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ASFA Policy and Industry Practice

Developing Australia's fixed interest markets

Discussion Paper

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Association of Superannuation Funds of Australia

ASFA Secretariat
Level 6
66 Clarence Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Ph: +61 2 9264 9300
Fax: +61 2 9264 8824 or 1300 926 484

Outside Sydney
1800 812 798

Website: www.superannuation.asn.au

The Association of Superannuation Funds of Australia Limited ABN 29 002 786 290 ACN 002 786 290

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DEVELOPING AUSTRALIA'S FIXED INTEREST MARKETS

Australia is at an important moment in its economic history. The vision of 20 years ago, with the introduction of the Superannuation Guarantee (SG), of a system that will deliver a comfortable retirement for most of its citizens, is about to be tested. The baby boomer generation has started retiring and so the first people to have two decades or more of compulsory super savings will see what the system actually delivers in retirement. At the same time, the pool of retirement savings has reached a tipping point: at almost 100 per cent of GDP and growing fast, the super pool is too big to be ignored in any sensible view of Australia's economic policy.

To address some of these issues, the Association of Superannuation Funds of Australia (ASFA) brought together the superannuation industry and many external stakeholders in March of this year, to discuss the role of fixed interest investments in superannuation portfolios. While newspapers paid attention to the comments by former Secretary to the Treasury Ken Henry that there is a need for super funds to consider their overall allocation to equities, the forum also featured former US vice president Al Gore voicing his concerns about the structure of the financial services industry and a panel of experts that debated the merits and challenges of creating a deep and liquid corporate bond market.

ASFA's Investment Interchange event represented the continuation of a conversation on the role that Australia's fixed interest markets should have in the financial services industry and more broadly in the investment portfolios of superannuation fund members.

ASFA is working with the Australian Securitisation Forum and Finance and Treasury Association on a research project that will specifically identify and make recommendations regarding policy or market factors that inhibit the allocation of Australia's superannuation and broader investment markets to the domestic fixed income asset class.

It is important to understand that the conversation about Australia's fixed interest markets is not about the relative attractiveness of bond investments today: Bond markets have had a strong recent performance history and now may, or may not, be the time to increase exposure to bonds. This is however not the question.

There are two key reasons why it is important to have a conversation around the role that the superannuation industry has to play in supporting the development of Australia's fixed interest markets. Firstly, that demographic reality of more people moving out of superannuation's accumulation phase creating greater demand for less volatile investment returns; and secondly, the expectations of the superannuation pool to play a broader role in our society and the economy.

Allocation to fixed interest investments

The first reason relates to the projected increase in demand for fixed interest investments by superannuation fund members. It is a fact that as a nation, many of our 4.5 million baby boomers will make decisions to retire over the next decade. As a significant portion of superannuation members and funds under management move from an accumulation phase to retirement phase, there are likely to be fundamental impacts on the structure of superannuation investments.

While a significant question to be explored is how superannuation funds should be invested in retirement, a separate question is whether we have the appropriate investment strategies in the accumulation stage. At the ASFA Investment Interchange, former Treasury Secretary Ken Henry was very forceful in his views stating:

> "It might be tempting to think that so-called 'growth' strategies serve the interests of fund members in the accumulation phase, with more 'conservative' strategies serving the interests of those who have already retired; that is, those who are in the drawdown phase. The latter is probably true. The former might also be true. Then again, it might not be.
>
> "In essence, the argument supporting a heavy weighting of stocks over bonds in the accumulation phase goes like this: Shares outperform bonds over a long period of time. The accumulation phase of superannuation is also a long period of time. Therefore, shares are a superior investment in the accumulation phase of superannuation. Stated as baldly as this, the non sequitur will be clear.
>
> "What should be a key concern for super fund members is 'sequence risk'.
>
> "Even over periods as long as 20 years, it has not always been the case that equities outperform fixed interest, though it has generally been the case. The more important point, though, is that timing – specifically, the sequencing of variable returns – is everything. The non sequitur I retailed earlier should properly be reconstructed as follows:

Shares can be expected generally to outperform bonds over sufficiently long periods of time. The accumulation phase of superannuation is also a long period of time. Therefore, considering the average experience of all superannuation fund members over a sufficiently long period of time, shares are a superior investment in the accumulation phase of superannuation. But that's the average. Thus, around that average experience, depending upon when they enter the system and when they retire, some fund members will benefit enormously from a portfolio weighted heavily toward equities while others will lose 'big time'. And nobody knows, in advance, who will win and who will lose. That is an implication of sequence risk."

Henry concluded the superannuation industry needs to think about what is in the best interests of members:

"In the depths of the global financial crisis I convened a meeting of fund managers to discuss the macroeconomic debt-funding issue and, in particular, what it would take to get Australia's superannuation funds more interested in bank term paper and in supplying debt financing directly to the Australian non-financial corporate sector. It was not a very successful meeting. I was told that equity would always out-perform debt over any time period relevant to Australia's superannuation fund members. I wasn't convinced then. And I'm even less convinced today. There are very good reasons, it seems to me, to be asking the question again. In doing so, we should be thinking much more seriously about what sort of asset portfolio really is in the best interests of our superannuation fund members, especially as they move into retirement."

Contributing to the national economy

The second issue relates to the responsibilities that the superannuation system has to our wider society and economy. There are many ways that superannuation investments already contribute to the wider economy. ASFA's research has demonstrated that the superannuation pool has increased Australia's economic growth rates above that which would have applied if we didn't have a compulsory superannuation system.

It is likely that over coming years there will be increased focus on the role that the superannuation pool plays in the economy. We have already seen this in the conversation around infrastructure investment. A specific question that has been put to the superannuation industry is whether superannuation can contribute to the development of a deep and liquid corporate bond market.

The Federal Treasurer, Wayne Swan, convened a meeting of major superannuation funds, corporate treasurers, investment banks and Treasury officials on 13 December 2011 to discuss the challenges of developing a deep and liquid corporate bond market in Australia. The hope of the Government is that developing Australia's corporate bond market provides an alternative funding mechanism for smaller corporations to reliance on bank funding. There is concern in Government that banks' reliance on wholesale debt markets makes Australia particularly vulnerable in the event that either markets freeze or margins rise.

Speaking at the ASFA Investment Interchange, executive director - markets group from the Federal Treasury Jim Murphy described why it was important that the superannuation industry assist in developing Australia's corporate bond market from a government policy perspective:

"Realistically the GFC [global financial crisis] was a watershed. Maybe prior to the GFC we didn't need a corporate bond market. We were happily going along with offshore funding sources. As a policy goal we think there is great benefit having diversification of funding sources for corporate Australia and the financial system. Why? Double diversify risk in the system.

"The development of a corporate bond market would principally fund medium sized Australian companies. It is much more difficult for smaller companies to go offshore to raise capital. A vibrant debt market would provide that facility. What the government is going to do is to list CGS [Commonwealth Government Securities] to provide a platform. We are simplifying disclosure and liabilities for those issuing debt.

"What the Government is trying to do is set up the environment for this to happen. As a Treasury person we would say it is over to the market to take up this opportunity. But at the same time it is a responsibility. Would we even be here if we didn't have a mandated compulsory superannuation system? Why? One way of casting it is let's all open our eyes in the superannuation industry and say well in the past we have done reasonably well but do we need to see it is a changing scene and look at the opportunities and whether we need to change our practices, support a debt market and the development of more products to suit the post-retirement phase.

"The bottom line is that a debt market would be a very useful diversification for Australia's financial system."

A difficult conversation

The comments by both Henry and Murphy at the ASFA Investment Interchange are confronting. Superannuation funds are in reality being asked to question fundamental assumptions which have formed the basis of Australia's compulsory superannuation system.

Henry is asking the superannuation system to consider whether the focus on growth investments serves the interests of members in the accumulation stage. This challenges investment professionals who have based asset allocation decisions around the return characteristics of different assets. From Henry's perspective it doesn't matter if equities outperform bonds over long periods of time if an individual superannuation fund member is exposed to sequence risk. For Henry, in a game of trump cards it is sequence risk that overrides the other cards in the deck. If this proposition is accepted, then the way super funds invest would be fundamentally changed.

Murphy by contrast is asking the superannuation system to consider the impact that superannuation has on the overall economy. The sole purpose test has always provided the superannuation system with a defence against interference. It is the job of superannuation trustees, and their professional investment advisers, to determine the appropriate asset allocation strategies. What Murphy is suggesting however is that the superannuation system is more than the sole purpose test. To paraphrase Murphy, it can be argued that superannuation has a social and economic responsibility.

It is likely that the discussion in response to both Henry's and Murphy's arguments will continue for some time. Rather than seeking to definitely decide whether Henry and Murphy are right or wrong, a practical application for the industry is to consider the role that superannuation funds can play in developing Australia's corporate bond market.

This paper summarises the key presentations at ASFA's Investment Interchange, held on Friday 16 March 2012 in Sydney, that informs ASFA's continued policy work in the area of fixed interest investments and more particularly in the development of Australia's corporate bond market.

ASFA will form its own Corporate Bond Working Group to provide input into the broader stakeholder research program that we are working on with the Australian Securitisation Forum and Finance and Treasury Association.

ASFA members who are interested in participating in ASFA's work on fixed interest investment markets should contact:

Gordon Noble
Director, Advocacy and Policy Strategy
Email: gnoble@superannuation.asn.au

THE INVESTMENT INTERCHANGE DEBATE

Setting the scene: Al Gore

Former vice president of the United States Al Gore is well known to ASFA members, having generously given his time at ASFA events on a number of previous occasions.

Mr Gore opened the ASFA Investment Interchange with a speech based on the recent paper *A Manifesto for Sustainable Capitalism* that he and his partner, David Blood, had recently produced.

Gore's thesis is that there is an urgent need to abandon short-term economic thinking for "sustainable capitalism". According to Gore "we are once again facing one of those rare turning points in history when dangerous challenges and limitless opportunities cry out for clear, long-term thinking. The disruptive threats now facing the planet are extraordinary; climate change, water scarcity, poverty, disease, growing income inequality, urbanisation, massive economic volatility and more. Businesses cannot be asked to do the job of governments but companies and investors will ultimately mobilise most of the capital needed to overcome the unprecedented challenges we now face.

Gore is seeking the establishment of a more responsible form of sustainable capitalism and is recommending five key actions for immediate adoption by companies and investors:

1. Identify and incorporate risk from stranded assets.
2. Mandate integrated reporting.
3. End the default practice of issuing quarterly earnings guidance.
4. Align compensation structures with long-term sustainable performance.
5. Incentivize long-term investing with loyalty-driven securities.

"Sustainable capitalism will create opportunities and rewards but it will also mean challenging the pernicious orthodoxy of short-termism. As we face an inflection point in the global economy and the global environment, the imperative for change has never been greater," says Mr Gore.

Investment challenges

Former CEO of Challenger Limited Dominic Stevens asked: "If the primary purpose of the super system is to create stable retirement income, how do we measure the outcome of this?"

According to Stevens the "outcome" reflects not just the investment returns but how they are delivered as an outcome to the retiree. So, not only are the expected returns important but three other issues also affect the outcome:

1. the variability of those returns;
2. the sequence of those returns making up overall performance; and
3. how these returns interact with your longevity (as by definition 50 per cent of people will live longer than the assumed average).

Stevens delved into behavioural economics to grapple with how members deal with investment losses. According to theories first developed by Nobel prize psychologists Amos Tversky and Daniel Kahneman, loss aversion refers to people's tendency to strongly prefer avoiding losses to acquiring gains. Studies suggest that losses are twice as powerful, psychologically, as gains.

According to Stevens in finance we all generally work in what is basically an expected return framework. That is, we generally look at outcomes in terms of maximising expected returns. What that means is we don't differentiate between utility and return and we assume a one-to-one relationship between these measures. Take a dollar away and it has the same effect on utility. However in reality we find people value each additional dollar a bit less.

"Asset allocation is all about loss aversion. If we had absolutely no aversion to loss we would always choose the highest return assets. As such if we want to understand what asset allocation is optimal, we need to begin with what our aversion to losses are," says Stevens. "If we can understand what retirees' loss aversion characteristics are, it will give us an objective basis to imply an efficient asset allocation in their portfolio and by implication, the super system."

The question that Stevens pondered is: What are the loss aversion characteristics of Australian retirees?

In the absence of Australian studies, Stevens examined a joint study by the American Association of Retired Persons and the American Council of Life Insurers (ACLI) in association with Eric Johnson of Columbia University [1]. The research was based on a survey of 800 retirees conducted prior to the GFC. It showed that retirees were highly loss averse with 80 per cent of retirees wanting at least 10 to one odds in their favour before risking their retirement savings. This surprised the researchers and further work is being done in the US on what they call the 'hyper risk averse' nature of retirees.

Key findings of the study include:

- Nearly all respondents (91 per cent) said keeping enough money for their needs later in life is very or somewhat important when making decisions about withdrawing money.
- About four in ten respondents would be very or somewhat likely to trade liquidity for income that was guaranteed to last for the rest of their life if they were given certainty that they would not lose any money (42 per cent).

Stevens concluded that because decision makers in the superannuation industry are in general highly financially literate, we assume that everyone else is. In our own minds we are correctly recommending an expected return maximisation strategy. However, are we accurately representing our members' interests? Maybe our members just might want a 'no material downside' strategy.

"I would say that there needs to be more work done around what loss aversion characteristics super savers and retirees actually have. In my own mind and backed up by limited research from the US, over 50s are quite risk averse, we just are not sure how much. If this indeed is the case then it might suggest lower risk portfolios for this cohort," says Stevens.

Brad Holzberger, chief investment officer at Q Super, argued that when you start to think about retired members and what their asset allocation should be, we know nothing about behaviour of retirement members. "The research is extremely thin. Before we make too many decisions about what our asset allocations should be, we should start at least observing behaviour and inferring risk preferences."

Jeremy Cooper, Chairman, Retirement Income at Challenger Limited says that retirement is different: "We don't know how to measure success in retirement. We think it is just investment performance and in fact there is a whole different utility function in retirement and, until we can work out what that is, we are simply going to chase investment returns that come at the price of high volatility and bad outcomes potentially for members. Part of success in retirement is about compounding and not losing your money rather than chasing excess returns."

Brad Holzberger argued that: "Superannuation fund default strategies look very similar and they haven't changed over 20 years. That is despite the fact that we have had at least three financial crises, the profile and difference amongst the membership has changed remarkably despite the fact that tax has changed significantly and contribution rate which has gone from three per cent to nine per cent and now to 12 per cent. Despite all those externalities, asset allocations have not changed."

Discussion points

Further research needed on the loss aversion of Australian superannuation fund members. There is a debate that fixed interest is a global asset class with the implication that to deliver returns to members, investing locally can only form a subset of an overall portfolio allocation. This issue needs to be explored in greater detail.

[1] AARP, American Council of Life Insurers, What Now? How Retirees Manage Money To Make It Last Through Retirement, December 2007 http://www.aarp.org/work/retirement-planning/info-2007/guaranteed_income.html

THE ACHILLES HEEL OF THE AUSTRALIAN FINANCIAL SYSTEM

While compared to the rest of the world Australia came through the GFC relatively unscathed, policy makers have come to realise just how vulnerable Australia's financial system is. Ken Henry painted a vivid picture, describing Australia's national balance sheet as having the characteristics of a distressed margin-lending scheme:

> "We are a relatively small economy with a large and growing exposure to international financial markets in respect of both assets – principally foreign equities held by our super funds – and liabilities – principally the offshore wholesale borrowings of our banks. In this post-GFC environment, our ability to access global debt capital has a lot more to do with the quality of policy settings and regulatory performance in a lot of other places, especially the United States and Europe. And, to state the obvious, we don't have much control over US and European economic policy makers."

Dominic Stevens described what he labelled the Achilles heel of the Australian financial system:

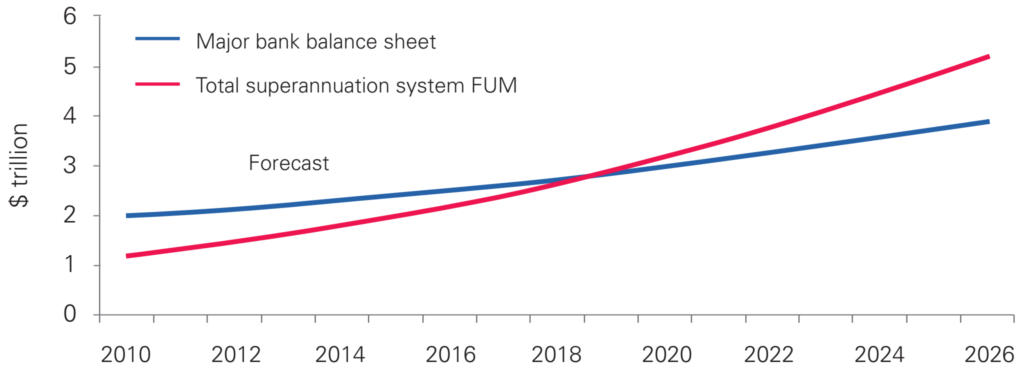
> "We borrow overseas to fund our current account deficit and in addition we further borrow in offshore markets to fund purchases of offshore equities and, to a lesser extent, offshore fixed income. If you step back from that and think of Australia as an individual, this would appear like a $200-300 billion margin lending exercise. The purpose of this offshore investment is the valid attempt to diversify our holdings of investment assets. However, with a significant current account deficit and challenging global financing markets, this may reduce overall efficiency and add to instability.
>
> "This reliance of foreign capital to not only fund the excess of investment over savings but, in addition, significant net investment into offshore assets, has helped cause the slow deterioration in the loan-to-deposit ratio of the banking system. In addition, it has also exacerbated the refinancing risk inherent in our banking system as our liabilities are of significantly shorter term than our assets."

But is Australia's financial system imbalance a problem for superannuation?

Simon Maidment, head of group funding and execution, Commonwealth Bank of Australia (CBA), provided a banking perspective, arguing that compulsory superannuation is one of the primary reasons the imbalance exists.

> "The concept of forced savings; we all appreciate the public policy benefit of that. One of the unintended consequences of forced savings is that while ideally it may have caused consumption to drop, in fact forced savings may have caused leverage to increase; people desire to keep the same level of consumption and in doing that increase the amount of debt that they have, which is why household debt to income levels are very high.
>
> "The other influence that superannuation could have had on the banking sector is clearly extracting savings which otherwise may have come to the banking sector because that saving is taking place off the balance sheets of banks. It is only really in the last two years that we have seen a more risk adverse situation with households and businesses that we have seen the savings rate in Australia increase."

Analysing the size of Australia's superannuation pool, Stevens argued that it will soon be greater than the banking sector.



Source: Banks' balance sheet growth (UBS Research Feb 2012).
Superannuation FUM: Rice Warner Projections 2011

Stevens believes that as the superannuation pool grows it will become the primary savings mechanism for the average Australian and, by definition, the primary source of long-term capital in the Australian economy.

> "This means the question that we should be asking ourselves today is 'how do we bring the primary purpose of super, that is creating stable retirement income, together with the funding needs of our growing economy to maximise the efficiency of our capital and investment markets?'.
>
> "The borrowers' demand for debt finance is being met by borrowing offshore. Because local savings are being used to buy foreign assets, they are not being used to fund domestic investment, which means we need to source finance offshore. To complete the picture, because the total demand for investment capital actually outweighs the total supply of saving, we borrow even more funds overseas to finance the Current Account shortfall. So, as a country at a high level, a large proportion of this margin lend is effectively funded by the domestic banking system. This has two major issues:
>
> "Firstly, much of the debt finance is originated offshore and can be an unreliable source of finance, as in 2008 when the global economy hit problems. In fact I would argue that there is a structural shift going on in debt capital markets. This change is fundamentally increasing the cost of cross-border debt finance.
>
> "Secondly, the concentration of these borrowings through four major banks who are highly correlated with one another. It is no secret that for an economy that is close to one-and-a-half per cent of the worlds' GDP [gross domestic product], we often see these four banks figure in the top 20 global wholesale finance borrowers.
>
> "This importing of capital is a conduit for importing the financial instability of other countries. We can reduce this exposure by funding more of our investment needs internally. This is not to say that we should not borrow overseas, because we have to. We are a net importer of capital. But we should question the efficiency of the system and whether it would be better with both less offshore assets and less offshore debt."

From a banking perspective, Simon Maidment was well aware of the risks to the banking sector of Australia's funding model. "There is a scenario clearly where if Australia is not flavour of the month that global investors willing to lend to the domestic banking sector is going to stop. You only need to look at what happened to French banks and their access to US capital markets over the last 12 to 18 months. In that situation the Australia Inc. model, which is that we are an exporter of equity and importer of debt, will break down and it won't just be fixed income investors and borrowers that suffer as a consequence of that, it will also be the equity value and the general prosperity of Australia."

The clear message from Henry, Stevens and Maidment is that Australia's short-term, offshore debt financing is not sustainable and exposes the Australian economy to long-term structural risks.

The question is: What role can the superannuation sector play to address this structural risk which, it is argued, Australia's compulsory superannuation system has contributed to?

Australia's corporate bond market

One of the suggestions to address Australia's financial system imbalance is to encourage the development of a deep and liquid corporate bond market that would provide alternative avenues for the corporate debt to finance their debt needs.

A panel of experts debated the merits of developing Australia's corporate bond market at the ASFA Investment Interchange.

Vincent Chin, head of treasury at Goodman, described the challenges that corporates have issuing debt. The depth, tenor and liquidity of US markets meant that despite cost and inconvenience, corporates overwhelmingly sought to issue internationally. Chin questioned why it was not possible to raise in the Australian market believing that the finance sector had quality credit skills as well as the presence of credit desks from major financial institutions.

An issue raised by Chin was the fact that most of the companies listed in the ASX are not rated. Basel III was also likely to lead to increased funding costs for corporates from banking funding.

As one of the largest debt issuers in the world, CBA's Maidment stated that his capacity to fund the bank's funding requirements was limited. "The feedback we constantly get from the domestic funds management industry is that they are full on their capacity of Australian banks and full on their capacity on CBA. They love the credit and they are happy with the positions they hold but they can't add to it. That for me means that in a typical year I can get $10 billion of term issuance executed in the Australian market, of which about $8 billion is re-financing existing redemptions, so that the net increase is $1-2 billion a year, in the context of a $600 billion balance sheet."

From the superannuation perspective, Brad Holzberger argued that while there may be some impetus for superannuation funds to change exposure to bonds it will happen very slowly and strategically.

> "I don't think we see a failure in the corporate bond market. Issuers issue where they see that yields are favourable to them. Super funds buy where we see yields are favourable to us. The single most important thing that will clear a market is yield. If we are looking to increase the activity in the corporate bond market, and we have to ask why we would want to do that, then superannuation funds will act if issuers start offering us a better deal.
>
> "Funds act through investment managers. Superannuation funds are a very distant part of this lever pulling. More and more superannuation funds will issue a global debt mandate. Mandates should be written to manage the factor risks; inflation, credit and interest rates. The issue is that corporate bonds can fit all of those risk factors. I don't think there are structural impediments that would preclude managers investing in corporate bonds. The only way to incentivise funds is to offer them a risk-adjusted return, which is in the context of their portfolio a superior investment. We shouldn't be distorting markets."

An issue that limits that capacity for the superannuation sector to develop the corporate bond market is the fact that corporate bonds are only a component of a fixed interest portfolio.

Doug McTaggart, CEO of QIC, provided a perspective on the way in which superannuation funds manage fixed interest investments, arguing that funds need to be careful not to treat fixed interest as an asset class that can be done simply in-house once critical mass is reached.

According to McTaggart, fixed interest is complex and needs careful thought and understanding in order to manage three high level risk factors; interest rate risk, inflation risk and credit risk. Managing these risks according to McTaggart requires practicing dynamic risk factor allocation.

> "Simply allocating a portion of your funds to capture fixed interest benchmarks has its own pitfalls. The benchmarks themselves are problematic for two main reasons. First, the duration of the benchmark is set by the preferences of issuers – it is supply driven. This might not match your preferences, which is the demand side. Second, unlike market capitalisation-weighted equity benchmarks where, outside of bubbles, the most successful firms get the biggest weight, with fixed interest benchmarks it is the biggest *borrower* that gets the biggest weight. As the benchmarks change, your ability to achieve your objectives will also change. This should be actively and dynamically managed. In other words, when managing your fixed interest portfolios, you need to be constantly setting and resetting these levers as circumstance change."

When building a portfolio McTaggart argues that investors need to clearly understand how each risk component should perform and whether it is appropriate.

Providing the example of interest rate risk, McTaggart illustrated the risks that need to be dynamically managed.

> "As you invest out along the term premium, your duration increases but so does your volatility as the price of longer dated debt becomes more sensitive to changes in interest rates. The key risk with inflation is hedging against unexpected inflation, because only expected inflation gets reflected in nominal interest rates. It is unexpected inflation that transfers wealth."

Analysing the current global economic environment, McTaggart argued that while global focus is on deflation we ought to be looking at how to deal with future inflation.

Mercer senior partner Tony Cole, a former Treasury secretary himself, cautioned that any discussion about a corporate bond market creates concerns about concentration risk.

> "Everyone has exposure to banks through equity. Are we in danger if we are very successful creating a domestic bond market that we end up with concentrated exposures to Australian names in that bond market and another home country bias to go with home country bias in the equity area? One of the things that the GFC should have

> shown us all is that country risk and diversification across countries is an important thing to do and that even matters when it is your own country – just ask the Greeks."

Elmer Funke Kupper, CEO of ASX Group, argues that a corporate bond market is both attractive and necessary.

> "We need an alternative source to fund corporate Australia and we need to recognise that these products are attractive to fund the infrastructure needs of the country. Australian corporate bond market is not competitive compared to alternatives. The US market is established and well educated. The people we talk to have credit skills. There is a strong demand for that, particularly from investment grade companies and there are low entry requirements. What do we do? We need to work on supply, demand, and to establish a market. We need to make it more attractive to issue bonds. On the disclosure front I can't see why we can't fix it by 1 July. To raise corporate debt we had to have two months of due diligence committees and a 200-page prospectus. We need to establish a benchmark price curve by listing Commonwealth Government securities."

Kupper raised liquidity as an obstacle that is preventing the development of a deep corporate bond market.

> "A lot of product out there is buy and hold; investors do require an ability to trade if they so choose. We will struggle until we have sufficient liquidity in the market. We need liquidity support through market makers."

He concludes that developing Australia's corporate bond market won't solve all corporate funding needs, particularly with concentration risk in our market, but it may take pressure off for smaller companies.

APPENDIX 1: Ken Henry speech

The finance textbooks tell us that the average yield on a corporate share (ie equity) will exceed the yield on a debt instrument denominated in the same currency and with similar counter-party risk characteristics. The equity premium is not a gift to shareholders. It is what they require in order to compensate them for the additional risk to which they are exposing themselves in holding an instrument on which the economic income is uncertain and variable due to fluctuations in dividends and capital value.

Of course, precisely because equity investors are exposed to a higher degree of volatility, it is not always the case – that is, over all time periods – that a share portfolio will generate a higher economic yield than a bond portfolio. But statistical analyses conducted over long periods of time seem to support the proposition that shares out-perform debt instruments, the former occupying a position to the north-east of the latter on the risk-return frontier.

Despite the superior expected yield on shares, an investor with some degree of risk-aversion will avoid loading all of her wealth into shares; the more risk-averse she is, the higher proportion of her investment she would want in fixed interest assets, including (especially) government bonds.

To this audience, all of what I have just said is so well-known it would likely have been found tedious. But what proportion of the owners of Australia's 33 million superannuation accounts do you think would have any idea what I have been talking about?

Maybe it doesn't matter. After all, they have superannuation fund trustees looking after their interests. Even so, among the 400 or so entities with more than a handful of members, about 300 entities offer investment choice; they put the question back to the fund member. Retail funds offer the most choice – on average, more than 200 different investment choices per fund – but even the industry funds offer, on average, 10 different investment options to fund members. And a lot of fund members do exercise the choice, especially in the retail fund sector. A lot choose the default strategy, of course, with almost one-half of superannuation fund assets invested in options described this way. Those default strategy options, on average, have about 55 per cent of assets invested in equities (of which, about 25 per cent are offshore equities, with embedded currency risk exposure), 10 per cent in property, 10 per cent in fixed interest, 10 per cent in cash and 15 per cent in other things.

In so-called 'growth funds', the proportion of assets invested in equities is even higher; at least 70 per cent, not unusually 90 per cent.

In comparison with pooled investment vehicles overseas, Australian super funds have a much heavier weighting in favour of equities.

It might be tempting to think that so-called 'growth' strategies serve the interests of fund members in the accumulation phase, with more 'conservative' strategies serving the interests of those who have already retired; that is, those who are in the drawdown phase. The latter is probably true. The former might also be true. Then again, it might not be.

In essence, the argument supporting a heavy weighting of stocks over bonds in the accumulation phase goes like this: Shares outperform bonds over a long period of time. The accumulation phase of superannuation is also a long period of time. Therefore, shares are a superior investment in the accumulation phase of superannuation. Stated as baldly as this, the non sequitur will be clear.

What should be a key concern for super fund members is 'sequence risk'. Let me illustrate what is at issue: Suppose you had been investing in superannuation for 20 years – a long period of time – with the intention of retiring at age 60 in the first quarter of 2009. Your accumulation phase would have commenced after the stock market crash of 1987. And while you would have seen a substantial loss of value in the stock market correction of 2000 to 2002, by late 2007, with your 59th birthday only a few months away, you would have been feeling pretty happy with your decision to select the aggressive growth option offered by your superannuation fund. No doubt, you would already have been making post-retirement plans based upon an expectation of even greater capital accumulation by the time you reached age 60. But in late 2007 you were aged 58 years and 9 months. Who knows how your fund managed your account balance over the following 12 months. If the equities component of your account balance had simply tracked the ASX200, you would have lost about a half of your superannuation wealth in your 60th year. I'm guessing you wouldn't have been made any happier to have been told, in the first quarter of 2009, that there was a pretty good chance your account balance would recover if you were to postpone your retirement for a decade or so.

Now this may strike you as an extreme example. The events of 2008 and 2009 were quite unusual. And that's true. But then so were the events of 2000 to 2002; and so too the stock market crash of October 1987 when Australian equities fell by 42 per cent. And I have no doubt that the next stock market crash will also be highly unusual. And that really is the point: highly unusual things do happen. And precisely when they happen is a matter of some significance to a super fund member.

Even over periods as long as 20 years, it has not always been the case that equities outperform fixed interest, though it has generally been the case. The more important point, though, is that timing – specifically, the sequencing of variable returns – is everything. The non sequitur I retailed earlier should properly be reconstructed as follows: Shares can be expected generally to outperform bonds over sufficiently long periods of time. The accumulation phase of superannuation is also a long period of time. Therefore, considering the average experience of all superannuation fund members over a sufficiently long period of time, shares are a superior investment in the accumulation phase of superannuation. But that's the average. Thus, around that average experience, depending upon when they enter the system and when they retire, some fund members will benefit enormously from a portfolio weighted heavily toward equities while others will lose 'big time'. And nobody knows, in advance, who will win and who will lose. That is an implication of sequence risk.

That's the story in the accumulation phase of superannuation. I probably don't need to point out that if sequence risk can be an inconvenience in the accumulation phase, it can be a nightmare in the post-retirement, or drawdown, phase. No good telling somebody who retired at age 60 at the end of 1998 and invested her lump sum in a share portfolio tracking the ASX200, that now, at the age of 74, she had better find a job in order to re-build her retirement savings.

So far, I have been talking only about financial market risk – specifically, translating into 'sequence risk' – and its impact on retirement savings. The post-retirement phase crystallises another risk – something we have taken to labelling 'longevity risk'. Of course, this risk is present also in the accumulation phase. If a 40 year old knew she was going to live to be 100, she might want to think seriously about working into her 80s. But that might look like Hobson's choice to somebody debating, more realistically, whether to plan for retirement at age 60 or 65.

In the post-retirement phase, the case for a heavier weighting to fixed interest assets seems clear. But longevity risk not only raises issues concerning volatility in earnings, it also forces one to consider the appropriate drawdown rate; that is, at what rate should the capital be consumed? As to that, at least from a public policy perspective, but also I would think from a private perspective, longevity risk should properly be thought of as an insurance matter.

In our report to the Government on Australia's Future Tax System, my review panel colleagues and I recommended that there should be no restrictions on people wanting to purchase longevity insurance, including in the form of a deferred income annuity, from a prudentially regulated entity. We also recommended that the government issue long-term securities to help product providers manage the investment risk associated with longevity insurance, that it also remove certain restrictive rules in the SIS regulations relating to income streams that restrict product innovation (a recommendation repeated in the Cooper Review), and that it consider offering an immediate annuity and deferred annuity product that would allow a person to purchase a lifetime income, up to a cap that limits the taxpayers' exposure to longevity risk.

The development of these insurance-style products, vital to the strength of our retirement income system, will involve a significantly greater reliance on fixed interest assets.

But do such assets exist?

Macroeconomic considerations

This is a good time to be asking that question.

About a decade ago, in discussion with people in the superannuation industry, I drew attention to the fact that the development of superannuation, especially under the Superannuation Guarantee, had altered fundamentally the flow of funds in the Australian financial system.

When I was growing up, Australian households invested their cash savings in bank accounts. These savings were intermediated back to the household sector in the form of housing loans. Banks made money out of the margin between relatively high mortgage interest rates and very low deposit rates.

With the development of superannuation, things have changed a great deal. For most of the past 20 years, the cash savings of the Australian household sector have strongly favoured superannuation over deposits. And superannuation funds haven't had much interest in recycling those household savings in fixed interest debt finance to the banks. Indeed, they strongly prefer offshore equity to onshore debt. Yet the household sector hasn't been denied mortgage finance for housing; far from it. The gap funding has come, predominantly, from so-called wholesale borrowings, and increasingly those funds have been sourced from offshore. Pre-GFC, in a relatively benign macroeconomic environment, the supply curve of offshore wholesale funding was viewed as approximately flat; that is, offering unlimited funds at a reasonably low and predictable cost.

The Australian household sector has benefited from this new model of intermediation in two ways: higher rates of return on savings in the form of superannuation account balances rather than bank deposits, and lower mortgage interest rates. Bank net interest margins have fallen a long way, but the rate of return on equity in banking has been compensated by very considerable growth in volume.

Of course, considering the national balance sheet, this new world differs significantly from the old. It involves a larger exposure to foreign equities and a correspondingly larger reliance on relatively short-term foreign debt. In effect, at a national level, Australian households have been arbitraging the equity premium in international markets. How clever! Well, clever if one ignores risk, especially refinancing risk.

The possibility that it might not be so clever was explored in the IMF / World Bank Financial System Stability Assessment (FSSA), conducted for Australia in 2005 and 2006 as part of the Financial Sector Assessment Program (FSAP). The FSSA drew attention to the Australian banking systems' reliance on offshore wholesale funding, noting that it made the Australian financial system vulnerable to catastrophic events in the global financial system. That was 2006.

In 2006, the prospect of catastrophic events in the global financial system was not being factored into the pricing of financial assets. But that doesn't mean that such events had a probability of zero.

The FSAP was launched by the IMF and World Bank in 1999, following the Asian financial crisis. That crisis had exposed financial system fragility in a number of economies in the Asian region. The FSAP's purpose is to identify financial system vulnerabilities. Its assumption was that those vulnerabilities would be found in emerging markets. That looked like a rather silly assumption when the global financial crisis emerged in 2008. But the truth is that it had looked quite silly for some time before that.

In July 2003, I had the honour of delivering the Sir Leslie Melville Lecture, in which I addressed the topic of financial system vulnerabilities, and the role of the IMF in managing them. Here is a short extract from that address:

…… one might want to question the presumption …… that the primary source of global financial instability is, and will continue to be, in the emerging markets. This perspective might have been understandable when the major economies saw themselves as capital exporters to emerging markets. But it is a particularly odd perspective today (when) ….. the United States is attracting more capital than the whole of the developing world. Moreover, given the size of the United States' current account deficit, this is likely to be the case for many years. As far as the immediate to medium-term prospects for international financial stability are concerned there is at least as much riding on the quality of United States economic policy as there is the macroeconomic and structural policies of the emerging markets.

So there is some irony in the fact of the major economies having stopped using the IMF as a source of advice. The reason they have done so is presumably that they have stopped using the Fund as a source of external finance. Why listen to what the bank manager thinks of you if you have no need to apply for a loan? Not surprisingly, the Fund has not brought about necessary corporate and financial restructuring in Japan. Persistent constraints to product and labour market flexibility in Europe remain. And the Fund has done little to convince the United States (or anyone else for that matter) of the risks associated with its singular current account position. These failures could have serious implications for international financial stability.

That address, in July 2003, got some front-page headlines in the Australian print media, suggesting that I had predicted the collapse of the United States economy. Instead, I was drawing attention to a much bigger issue – the fact that the quality of United States policy, and structural rigidities in Europe, posed a threat to global financial stability. Ironically, when, five years later, the global financial crisis struck, the United States was one of only a handful of countries (others being Spain and Portugal) that had still not had a FSAP assessment.

When the GFC hit, our national balance sheet, featuring substantial super fund investments in foreign equities and substantial bank borrowings from offshore, contained something with the character of a distressed margin-lending scheme.

For Australia, the core macroeconomic issues laid bare by the global financial crisis, and highly relevant to today's topic, are these: We are a relatively small economy with a large, and growing exposure to international financial markets in respect of both assets – principally foreign equities held by our super funds – and liabilities – principally the offshore wholesale borrowings of our banks. As to the latter, since liberalising the capital account in the 1980s, Australian economic policy commentary has made much of the point that its cost and its reliability (that is, its refinancing risk) would have something to do with the quality of our domestic policy settings. And it does; but only something, not everything. Certainly, we could make ourselves an unattractive destination for global capital. But, in this post-GFC environment, our ability to access global debt capital has a lot more to do with the quality of policy settings and regulatory performance in a lot of other places – especially the United States and Europe. And, to state the obvious, we don't have much control over US and European economic policy makers.

What we do have going for us is that our banks are very well regarded internationally. They are seen as attractive borrowers. And it is possible that they will become increasingly attractive destinations for internationally mobile debt capital. But nothing can be taken for granted. If only for purposes of macroeconomic insurance, I would argue that it is strongly in our interests to find ways of reducing, over time, the banks' reliance on offshore debt finance.

There has already been some adjustment in bank funding, of course. As a share of total bank funding, deposits from households and businesses now make up about 55 per cent – up from a low of about 45 per cent immediately pre-GFC. But other sources of domestic funding have declined. Overall, it's difficult to conclude that bank funding is sourced any less heavily offshore than it was pre-GFC, though the offshore funding certainly is of longer term.

As far as macroeconomic stability is concerned, matters are being helped also by Australian non-financial corporates increasingly accessing global capital markets with corporate bond issues. That form of offshore debt funding has grown in nominal terms by about 75 per cent since mid-2008.

Yet, despite the several important macroeconomic functions it could serve, and the very large pool of investor capital sitting in Australian super funds that could provide reliable finance, the corporate bond market in Australia is quite immature. It's hard to know what can be done about this while asset allocation managers and others have the mindsets they do. It is natural to wonder whether there isn't a role for government in accelerating market development. But, from my experience, the ability of government to drive such market development is – and I think appropriately – quite limited.