SUBMISSION

House of Representatives Standing Committee on Tax and Revenue: Inquiry into the Development of the Australian Corporate Bond Market

1 October 2020

The Association of Superannuation Funds of Australia Limited
Level 11, 77 Castlereagh Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T +61 2 9264 9300
1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au

ABN 29 002 786 290 CAN 002 786 290

File: 2020/25

House of Representatives Standing Committee on Tax and Revenue

PO Box 6021

Parliament House

CANBERRA

Canberra ACT 2600

Via email: taxrev.reps@aph.gov.au

1 October 2020

Dear Committee Secretariat

Inquiry into the Development of the Australian Corporate Bond Market

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the Inquiry into the Development of the Australian Corporate Bond Market.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.9 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing almost 90 per cent of the 16 million Australians with superannuation.

*****

If you have any queries or comments in relation to the content of our submission, please contact Andrew Craston, Director Economics, on (02) 8079 0817 or by email acraston@superannuation.asn.au

Yours sincerely

Martin Fahy

CEO

Introduction

For several years, there has been an ongoing debate around the merits of developing a deeper and more liquid corporate bond market in Australia, including with respect to the retail segment of the market. It is argued that a well-developed domestic corporate bond market would provide:

- Australian SMEs, in particular, with alternative sources of funding
- domestic investors, including private individuals, with greater opportunity to invest in domestic corporate debt as part of a diversified investment portfolio.

There are numerous impediments to market development, which have been highlighted in a number of government reviews – including the 2014 Financial System Inquiry (the Murray Inquiry). While recent reforms have helped to increase corporate bond issuance and support the domestic market, key impediments to development are largely systemic in nature – such as the size of the Australian economy and the availability of alternative funding sources for corporates (including offshore funding sources).

A key focus of this submission is the role of APRA-regulated superannuation funds as investors in the corporate bond market on behalf of households.

APRA-regulated superannuation funds invest in Australian corporate bonds as part of a diversified portfolio of investments. As at the end of June 2020, superannuation funds had direct holdings of Australian corporate bonds totalling $34 billion, as well as indirect holdings. Overall, ASFA estimates that holdings of Australian corporate bonds by superannuation funds total around $60 billion.

Corporate bonds are but one of many mechanisms by which APRA-regulated superannuation funds invest in the Australian corporate sector. Other forms of investments include listed equity, listed and unlisted interests in property and infrastructure assets, syndicated lending, and venture capital and private equity. ASFA estimates that current investments of superannuation funds in listed Australian equities are equivalent to around 20 per cent of the market capitalisation of the ASX – a share that has been increasing over time.

Future investments by superannuation funds in Australian corporate entities, including via corporate bonds, will support the economy's recovery from the COVID crisis and beyond. Superannuation funds stand ready to mobilise the savings of Australian workers to help fund new investments by Australian corporates. Higher levels of productive capital in the economy underpin higher levels of GDP and labour productivity. Ultimately, this leads to higher wages for workers and higher living standards for the broader Australian population.

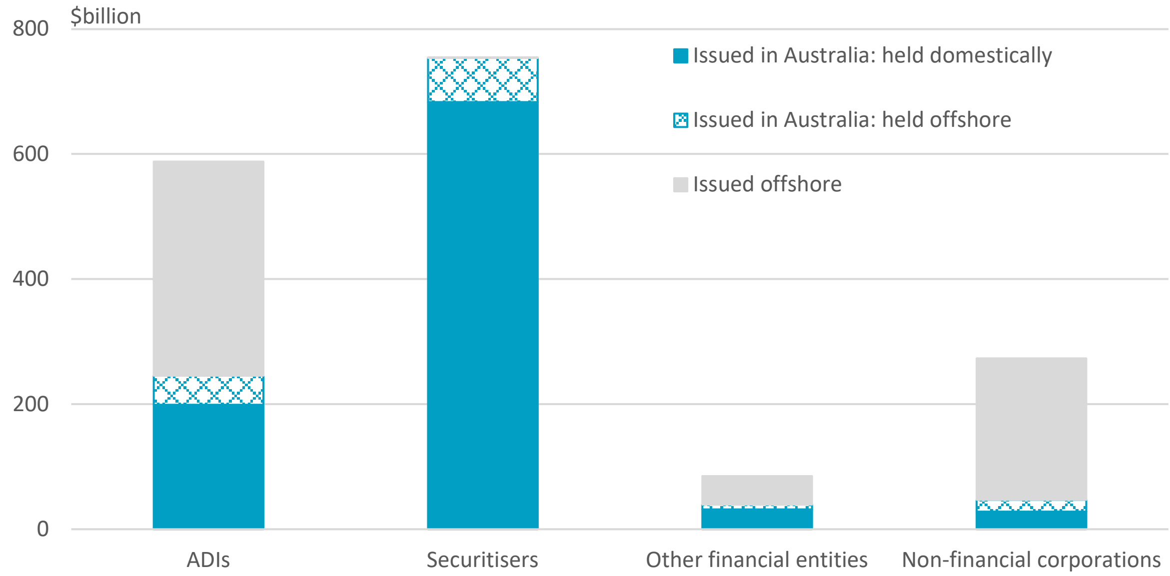
Context: Australian corporate bonds

Australian corporate bonds are bonds issued by any Australian non-government entity – whether issued in Australia or offshore. This includes bonds issued by Australia's major banks and other financial entities, and Australia's private non-financial corporations (hereon referred to as *non-financial corporations*). As at the end of June 2020, the value of bonds (outstanding) issued by Australian corporate entities, in Australia and offshore, totalled $1.7 trillion.[i]

The domestic market for Australian corporate bonds is smaller than suggested by the headline data

With respect to bonds issued in Australia only (by Australian corporate entities), the value of bonds outstanding totalled $1.1 trillion at the end of June 2020. Issuance in the domestic market is dominated by Australian financial entities (96 per cent of total bonds outstanding). Non-financial corporations account for just 4 per cent of domestic issuance outstanding (Chart 1).[ii]

Chart 1: Corporate bonds outstanding, by issuer and jurisdiction of issuance



Source: ABS

The largest issuer segment in the domestic market is securitisers. Securitisation is utilised by Australian financial institutions (mainly authorised deposit-taking Institutions, or ADIs) to raise funding indirectly through capital markets – mainly to help fund their mortgage lending activities.[1] While Chart 1 shows around $750 billion of (domestically-issued) securitised bonds outstanding, only a relatively small proportion is marketed to investors. At present around three-quarters of the bonds on issue are the result of so-called self-securitisation, where the bonds are held by the originating ADI for use as collateral with the RBA for its market operations.[iii] [2]

This means that the effective size of the domestic securitised bond market is around $150 billion (rather than around $750 billion), and that the effective size of the domestic market for Australian corporate bonds is around $475 billion (rather than $1.1 trillion). Foreigners hold around 13 per cent ($144 billion) of domestically-issued bonds. Thus, domestic investors hold around $330 billion of domestically-issued bonds (excluding self-securitisation bonds).[iv]

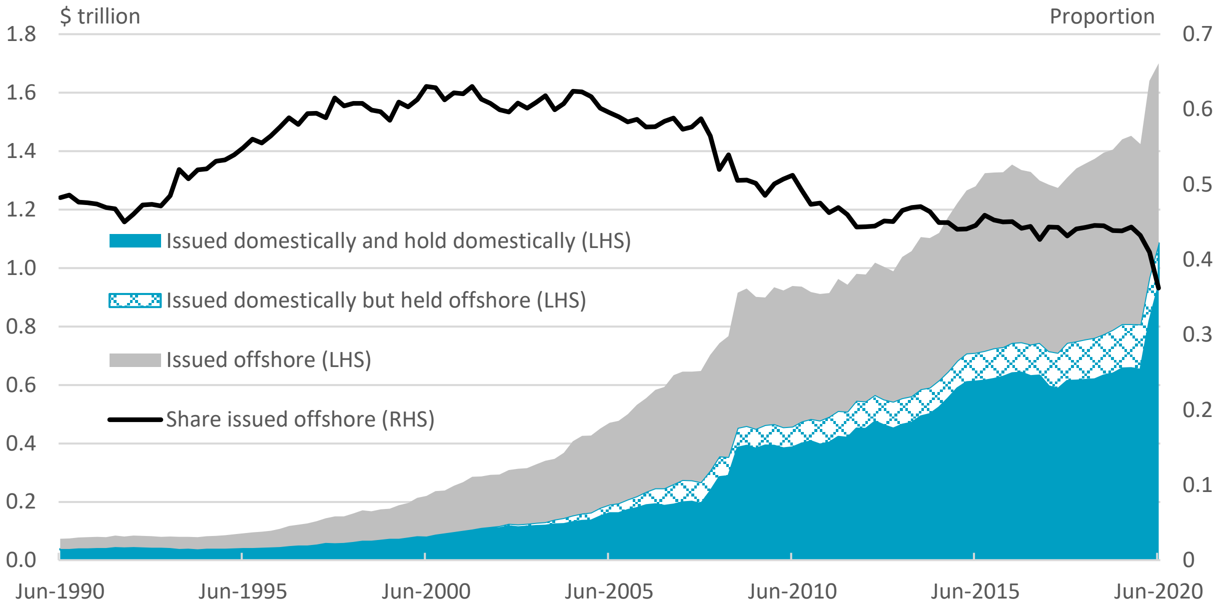
The offshore market remains a key component of the broader market for Australian corporate bonds

As at the end of June 2020, the value of bonds (outstanding) issued offshore by Australian corporate entities totalled $616 billion, with the bulk of those issued in the US. As shown in Chart 2, offshore issuance currently represents 36 per cent of all Australian corporate bonds on issue (this proportion *includes* self-securitised bonds). The current share is at its lowest level since the late-1980s. The sharp drop in the offshore share in the first half of 2020 largely reflects the self-securitisation activities of major ADIs.[v]

[1] A financial institution sells a pool of assets to a specially-created company or trust – typically referred to as a special purpose vehicle – which finances the asset purchases by issuing securities (the assets serve as collateral for the securities). In Australia, as is the case in many other advanced economies, the majority of such securities are backed by residential mortgages.

[2] Particularly for the RBA's Committed Liquidity Facility.

Chart 2: Corporate bonds outstanding, by jurisdiction of issuance



Source: ABS

Particularly for well-established corporates, offshore issuance can be cheaper, in larger volumes, and for longer tenures than in the Australia market. It also allows corporates to diversify their sources of funding (the Murray Inquiry addressed these issues in detail).

Issuers of Australian corporate bonds

In Australia, corporate bonds are typically issued into the wholesale corporate bond market (for purchase by institutional investors), with subsequent trading occurring in over-the-counter (OTC) markets. Historically, in any year, upward of 95 per cent of domestically-issued Australian corporate bonds (by value) are issued into the wholesale market.[vi]

Institutional investors that purchase corporate bonds include APRA-funds, which access the wholesale market through mandated investment managers. Individuals who qualify as sophisticated investors can also purchase corporate bonds in the wholesale market via third parties.

Only a small proportion of corporate bonds on issue can be directly purchased by retail investors. There is a small number of listed bonds available for retail investors on the ASX. While the number of corporates issuing listed bonds each year has not increased appreciably over recent years, the value of individual issuance has tended to increase.[vii]

Financial entities

Generally speaking, Australian financial entities do not face structural impediments to issue bonds in the domestic market. Indeed, for the large banks in particular, the major factor likely to influence future issuance in the domestic market is the capacity for domestic investors to absorb that issuance.

Financial entities include ADIs, securitisers and a variety of wholesale investment funds that raise funding via bond issuance (the *other financial entities* category).

For ADIs, only around 34 per cent of bonds currently outstanding were issued locally, and of that only three-quarters are held by domestic entities ($130 billion). For Australia's major banks in particular, the large proportion of offshore issuance reflects banks' capacity to tap offshore funding sources – generally on more attractive terms than in Australia.[viii]

However, it also reflects their capacity to raise additional funds in the domestic market. APRA-regulated superannuation funds have exposure to the major Australian banks through a variety of investments, including listed equities and short and long-term debt securities (including bonds). Broadly speaking, there is a substantial exposure to the major banks, and this may to some degree limit funds' appetite for further issuances from them.

APRA-regulated funds hold around $20 billion in ADI bonds directly, or around 16 per cent of total domestic holdings of locally-issued ADI bonds (outstanding).[ix]

Similar issues apply to bonds issued by securitisers. RBA analysis suggests that the stock of securitised bonds marketed to investors is more-or-less evenly split between three types of (ultimate) issuers: the major banks; other ADIs and non-ADI mortgage lenders.[x] Overall, the bulk of securitised bonds are backed by residential mortgages. That institutional investors – including APRA-regulated funds – have significant exposure to Australia's residential property market via holdings of ADI equities and bonds suggests limited appetite for further issuance. In this regard, it should be noted that around half of all marketed securitised bonds (outstanding) that have been issued in Australia are held by foreign investors.

Non-financial corporations

Barriers to fund raising for non-financial corporations are relevant to small and medium-sized enterprises (SMEs) rather than large corporates.

The corporate bond market is just one of various mechanisms through which non-financial corporations raise funding. For corporates, the choice of funding mix aims to minimise the overall cost of capital, and so reflects the cost of competing funding sources. Financing decisions also reflect a host of other factors, including preferences for internal over external financing, and preferences concerning diversification of funding sources. Of course, lack of access to particular funding sources will exclude their use.[xi]

Large non-financial corporates

Corporate bond issuance is dominated by Australia's largest, and well-established companies.

While large non-financial corporates do not face barriers to bond issuance in Australia, offshore markets – particularly the US – can be more attractive than the Australian market. As noted above, for well-established corporations in particular, offshore issuance can be cheaper, in larger volumes, and for longer tenures than in the Australia market.[xii]

Domestic issuance of corporate bonds by large corporations remains, on average, a small share of their aggregate funding mix. Domestic issuance is typically into the wholesale market for institutional investors, but there is also a small number of listed retail bonds for retail investors on the ASX.

APRA-regulated funds hold around $7 billion in non-financial corporate bonds directly, or around 25 per cent of total domestic holdings of locally-issued bonds (outstanding).[xiii]

SMEs

The major barriers that SMEs face with respect to issuing debt relate to the cost of issuance and impediments to market access (compared to say bank intermediated funding). These issues are well-known and have been explored at length elsewhere, including in the Murray Inquiry.[xiv]

That said, the number and value of corporate bond issues that are below A-rated is increasing. At the beginning of the century, there was almost no BBB-rated corporate bonds (for non-financial corporates) on issue in Australia, compared with A-rated bonds (Chart 3).

Chart 3: Number of corporate bond issues outstanding

Chart 3a: A-rated bonds

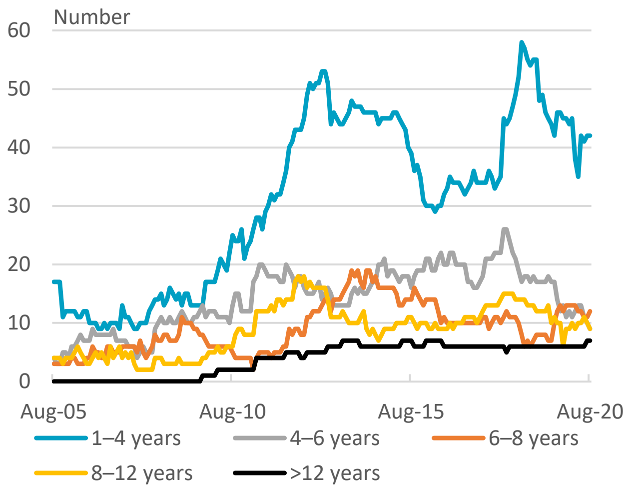
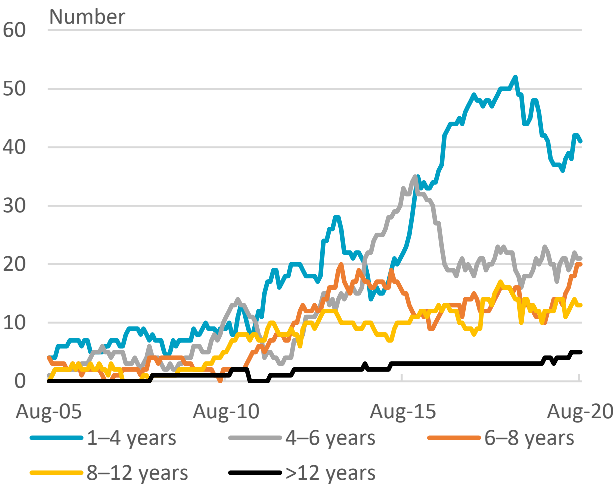


Chart 3b: BBB-rated bonds



Source: RBA

However, over the last two decades, the number and value of BBB-rated bonds on issue has increased markedly. This is particularly the case for bonds with maturities of between 1 to 4 years, and to a lesser degree for bonds with maturities of between 4 to 12 years.

Historically, corporates required a credit rating to issue in the Australian market. This is a lengthy and costly process, and for smaller companies, the costs may outweigh any benefits. However, a nascent market for unrated corporate debt is slowly developing. Over recent years, the number and value of unrated corporate debt issues have increased, which have been targeted at high net-wealth retail investors.[xv] Key players in facilitating recent unrated deals include bond brokers and some of Australia's major banks.

Development of the unrated market is likely to occur disconnected with development of the liquid, rated market. As a source of funding for corporations, these two markets are not substitutes – that is, there is little reason why a rated corporate would issue into the unrated market, and unrated corporates do not have access to the rated market. With respect to investors, a typical APRA-regulated fund may only have a mandate for investments in rated securities.

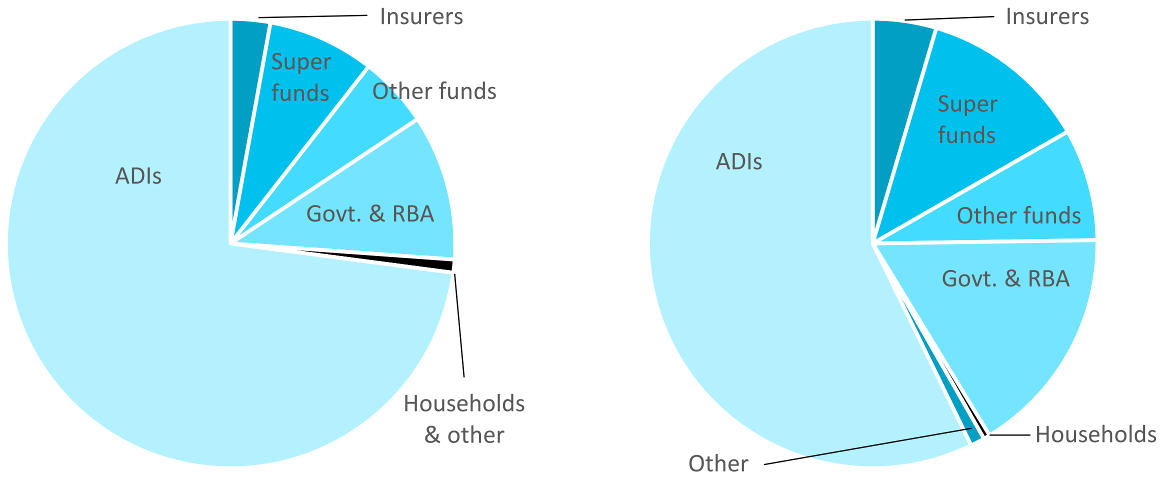
Domestic holders of Australian corporate bonds

Domestic holders of Australian corporate bonds include general government entities and the RBA, financial institutions (including APRA-regulated superannuation funds), and households (including SMSFs).

Chart 4a shows that ADIs hold around two-thirds of domestically-held corporate bonds. However, as noted above, the majority of bonds issued via securitisation vehicles for ADIs are not marketed to investors but held by the ADIs themselves. If these particular securities are excluded, the composition of domestic holders becomes more diversified (Chart 4b).

Chart 4: Domestically-held Australian corporate bonds outstanding

Chart 4a: All bonds | *Chart 4b: Ex. self-securitisation bonds*



Source: ABS and APRA

Superannuation funds

APRA-funds are a key investor segment for Australian corporate bonds.

As investors in corporate bonds, APRA-funds principally operate in the wholesale institutional market. The most common approach for APRA-regulated funds is to invest in corporate bonds (and fixed income securities generally) via fixed income investment managers that have the capability to source investments on a global basis. For a particular fund, investment managers can be external to the fund, or part of the fund's internal investment team.

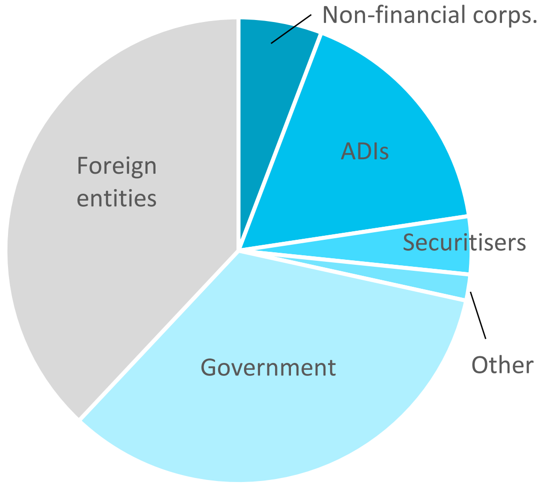
For a particular fund, a fixed income mandate will focus on managing the major factor risks; that is inflation, credit and interest rate risk. Fixed income investment managers have a sophisticated understanding of how risk factors impact on returns and are able to re-weight portfolios that take into account evolving market circumstances.

ASFA estimates that APRA-funds hold around $60 billion in Australian corporate bonds, which comprises around 10 per cent of the market (ex. self-securitisation bonds, Chart 4b). This includes bonds that are held directly, but also indirect holdings – typically as units in a wholesale investment trust.

In terms of the composition of APRA-funds' direct holdings, the majority represents funding for financial corporations. Around 60 per cent of holdings are bonds issued by ADIs, and a further 15 per cent are bonds issued by securitisation vehicles – largely as funding sources for ADIs that are backed by residential mortgages. Around 20 per cent of APRA-funds' holdings are bonds issued on behalf of non-financial corporations.

With respect to APRA-funds' broader bond holdings, which includes bonds issued by government and foreign entities, Australian corporate bonds account for just over a quarter of the total (Chart 5). Bonds issued by Australian non-financial corporations account for around 6 per cent.

Chart 5: APRA-regulated funds total bond holdings



Source: ABS and APRA

APRA-funds will continue to seek yield where the returns are most favourable. However, there are a number of structural impediments to APRA-funds increasing their allocation to Australian corporate bonds.

Firstly, there is only a small number of new bond issues each year (around 30 per year) in the Australian market. Furthermore, issuance tends to be concentrated in a few industries – particularly banking and resources. Together, this limits funds' capacity to diversify credit risk in their portfolios, and thus creates a natural limit on the capacity for APRA-funds to increase their allocation to Australian corporate bonds.

Secondly, investments in a particular corporation's bonds may add to concentration risk in a fund's broader portfolio. While a major Australian corporation may make a new bond offering in the Australian market, APRA-funds (and other institutional investors) may already have a (positive) correlated exposure to that corporation through holdings of the corporation's listed equities (depending on the structure of the corporations balance sheet).

This is particularly the case for the major Australian banks, where APRA-funds have exposure to banks' assets – the largest component of which is residential mortgages – through holdings of bonds and listed equities.

Superannuation funds: future demand

Demand in Australia for fixed income securities, including corporate bonds, is likely to increase over coming decades. A key driver of demand will be superannuation funds.

Superannuation assets will continue to grow over coming decades due to a combination of compulsory and voluntary contributions and investment earnings. Projections for the size of the system have total assets continuing to increase as a share of GDP until around 2050. All else being equal, this will increase demand for all asset classes including Australian bonds.

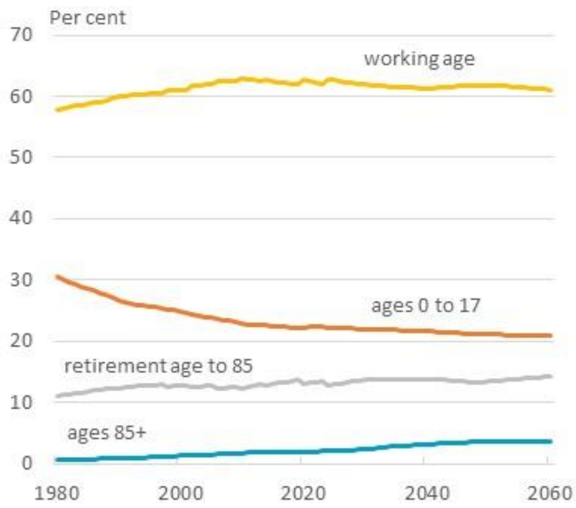
As the population ages, the proportion of system assets in the retirement phase will increase (Box 1). Since post-retirement products typically have higher allocations to fixed income investments compared to investments in the accumulation stage, this should amplify demand for fixed income investments in general.

Ultimately, the composition of APRA-funds' holdings of fixed income securities – between domestic and foreign issuers, and between financial and non-financial corporates – will in part depend on the development of the Australian market. This includes how the depth and liquidity of the market evolves, as well as the diversity of debt securities that are available for investors – which, at present, is a constraint on APRA-funds' allocations. That said, increased demand from APRA-funds for fixed income securities may help spur development of the Australian market. How this dynamic evolves in an open question.

Box 1: Australia's aging population and system assets

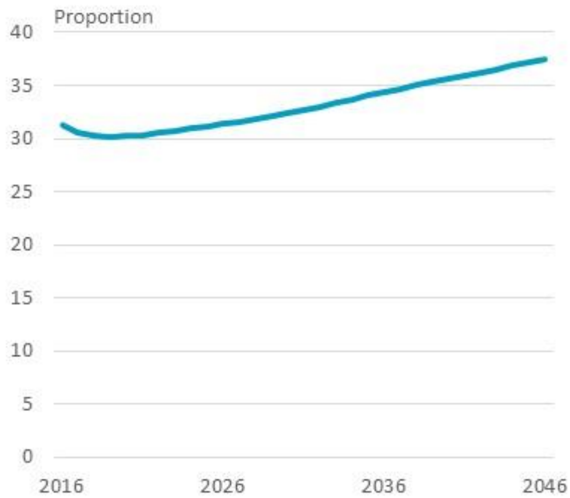
It is a long-established fact that Australia's population is getting older. Over the next few decades the proportion of people who are of working age will decline, while the proportion of those of retirement age and older will increase (Chart 6). By 2054-55, population ageing means there will be around three working-age people for each person of retirement age and older, compared with around four today and around seven in 1975.[xvi]

Chart 6: Population cohorts[xvii]
(% total population)



Source: ABS and the Australian Treasury[xviii]

Chart 7: Superannuation assets in the retirement phase
(% total superannuation assets)



Source: Rice Warner

Population ageing will drive the ongoing shift of superannuation assets—at the system level—from the accumulation phase to the retirement phase (Chart 7).

Today, around 30 per cent of assets in the superannuation system are in the retirement phase – where total retirement-phase assets are, broadly speaking, evenly split between institutional superannuation funds and self-managed superannuation funds (SMSFs). By 2040, the share of retirement-phase assets in the superannuation system is projected to be just below 40 per cent.

SMSFs and retail investors

Households directly hold around $3 billion in Australian corporate bonds, around two-thirds of which are bonds issued by ADIs. This represents only around 0.5 per cent of the market (ex. self-securitisation bonds). This includes holdings of SMSFs.

In households' portfolios, corporate bonds comprise a very small share of households' direct holdings of financial assets (around 0.25 per cent), which overwhelmingly comprise Australian listed equities. This is also reflected in asset allocations of SMSFs. That said, households are also exposed to Australian corporate bonds via their superannuation investments (and investments in other types of managed funds).

There are a number of fundamental, and well-known, reasons for households' limited investments in corporate bonds (and for that matter, fixed income securities more broadly).

Firstly, access for retail investors to corporate bonds is limited. With respect to the rated corporate debt market, upward of 95 per cent of domestically-issued Australian corporate bonds are issued into the wholesale market, with subsequent trading undertaken in the OTC market.[xix]

Retail investors can directly purchase units in Australian corporate debt securities via the ASX, however there is only a small number of individual offerings available. As noted in preceding sections of this submission, for a corporate, the attractiveness of issuing to retail investors will depend on the availability and cost of alternative funding options.

A second impediment is the availability of close substitutes (for fixed income securities) for retail investors. In particular, the ability of SMSFs to invest in bank deposits – that are subject to a government guarantee for the first $250,000 of deposits – acts to reduce incentives to invest in fixed income securities and corporate bonds, and would continue to do so even if retail access to corporate bonds improved. SMSFs' appetite for deposits is highlighted by the fact that, on average, SMSF holdings of cash and term deposits account for 22 per cent of total assets.[xx]

Thirdly, there is a lack of understanding about the role and features of fixed income securities and corporate bonds in particular. For example, research undertaken by Deloitte found that almost 70 per cent high net-worth individuals (HNWIs) without corporate bond holdings did not have sufficient understanding of corporate bonds to feel comfortable making an investment in corporate bonds. The same research found that only around 16 per cent of HNWIs own corporate bonds.[xxi]

Individuals with sufficient assets can qualify as a sophisticated investor and purchase bonds from the wholesale market through a broker. This includes rated corporate bonds, but also unrated bonds.

With respect to the latter, issuers of unrated bonds have targeted HNWIs as potential investors (HNWIs would tend to be able to qualify as a sophisticated investor). However, as the survey results above suggest, only a small proportion of those individuals are likely to have sufficient expertise to determine whether a particular corporate debt security is a sound investment. Looking ahead, greater participation of HNWIs in this market would mean that a growing share of that cohort of Australians would be exposed to potentially significant (downside) credit risk associated with unrated debt.

[i] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, June 2020, ABS Cat. no. 5232.0, Table 44.

[ii] ibid.

[iii] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, June 2020, ABS Cat. no. 5232.0, Table 25, and Reserve Bank of Australia 2018, *The Reserve Bank's Securitisation Dataset*, RBA Bulletin, December 2018 (https://www.rba.gov.au/publications/bulletin/2018/dec/the-reserve-banks-securitisation-dataset.html).

[iv] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, June 2020, ABS Cat. no. 5232.0, Tables 25 and 44, and Reserve Bank of Australia 2018, *The Reserve Bank's Securitisation Dataset*, RBA Bulletin, December 2018 (https://www.rba.gov.au/publications/bulletin/2018/dec/the-reserve-banks-securitisation-dataset.html).

[v] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, June 2020, ABS Cat. no. 5232.0, Tables 25 and 44.

[vi] Deloitte 2018, *The Corporate Bond Report*.

[vii] For example, see https://www.nab.com.au/content/dam/nabrwd/documents/reports/investment/an-investors-guide-to-debt-securities.pdf

[viii] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, June 2020, ABS Cat. no. 5232.0, Table 16.

[ix] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, June 2020, ABS Cat. no. 5232.0, Table 16.

[x] Reserve Bank of Australia 2018, *The Reserve Bank's Securitisation Dataset*, RBA Bulletin, December 2018. https://www.rba.gov.au/publications/bulletin/2018/dec/the-reserve-banks-securitisation-dataset.html

[xi] The Australian Government the Treasury 2014, *Financial System Inquiry: Interim Report* (https://treasury.gov.au/sites/default/files/2019-03/p2014-fsi-interim-report.pdf).

[xii] The Australian Government the Treasury 2014, *Financial System Inquiry: Interim Report* (https://treasury.gov.au/sites/default/files/2019-03/p2014-fsi-interim-report.pdf).

[xiii] Australian Bureau of Statistics, *Australian National Accounts: Finance and Wealth*, September 2019, ABS Cat. no. 5232.0, Table 44.

[xiv] For example, see The Australian Government the Treasury 2014, *Financial System Inquiry: Interim Report* (https://treasury.gov.au/sites/default/files/2019-03/p2014-fsi-interim-report.pdf).

[xv] In 2012 there were 3 issues valued at around $700 million, compared with 11 issues in 2017, valued at more than $1 billion (Deloitte 2018, *The Corporate Bond Report*).

[xvi] Australian Government 2015, *2015 Intergenerational Report*.

[xvii] Assumes anticipated changes to the eligibility age for the Age Pension from 65 to 67 (over the period 1 July 2017 to 1 July 2023).

[xviii] Australian Bureau of Statistics (*Australian Demographic Statistics*, ABS Cat. no. 3101.0, July 2017 and *Population Projections*, Australia, ABS Cat. no. 3222.0, November 2013), and The Australian Government the Treasury, 2015 *Intergenerational Report: Australia in 2055*.

[xix] Deloitte 2018, *The Corporate Bond Report*.

[xx] Australian Tax Office, *Self-managed Super Fund Quarterly Statistical Report*, March 2020

[xxi] Deloitte 2018, *The Corporate Bond Report*.