) have been liable for income tax since 1997 but their tax treatment differs from that applying to Australian banks.

Current arrangements lead to an unequal taxation outcome for mutuals relative to banks and other corporates. Since mutuals pay tax, they accumulate franking credits but, unlike corporates and banks, mutuals are unable to release accumulated credits to their members through dividends.

Allowing mutuals to raise capital through bonds with franking credits attached could be considered. Not only would this increase the size and diversity of the fixed income market in Australia but it would also open an avenue for mutuals to raise funds in competition with bank term deposits.

4.2 Improving access and infrastructure

A trading platform that brought together the buy- and sell-sides of FI markets in a timely, relatively costless way would significantly enhance the attractiveness of FI assets to investors and issuers.

For example, an online facility would:

- **increase price transparency**—by allowing investors and issuers to view each other's products and prices;
- **increase liquidity**—by increasing transparency, reducing transaction costs (either monetary or time and effort) and increasing investor confidence and product knowledge;
- **enable retail investment and encourage smaller corporates to issue bonds**—by facilitating issues in smaller 'retail-size' tranches; and
- **educate the market**—by offering circulars and prospectuses in a central repository to aid transparency and providing information about FI products.

One such platform has recently been established in the UK—the London Stock Exchange Order Book for Retail Bonds (ORB). The ORB was launched on 1 February 2010 and is modelled on Italy's successful MOT market, which is thought to be the most liquid and heavily traded retail fixed income market in Europe.

The key aims of the ORB are to:

- provide issuers with an efficient mechanism for distributing bonds to retail investors; and
- provide retail investors with a cost effective and transparent means of trading debt securities.

Prior to the launch of ORB, a private investor could not trade corporate bonds online but needed to deal through a stockbroker by telephone in minimum lot-sizes of GBP10,000-50,000 per bond—akin to conditions currently applying in Australia.

Listing bonds on the ASX could also improve access and foster development of the FI market. ASX has recently proposed an arrangement to ASIC whereby it would adopt the structure of American Depository Receipts and appoint exclusive market makers in these

instruments. This proposal appears to offer a practical and viable means of developing a retail corporate bond market within a relatively short period of time that will add liquidity to the wholesale market and not disrupt it.

Access to an Australian FI market is currently impeded by regulatory requirements. The legal liabilities imposed on company directors when issuing corporate bonds to the retail market are onerous and act as a deterrent to issuers. They also deter investors, especially when they are required to establish due diligence.

Standardising terms and conditions, particularly for 'vanilla' bonds, and allowing disclosure or regulatory exemptions for FI offers made by an issuer to its own shareholders, would improve access to the corporate bond market.

The recent issue of A\$20-30 million of corporate bonds by Silver Chef, arranged through FIIG Securities Limited, shows that even smaller issuers are reconsidering how they raise funds to diversify their funding sources (Silver Chef Limited, 2012).

4.3 Financial education

There is a strong view that education is one of most important factors in fostering growth of the FI market. Australian investors have a limited understanding of complex financial issues like investing and planning for retirement. Even portfolio managers and financial advisors appear to lack a thorough understanding of fixed income assets.

Education can be provided through a number of channels, both formal and informal. For instance, an online central repository for debt instruments that offers circulars and prospectuses is one mechanism.

The onus to educate should not fall on policymakers alone. While governments can provide the platforms and encourage take-up, educators within training intuitions, employers, consultants and advisors, and investors themselves can all foster information-sharing and assist in educating investors and their advisors.

To the extent necessary, this might include financial planners, financial advisors and other industry participants, where their familiarity with fixed income assets is lower than that with other asset classes.

4.4 Encouraging development of new and niche products

Allowing new products into the market and niche products to flourish could increase the size of the local FI market.

4.4.1 Municipal bonds

As well as increasing the supply and range of FI assets in the Australian market, a municipal bond market would enable borrowing at the local government level for local infrastructure. Borrowing could be facilitated by setting up a special-purpose bank that made loans to local government funded by domestic municipal bonds issued with a high credit rating.

This would be a similar mechanism to that through which statutory authorities currently access funding via State treasury corporations. This would provide competition to existing lenders, provide councils with necessary technical and administrative expertise, and allow councils to use their combined size to secure cheaper and more diversified funding.

Furthermore, a municipal bond market would bring the familiarity of local government to new investors, which would help overcome barriers and increase the scope of demand. In adding diversity to the corporate bond market, the additional product will also help mitigate concentration risk, i.e., the risk of concentrated exposure to the liabilities of a limited number of creditors.

A municipal bond market in Australia could be modelled on the Local Government Funding Authority recently established in New Zealand (1 December 2011).¹² However, securing agreement among the States, which are ultimately responsible for the debts of their local councils, may be an obstacle, particularly as various States face pressure on their credit ratings.

4.4.2 Annuities

Australia has an underdeveloped annuities market. Annuities are widely viewed as a sound means of providing retirees with secure income streams. Selling annuities would provide another avenue for borrowers to access FI investors.

A White Paper published by the Institute of Actuaries suggests ways to encourage take-up of annuities, including:

- introducing post-retirement default annuity products to guard against retirees spending their retirement lump sums too quickly; and
- addressing unfavourable income tax and pension test treatments of longevity insurance, especially deferred annuities.

Development of an annuities market will help to mitigate sequence risk. Retirement savings which are drawn down over time, as with annuities, rather than immediately upon retirement as a lump sum benefit allow markets time to recover from periodic downturns, thus mitigating sequence risk.

4.4.3 Securitisation

Securitised products, including those backed by residential mortgages, are long-term annuity-style assets well suited to the pension phase of superannuation.

The credit oversight of banks and mortgage insurers brings stability to the market for securitised products and militates against practices seen in other countries, especially during the GFC.

Facilitation of markets for securitised products in Australia would assist in augmenting the supply of fixed income assets and meeting the latent demand for annuity-style assets from retirees and superannuation funds whose members are increasingly in the pension phase of their savings plans.

¹² <http://www.lgfa.co.nz/>

Master Trusts

The introduction of master trusts would assist Authorised Deposit-taking Institutions (ADIs) to offer bullet-style RMBS and ABS. These have a long track record in the UK. Subject to adapting the security for Australian markets, this would offer investors a new class of bonds and add liquidity to the bond market, while allowing ADIs to diversify their sources of funds.

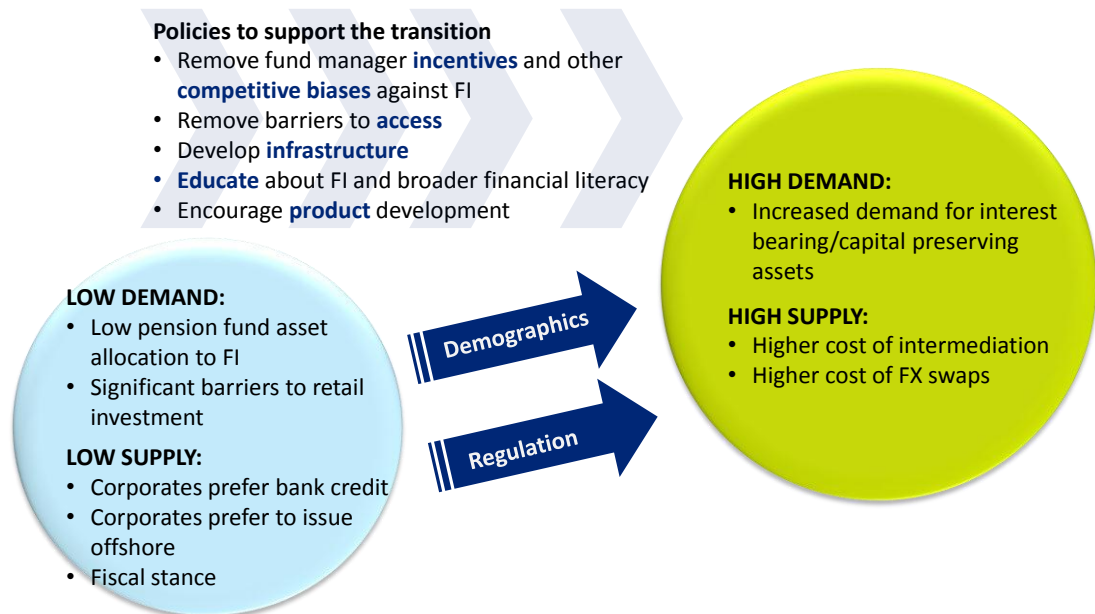
Master trusts would also become a new source of AAA-rated bonds in Australia and potentially attract other investors, including Asian buyers of A\$ bullet-style bonds.

Master trusts could also alleviate concentration risk in Australian financial markets. There are very few A-rated and AA-rated corporate issuers in Australia. These new securitised assets would be tied to a large pool of liabilities rather than to one issuer, introducing greater diversification to fixed income markets.

5 Conclusion

Imminent demographic and regulatory developments have the potential to catalyse policy interventions aimed at changing demand for and supply of fixed income assets in Australia. This presents an opportunity to nudge the current low equilibrium in Australian FI markets towards one characterised by higher volumes.

Figure 5.1: Nudging the system away from a “low” towards a “high” equilibrium



Policy interventions that could be considered include:

- correcting the competitive bias against FI caused by regulatory, tax and remuneration incentives by, for example, introducing a fee for deposit insurance and/or “too big to fail” status, eliminating adverse incentives in portfolio management, and allowing mutuals to access franking credits;
- improving access to the market and reducing the regulatory burden associated with FI by, for example, standardising terms and conditions for corporate issues—particularly for ‘vanilla’ bonds;
- developing infrastructure to facilitate the market for FI assets, including an online trading platform similar to the London Stock Exchange Order Book for Retail Bonds (ORB), or listing bonds on the ASX;
- educating investors and other market participants, using mechanisms like an online central repository for debt instruments where circulars and prospectuses can be accessed, and enlisting the support of governments, training institutions, employers, consultants and fund managers; and
- encouraging and supporting product developments such as a municipal bond market, a deeper annuities market, and a wider range of securitised products.

Figure 5.1 illustrates how emergent forces for change could catalyse policy interventions aimed at fostering a higher allocation to FI assets. While governments can prepare the way for such a transition, market participants must also engage if movement beyond the status quo is to occur.

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Appendix A Steering Committee

Table A.1: Members of Steering Committee

Participant	Title	Organisation
Philip Bayley	Ph.D Candidate	Monash University
Jeff Brunton	Head of Credit Markets	AMP Capital
Philip Carmont	Executive Director Funds, Financial Institutions Group	ANZ Banking Group
David Cox	Head of Government Relations	Challenger Limited
Shannon Finch	Partner	King & Wood Mallesons
John Hopper	Head of Income Assets	AustralianSuper
Chad Karpes	Director, Capital Markets	BankAmerica Merrill Lynch Australia
Mihkel Kase	Fund Manager - Fixed Income	Schroders Investment Management Australia
Tim van Klaveren	Executive Director Senior Portfolio Manager	UBS Global Asset Management (Australia)
Rob Kenna	Executive Manager Debt Capital Markets	Commonwealth Bank
David Michell	Chief Executive Officer	Finance & Treasury Association
Gordon Noble	Director of Advocacy and Policy Strategy	Association of Superannuation Funds of Association
Greg O'Neill	President & Chief Executive Officer	La Trobe Financial
Mary Ploughman	Executive Director Securitisation	Resimac Limited
Patrick Tuttle	Chief Executive Officer	Pepper Home Loans
Andrew Twyford	General Manager, Group Treasury	National Australia Bank
Geoff Weir	Executive Director	Financial Centre Task Force
Chris Dalton	Chief Executive Officer	Australian Securitisation Forum
Alex Sell	Chief Operating Officer	Australian Securitisation Forum

Appendix B ANZ Survey

Summary

The investment mandates for most FI managers surveyed by ANZ allow investment in the broad spectrum of domestic fixed income securities. However there were some conditions imposed including: restrictions based on credit ratings and currency; and investment grade investments only. Only one FI manager stated that, despite having a mandate which allows them to invest in FI, they choose not to. In only small minority of cases were FI managers restricted from investing in the broad spectrum of domestic FI.

Credit ratings are an important consideration for most domestic FI managers. For a majority the credit rating requirements are outlined in their investment mandates. The mandates provide investment parameters such as the amount that can be invested at each credit rating. Credit ratings had no importance or limited importance for only a minority of investment fund managers.

Asset consultants were considered to be a driving factor in the amount of funds allocated to domestic FI for around half of those surveyed by ANZ. However while many thought it was important, the views of asset consultants were only part of a broader range of factors. Other factors that were considered important include: the competitiveness of term deposits as an alternative; yield on FI products, value relative to global alternatives; market sentiment; and perceived risk. Tax and government guarantees were only considered important for a minority of domestic FI managers.

A majority of the FI fund managers surveyed felt that an increase in the volume of long dated bonds being issued by the Government would be beneficial for the Australian bond market. Increasing liquidity and the pricing benchmark associated with government bonds were the main reasons given for why this would be beneficial. Of those who did not think that it would benefit the market, the existing structural impediments and lack of demand for Australian bonds were considered to be more important.

There was not a strong consensus amongst the domestic FI managers surveyed that the bond market would benefit from being listed or quoted on the ASX. In particular, some respondents doubted that listing on the ASX would considerably increase liquidity in the bond market. Greater transparency of pricing, and benefits to retail investors were cited as positive outcome of listing on the ASX.

Imputation credits, franking credits and negative gearing on property were highlighted as the main tax hindrances for fixed income relative to other asset classes. In particular a bias towards equities as a result of these hindrances was noted by many of the FI managers. However, while disadvantages were noted, some FI managers felt that it was immaterial to the asset allocation decision.

A number of policy or regulatory factors were identified as constraints for investments in domestic fixed income. The government guarantee for bank deposits was noted by a number of FI managers as being a particular issue. The inconsistency of treatment by regulators (ASIC and APRA) between debt and equity for the same or similar companies was also seen as a constraint for the domestic FI market. A lack of financial literacy and the taxation issues for FI were noted by a small number of FI managers.

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