



16 June 2020

Committee Secretariat
House Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
CANBERRA ACT 2600

Email: TaxRevs.reps@aph.gov.au

Development of the Australian Corporate Bond Market

1. Introduction

The Australian Financial Markets Association (**AFMA**) represents the interests of over 110 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and investors who use the financial markets.

AFMA is principally a body that represents its members in relation to issues arising in Australia's wholesale financial markets. We are conscious, however, that there is an intersection between the wholesale and retail markets, as there are financial products that are generally available in the wholesale financial markets that may also be accessed by retail investors, such as corporate bonds. Accordingly, our submission to the Committee's Inquiry provides comments on specific issues raised by the Terms of Reference for the Inquiry, highlights impediments that have been raised by AFMA members to the development of a deeper and more liquid bond market and then outlines principles that should assist in driving increased participation by retail investors in the Australian corporate bond market.

The key points of our submission are as follows:

- AFMA **notes** that to enhance the depth and liquidity of the Australian corporate bond market, reforms should be focussed at removing any constraints for issuers to issue corporate bonds and then, to the extent possible, and while balancing investor protection concerns, enhancing alignment between products available to retail and wholesale investors;
- AFMA **recommends** that the Board of Tax review the tax observations of the Final Report of the Financial System Inquiry, as while such tax issues go beyond corporate bonds and have broader implications, taxation differences for both issuers and investors may be hindering the development of the Australian corporate bond market;

Australian Financial Markets Association

ABN 69 793 968 987

Level 25, Angel Place, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7907 Email: secretariat@afma.com.au Web: www.afma.com.au

- AFMA **recommends** that further consideration should be given to the reforms suggested by the Final Report of the Financial System Inquiry to reduce disclosure requirements for large listed corporate issuers of “simple” bonds;
- AFMA **notes** that there are issues bespoke to the Australian corporate bond market that can both enhance and hinder the development of the market, such as the Financial Claims Scheme and the recent announcement from the Reserve Bank of Australia permitting investment-grade non-financial corporate bonds (minimum rating BBB-) as being eligible collateral for domestic market operations ; and
- AFMA **recommends** that the licensing regime for Credit Ratings Agencies should be reviewed, insofar as the regime reduces accessibility of ratings to retail investors.

2. Economic Benefits from Vibrant Corporate Bond Market

AFMA has articulated the benefits arising from a vibrant domestic corporate bond market in a number of previous Government enquiries, most notably the Financial System Inquiry. Our reasons still hold true today, with potential benefits for borrowers and investors.

Borrowers

For corporate borrowers, a vibrant corporate bond market can provide a secure, flexible and reliable source of term finance. Corporate bonds provide diversity for issuers as an alternate source of funding to equity finance and bank loans, and hence reduce the reliance on intermediaries.

A vibrant corporate bond market in Australia reduces foreign exchange risk that would otherwise arise from issuing in offshore markets in foreign currencies and eliminates the need for managing such risk. In a robust corporate bond market allowing for the issuance of a significant number of differing instruments, bonds provide a useful tool for better management of interest-rate risks and mitigating cash flow/maturity mismatches.

A company's choice between bank debt and bond financing is influenced by the company's size, the state of market development and the availability and relative costs of different forms of finance. Smaller companies generally prefer bank debt or bespoke funding as they become established but may look to issue bonds as they grow.

Large companies take a strategic view in determining their capital structure and utilise bond markets to facilitate capital ratio, leverage and gearing decisions. Established bond programs provide borrowers with confidence to tap funds as and when required and can give them diversity in their investor base and funding currencies. The ability to issue bonds facilitates the efficient use of working capital and avoids the need to hoard cash.

Investors

For Australian wholesale/institutional investors, growth in superannuation funds under management has increased the need for fund managers to source fixed income alternatives and provide a greater range of investment opportunities beyond government debt and equities. A well-functioning corporate bond market can assist in reducing the current Australian investment bias toward equity allocation, specifics of which are outlined below. A strong domestic bond market allows local fund managers to achieve diversification in fixed income investments without having to go to offshore markets which reduces foreign exchange risk.

Demographic trends in many advanced economies, including Australia, make it essential for investors to save appropriately for lifetime financing needs and to reduce reliance on government pensions. Individual investors (retail, self-managed superannuation funds) approaching retirement age need less volatile investment returns to protect capital that will be required after retirement. This need becomes more prevalent during times of heightened volatility and instability in financial markets such as the global financial crisis (GFC) and the current COVID-19 crisis. During these unsettling periods, investors are more interested in securities that provide less volatile returns, safer income streams, and more diversified investment portfolios. Having access to a market which is largely stable and secure, reduces the risk of major losses of value prior to retirement and allows retail investors to

diversify investments away from equities, property and cash, which reduces the risk of retirees needing to rely on government pensions.

3. Corporate Bond Market Observations and Developments

This section of the submission sets out observations on factors that either hinder or have enhanced the development of the current status of the Australian corporate bond market.

Current Status of the Australian Corporate Bond Market

There are particular idiosyncrasies of the Australian corporate bond market that are appropriate to draw to the Committee's attention for the purpose of the current inquiry.

Based on data from the Australian Bureau of Statistics, since 2015, the proportion of Australian corporate bonds outstanding that were issued in Australia is less than one-third on average, with the remainder issued offshore. It is also notable that, according to the OECD, the percentage of Australian pension funds allocated to bills and bonds was the third lowest in the OECD at 16.1per cent as at 10 June 2020.

To assist in the identification of factors hindering the development of the Australian corporate bond market, AFMA has previously provided information to Government on the costs of an investment grade issuer seeking finance from a variety of sources, including the retail corporate bond market, the wholesale corporate bond market, directly from a lending institution and through the US markets (Reg 144A issuance). Of note, this information stated that the wholesale corporate bond market would offer the cheapest funding as a spread over the relative benchmark and that retail corporate bonds were, on annum, between 15-20 basis points more expensive per annum than the wholesale bonds.

We also note the following table, extracted from the Explanatory Memorandum to the *Simple Corporate Bonds and Other Measures Bill 2014*, which specified the difference in the fee structures between retail and wholesale issuances, equity financing and obtaining finance from a lending institution in Australia:

		<i>Retail Corporate Bond</i>	<i>Wholesale Bond Market</i>	<i>Lending Institution</i>	<i>Equity</i>
Cost Effectiveness	Spread over benchmark	250 - 300 bps	200 - 250 bps	150 - 200 bps	Na
	Syndicate Fees (bps)	Arranger fee: 25 bps Management fee: 50 bps Selling fee: 100 bps	30 bps	50 to 60 bps	Underwriting: 200 bps Management: 50bps
	Documentation, accounting, legal and due diligence costs²	Prospectus \$1.1-\$1.3 million (55 - 65 bps)	Information Memorandum and Bond Deed Poll \$300,000-\$420,000 (15 - 21 bps)	Information Memorandum (\$80,000-\$120,000) (4 - 6 bps) Arranger fee (3 - 5 bps)	Investor Presentation and Low Doc Offer Booklet \$500,000-\$1.1 million (20 - 50 bps)
	Rating of bond offer²	\$140,000-\$160,000 (7 - 8 bps)	na	na	Na
	Roadshow and marketing cost²	\$200,000-\$450,000 (10 - 22 bps)	Minimal	Minimal	Minimal
	Listing and Registry costs	\$140,000-\$160,000 (7 - 8 bps)	na	na	Na
	Total	504 - 578 bps	245 - 301 bps	210 - 270 bps	270 - 300 bps
Comments	Advantages	Funding diversity No credit rating of bond issuer required (can be used by corporates too small to receive a credit rating)	Tighter pricing and relatively lower transaction costs Documentation is easy to execute with less onerous reporting requirements	Tighter pricing and relatively lower transaction costs Documentation is easy to execute with less onerous reporting requirements No rating requirement	Equity funding No rating requirement
	Disadvantages	Higher cost - more onerous documentation and reporting requirements	External rating required	Low funding diversity	More onerous documentation and reporting requirements

Price and Volume Certainty Offshore

Our members have advised that one of the drivers for issuers to issue in offshore markets as opposed to in Australia is that there is greater certainty on price and volume with respect to issuing in the offshore market. That is, the depth and liquidity that exists in offshore markets provides stiff competition to issuance in the Australian market.

Financial Claims Scheme

Under the Financial Claims Scheme, retail bank deposits are guaranteed by the Federal Government for deposits up to \$250,000 per account holder per Approved Deposit-Taking Institution. Accordingly, to the extent that a retail investor is looking to invest in a fixed-income product, there is a relative attractiveness for bank deposits covered by the Financial Claims Scheme relative to corporate bonds, which are unsecured, albeit ranking higher than equity in the event of insolvency. As such, in order to attract retail investors, the bond yields need to be significantly larger. This issue was exacerbated in the last few years, particularly as the cost of retail deposits for banks increased; however recently the returns on retail deposits has fallen, making corporate bonds increasingly attractive on a risk-adjusted basis.

RBA Repo Eligibility

One recent development which should enhance the development of the Australian corporate bond market was the recent announcement by the RBA that it would broaden the range of corporate debt securities that are eligible as collateral for domestic market operations to include investment-grade non-financial corporate bonds (minimum rating BBB-).

By being repo eligible, ADIs are incentivised to hold such corporate bonds on their balance sheets as they can be used for funding with the RBA. This, in turn, enhances secondary-market trading in such instruments, resulting in increased liquidity and price discovery. The ability for superannuation funds to post such bonds as collateral against short term loans may also enhance the attractiveness of such funds to invest in bonds to address liquidity issues the funds may face.

4. Tax Treatment of Corporate Bonds for Issuers and Investors

The consideration of tax treatment of corporate bonds for issuers and taxation outcomes for investors is reflective of broader asymmetry in the Australian tax system towards the outcomes for various savings vehicles. As such, while it is appropriate for the Inquiry to consider the extent to which tax asymmetries have stymied the development of the corporate bond market in Australia, any potential changes should not be restricted to corporate bonds in isolation, but rather be part of a holistic review of the taxation treatment of savings vehicles more generally.

Tax Treatment for Investors

In providing comments regarding the tax treatment for investors in holding corporate bonds, it is useful to contrast the taxation outcomes against Australian equities, particularly those paying fully-franked dividends.

For investors in corporate bonds, regardless of the structure of the particular bond and the extent to which it distributes returns to investors either through coupons or through an increase in the value of the bond, the return to the investor will be taxed at that investor's marginal rate. The coupon flows will be taxed as interest, while there are provisions in the *Income Tax Assessment Act 1936* that specifically deem any gains on disposals to be included in the investor's assessable income, either at the time of disposal (traditional security) or over the life of the holding of the bond (qualifying security).

The taxing regime for an Australian equity instrument is different, both in terms of the distributions made on the instrument and also the taxation of any gain made on disposal. In terms of the distribution, to the extent that the issuer has paid sufficient tax to allocate franking credits to the distribution, then under Australia's dividend imputation regime the investor will only need to pay additional tax on the difference between the investor's marginal tax rate and the corporate tax rate, currently 30 per cent. To the extent that the investor's marginal tax rate is below 30 per cent (such as complying superannuation funds) then the investor will receive a refund of the excess tax. As such, in respect of Australian investors and assuming all profits made by the issuer are distributed to investors as a franked dividend, the corporate tax paid by the issuer should be considered only to be a withholding tax, with the profits made by the issuer ultimately taxed at the marginal rate of the investor.

In respect of any gain made by the investor on disposal of the equity instrument, there are no provisions that deem any such gain to be included investor's assessable income and hence, to the extent that the instrument is held on capital account then the gain is taxed under the Capital Gains Tax (CGT) regime. Where the equity instrument has been held by the investor for more than 12 months on capital account, the investor may be eligible for the CGT discount, which reduces the amount of the capital gain that is brought to tax by 50 per cent (individuals and trusts) and 33.33 per cent for complying superannuation funds.

Tax Treatment for Issuers

The primary difference in the tax treatment for issuers between corporate bonds (characterised as debt for tax purposes) and equity instruments (characterised as equity for tax purposes) is that the returns on the corporate bonds will be deductible for tax purposes, while the returns on the equity instrument will not. The availability of a tax deduction may accordingly reduce the cost of debt issuance.

Previous Reviews of Tax Asymmetry

As noted in the introduction to this section, the differences in the taxation outcomes for both issuers and investors between instruments characterised as debt for tax purposes versus those with an equity characterisation is a deeper inquiry than just in relation to corporate bonds. On this basis, we have summarised below comments from both the Henry Tax Review and the Financial System Inquiry for the Committee's attention.

Henry Tax Review

In the "Australia's future tax system" report from 2009 (**the Henry Review**), the following principle was articulated:

"Savings should be taxed as consistently as possible to minimise tax arbitrage opportunities and to avoid biasing household and investor decisions about what assets best suit their needs and preferences."

The Henry Review sought to standardise the taxation treatment of various income streams and provide a broad discount for non-business related:

- Net interest income;
- Net residential rental income;
- Capital gains (and losses);
- Interest expenses related to listed shares.

The Henry Review noted in making this recommendation that certain investment products, like "income bonds" were taxed like bank accounts in some, but not all ways and that consideration should therefore be given as to how these investments should be taxed in light of a general savings income discount.

In its submission to the "Re:Think Tax Discussion Paper" in 2015, AFMA acknowledged the disparity in taxation treatments of various savings vehicles, and particularly the different treatment of capital gains versus other savings income, such as bank deposits and corporate bonds. Our submission noted that such differences may provide disincentives for investors to invest in certain products and, in the words of the Final Report of the Financial System Inquiry, potentially "distort the asset composition of household balance sheets and the broader flow of funds in the economy."

Financial System Inquiry

The Final Report of the 2014 Financial System Inquiry, chaired by David Murray, made similar comments that are appropriate to bring to the Committee's attention.

In noting the comments contained in the Financial System Inquiry Final Report, it is worthwhile reflecting on the Terms of Reference for the Inquiry, with regards to taxation matters, namely:

"The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent that these impinge on the efficient and effective allocation of capital by the Financial System, and provide observations that could inform the Tax White Paper."

The relevant point of the Terms of Reference, as they relate to tax, is that the Inquiry was only permitted to make observations, and not recommendations, in relation to taxation matters, on the expectation that the Tax White Paper process would give these observations further consideration. Ultimately, the Tax White Paper process did not proceed and accordingly the observations of the Inquiry were not considered further.

It is worthwhile, however, in the context of the current Inquiry, to reflect on comments made by the Inquiry with respect to corporate bonds and taxation. Particularly, the Inquiry recommended that:

“Obstacles to the growth of the corporate bond market should be addressed, including regulatory barriers and tax distortions, particularly the non-neutral treatment of savings vehicles.”

In this light, the Inquiry noted:

“The tax system treats returns from some forms of saving more favourably than others. For example, interest income from bank deposits and fixed-income securities are taxed relatively heavily. This distorts the asset composition of household balance sheets and the broader flow of funds in the economy. To the extent that tax distortions direct savings to less productive investment opportunities, a more neutral tax treatment would likely increase productivity. The relatively unfavourable tax treatment of deposits and fixed-income securities makes them less attractive as forms of saving and increases the cost of this type of funding.”

AFMA Recommendation

AFMA’s position is that the different tax treatment of corporate bonds, particularly for investors, and the extent to which this treatment has hindered the growth of the Australian corporate bond market, should be considered as part of a more holistic review of the tax treatment of savings vehicles, and potentially the tax system more broadly.

AFMA has previously recommended that the Government commission the Board of Tax to review the Taxation Observations set out in Appendix 2 of the Final Report of the Financial System Inquiry, given that these observations were designed to inform the Tax White Paper, which ultimately did not proceed. In our view, it would be an appropriate recommendation of the Committee to reiterate AFMA’s recommendation, as it would allow for the tax issues relating to the corporate bond market specifically, and savings vehicles more generally, to be considered as part of a more holistic review.

5. Corporations Act and Other Impediments to Development of Corporate Bond Market

This section of the submission sets out constraints in the *Corporations Act*, together with related impediments, that may have hindered the development of a deep and liquid corporate bond market in Australia.

Changes to SCB Regime

AFMA supports the recommendation from the Final Report from the Financial System Inquiry with respect to the retail corporate bond market, and the supporting comments that:

“Government should amend the law to reduce disclosure requirements for large listed corporate issuers of ‘simple’ bonds. The disclosure regime should comprise a term sheet for a standardised product and a cleansing notice...(t)he Inquiry believes that the proposed regime would strike the right balance between reducing issuance costs and providing potential investors with sufficient information to make a considered investment decision.”

Allowing listed issuers who comply with the continuous disclosure regime to issue senior bonds through a simple term sheet in conjunction with a statement that all material information has been disclosed to the market has been a long-standing proposal of eminent good sense. It is based on the firm foundation of the existing continuous disclosure system used by those listed companies which are the natural subject of retail investor interest because of their familiarity to the public. It also recognises that bonds are simple financial instruments that carry less risk than ordinary shares. It does not introduce any additional investor or market risk as it is based on the existing familiar disclosure practices which are readily available to the public and subject to close regulatory oversight. A measure which relies on existing infrastructure and processes means no additional regulatory burden and is inherently more attractive than adapting to some novel process.

The highly prescriptive terms of debt issued under the simple corporate bond disclosure regime have not proved successful because the result is a separate class of debt instrument that diverges from matching debt offered only in the wholesale market for the following reasons. Firstly, it requires different diligence processes for both the issuer’s directors and the joint managers from those used in the wholesale market because of the nature of the civil liability attaching to the prospectus. Different diligence processes and liability considerations are an important factor in the route selected to raise debt capital. Secondly, the strict prescribed terms, particularly the limitation in not permitting early redemption, mean that the bonds are not fungible with equivalents traded in the wholesale market. This presents a barrier to liquidity in the retail bonds of companies with well-established bond programmes.

The use of Chess Depositary Interests (CDIs) on the ASX for Australian Government Bonds has been a useful development and should be extended to corporate bonds, such that wholesale corporate bonds can be traded by both the wholesale and retail market.

Ratings Agencies

Under the Corporations Act, all credit ratings agencies must hold an AFS licence authorising the agency to provide financial product advice by issuing a credit rating. Disclosure of a rating in a PDS or a continuous disclosure statement requires a retail authorisation. To the extent that the Credit Rating Agency chooses only to hold the wholesale authorisation, such as due to increased costs or potential liability, then the result is that the ratings issued by such agencies in respect of corporate bonds can

only be available to wholesale and not retail investors. This seems incongruous from a policy perspective given that, generally, retail investors may be more in need in utilising the services of ratings agencies in order to assess the creditworthiness of the issuer and hence the risks attaching to the bond.

AFMA Recommendation

As noted above, our view is that the highly prescriptive nature of the Simple Corporate Bond regime has resulted in a bifurcation of the Australian corporate bond market and different classes of debt instruments. As such, the Committee should consider reforms that are aimed at reducing the differences between instruments that may be eligible for wholesale and retail investors. As an initial step, AFMA recommends that the reforms suggested by the Final Report of the Financial System Inquiry to reduce disclosure requirements for large listed corporate issuers of “simple” bonds should be given further consideration.

Additionally, our view is that impediments to Credit Ratings Agencies offering services to retail investors should be reviewed, given that such investors would likely benefit most from the provision of such services in terms of reducing information asymmetries.

* * * * *

We would be pleased to assist the Committee with any aspects of its Inquiry. Please contact me on (02) 9776 7996 or rcolquhoun@afma.com.au.

Yours sincerely,



Rob Colquhoun
Director, Policy