SOUND WAVES

Australia's financial system inquiry (FSI), commissioned in November 2013 by the new federal government, has the potential to rewrite the rulebook for the country's capital markets. A staggering range of proposals have been made to the inquiry, and *KangaNews* lays out those with most relevance to the debt market.

BY LAURENCE DAVISON

FSIs come around roughly every decade and a half in Australia, and the previous two have both spurred major reforms. The Campbell Report in 1981 led to the deregulation of the financial sector and the floating of the Australian dollar. In 1997, the Wallis Report was the catalyst for Australia's current regulatory system – including the creation of the Australian Prudential Regulation Authority.

The early signs suggest the latest FSI could be just as earth-shaking for Australian markets. A joint statement launching the inquiry from Australia's prime minister, Tony Abbott, and federal treasurer, Joe Hockey, said its scope "will reflect the government's desire for a 'root and branch' examination of the nation's financial system".

The FSI's terms of reference, published in December last year, are consequently broad. They take in the tax and regulatory regimes, the "philosophy, principles and objectives underpinning the development of a well-functioning financial system", opportunities and challenges in the domestic and global financial system, and government policy.

The overarching goal is to examine "how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth". The FSI has been given the best part of a year to do this: an interim report is expected in July this year, with publication of the final report slated for November.

The superannuation sector in particular expects to come under the FSI's microscope. Market participants note the growth of Australian superannuation in the time between the 1997 FSI and the latest incarnation. In 1997 superannuation was a nascent concept in Australia. By 2014 the industry's assets under management have reached A$1.8 trillion (US$1.7 trillion).

Within this major part of the inquiry's expected task will lie much of its debt-markets relevant content. The Australian superannuation system has a famously low relative allocation to fixed income. Meanwhile, the FSI's terms of reference include directions to explore "how Australia funds its growth", policies which "promote the efficient allocation of capital" and "changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, non-bank financial institutions, insurance companies, superannuation funds and capital markets".

Banking competition and the 'four pillars' policy may also be addressed by the FSI. Many market participants see the position of the big-four banks as anticompetitive and thus a drag on Australian growth.

THE SUBMISSION PROCESS

With such huge topics to be explored it is no surprise that the FSI submissions process prompted something of a drawing of battle lines among stakeholders. On asset allocation, the superannuation industry is quick to defend its decisions – while also broadly supporting the concept of a deeper and more liquid domestic debt market.

On banking competition, Australia's regional, second-tier and mutual financial institutions set out the case for procompetitive measures, while the big four remind the FSI of the value of the banking system stability they say the four pillars policy has assisted.

The first round of public submissions to the FSI, amounting to over 200 separate documents, was released on April 4. A further 70 submissions were published in two further releases, ending on April 17. Many of the documents run into the hundreds of pages.

Whether the FSI's final recommendations are game-changers – and the extent to which the government grasps any nettles handed to it by the inquiry and passes its recommendations into policy – remains to be seen. In the meantime, all that can be assessed is the huge potential of a light being shone across the entire market.

FSI SUBMISSIONS PART ONE: THE BOND MARKET

A number of submissions to Australia's financial system inquiry (FSI) include commentary and proposals on the bond market. Most relate to a desire to develop a larger domestic option for funding both corporates and the infrastructure sector.

Regulatory impediments, retail development and education, asset allocation and the tax system all come under the microscope of market participants. A number of submissions highlight the value of development of the corporate bond market in particular.

CORPORATE BOND GOAL

One of the more detailed submissions relating to corporate bonds comes from the Australian Financial Markets Association (AFMA), which devotes an entire section of its submission to the market and offers a range of proposals.

AFMA argues that a "well-developed corporate bond market has a significant number of benefits for the funding and financial stability of the economy and its various participants". The beneficiaries, it continues, include not just borrowers but also issuers and intermediaries.

For instance, AFMA suggests: "For investors, both wholesale and retail, it is arguable that there has never been a more appropriate time to have a well-developed corporate bond market. As our demographics continue to show a shift towards an ageing population, there has never been more of a need for less-volatile investment returns to complement investment portfolios."

There could be a significant economic benefit to a larger domestic corporate debt capital market, AFMA adds. It states: "To the extent that larger corporations can take further advantage of the corporate bond market rather than traditional bank financing, this further frees up the banks' balance sheets to support more small- and medium-sized enterprises."

A number of banks themselves mention developing the corporate bond market as a worthwhile goal for the Australian financial system. ANZ Banking Group (ANZ)'s submission even suggests doing so would "facilitate competition" as well as "providing a new source of capital for institutional borrowers and new investment products for clients".

From the banking sector it is Macquarie Group (Macquarie) which devotes the greatest proportion of its FSI submission to corporate bonds. Macquarie notes the benefits to issuers and also emphasises the value of "greater opportunity to diversify...investment portfolios by maturity, type of investment and issuers" to a superannuation system serving an ageing population.

Commonwealth Bank (CommBank) predominantly focuses on infrastructure funding in the capital markets section of its submission, but it still refers to the need for capital markets and the superannuation sector to play their part in the overall task.

It is not just the financial-services sector which advocates measures designed to assist the development of the Australian corporate bond market. For instance, the Business Council of Australia (BCA), an organisation which brings together "the chief executives of more than 100 of Australia's leading companies, whose vision is for Australia to be the best place in the world in which to live, learn, work and do business" devotes a substantial proportion of its FSI submission to the issue.

> "Any proposal to prescribe minimum investment levels in infrastructure, venture capital or corporate debt would pose a manifest risk to the best interests of members. If there is a view that some superannuation funds are not sufficiently investing in infrastructure, a better approach would be to investigate why it is that those funds are not investing more."
>
> UNISUPER

The BCA lists the lack of a liquid bond market in Australia first among three specific "imbalances in our debt and equity markets that if addressed have the potential to enhance our growth prospects". The second imbalance is the "lack of longer-dated debt capital" in Australia – for which the BCA blames corporate borrowers' over-reliance on bank funding.

SUPER SECTOR SPEAKS

Submissions from superannuation industry participants also refer to the value of infrastructure and corporate debt in their investment universe. The Association of Superannuation Funds of Australia (ASFA) argues: "Greater investment in infrastructure projects, particularly brownfield projects with predictable cash flows, will potentially assist superannuation funds to diversify and reduce risks associated with being equity-heavy or being forced into investing in offshore markets."

However, there is a notable degree of resistance to the idea that the Australian superannuation sector's relatively low allocation to fixed-income assets marks a failure on the part of the industry. UniSuper, for instance, tells the FSI: "Any proposal to prescribe minimum investment levels in infrastructure, venture capital or corporate debt (or indeed in any other sector) would pose a manifest risk to the best interests of members. If there is a view that some superannuation funds are not sufficiently investing in infrastructure (or other sectors), a better approach would be to investigate why it is that those funds are not investing more."

A similar message comes from the self-managed superannuation fund (SMSF) sector. The SMSF Owners Association is constructive on the development of the bond market, but adds: "While debt securities can be made more attractive to SMSFs we firmly believe investment in them must remain entirely voluntary. Any suggestion that there should be an obligation on SMSF owners to invest a proportion of their fund assets into particular asset classes, for example infrastructure bonds, cannot be acceptable."

> "The current definition of a sophisticated investor, as it appears in the Corporations Act, is anachronistic. Any reasonable test of sophistication would be knowledge based."
>
> AUSTRALIA RATINGS

ASFA suggests a number of reasons for the relatively low superannuation allocation to domestic corporate bonds – which it says has been around 6-7 per cent for the past decade. Most of these reasons are based on the fact that the local bond market remains relatively small – which, ASFA says, has been "influenced in part by government policies that favour equity investment".

Challenger, meanwhile, suggests that the development of the Australian annuity market will naturally draw more funds towards the long-dated assets of the corporate bond market. The company argues that the view that superannuation funds are already 'natural' holders of long-dated – and often illiquid – income assets is to some extent fallacious.

"Superannuation funds have an appetite for infrastructure but, in a choice environment, face liquidity constraints which limit their capacity to invest in less-liquid assets including infrastructure and domestic corporate bonds," Challenger argues.

By contrast, the firm adds: "To the extent that retirees choose annuities as the defensive component of their portfolios, life offices will seek investments in long-term assets – such as infrastructure and domestic corporate bonds – and are not subject to the same liquidity issues faced by super funds."

RETAIL PROPOSALS

FSI submissions cover a lot of ground in terms of how to progress the corporate bond market. Again, AFMA's suggestions are among the most extensive. The basis for its view is: "There is solid potential for development of the corporate bond market in Australia in both the wholesale and retail sectors (albeit the wholesale sector may offer better prospects in the short term), but this will take time. It will depend on a number of elements including government policy and legislation, taxation, distribution, and also the investment mentality or investment culture of Australians."

Another SMSF body – the SMSF Professionals' Association of Australia (SPAA) – suggests that it is only the fact that much of Australia's fixed-income product comes to market in wholesale-only format that stops its members from participating in the market. The SPAA claims: "Currently, SMSF capital is precluded from financing and participating in many areas of investment that would contribute to the wellbeing of Australia, such as direct investment in large infrastructure projects and the corporate bond market."

The answer, the SPAA argues, lies in making smaller parcels of both infrastructure debt and corporate bonds available to the SMSF investor base. "SPAA believes that addressing these liquidity issues and removing administrative barriers will provide the most significant challenges in allowing SMSFs to have better opportunities to invest in infrastructure projects. Unitising investment in infrastructure projects to smaller investments for SMSFs – for instance A$25,000 [US$23,205] units – would be one way to overcome current limitations, as would be issuing small-scale infrastructure bonds."

AFMA suggests further regulatory moves to facilitate corporate bond issuance, especially in the retail market. "The

message from corporate borrowers is that the current regulatory environment imposes onerous restrictions on their capacity to raise debt in the corporate bond markets (particularly in the retail market)," it says. "Given the lower-risk nature of corporate bonds versus equity products, it appears incongruous that the current regulatory regime appears to make it harder to raise corporate debt than equity finance."

Specifically, this means further simplification to retail prospectus requirements such as the use of wholesale-style termsheets instead of full prospectuses, reform of the directors' liability regime, and full use of the Australian Securities Exchange (ASX)'s continuous disclosure system for bond disclosure.

Ease of retail market access is also raised by the BCA submission. It suggests: "Steps should be taken to develop a standardised set of bond issuance documents, along with measures to improve the ease with which corporate bonds can be listed on the ASX."

Macquarie also highlights retail development, including the suggestion that the cost of issuing in the retail space be mitigated by reducing regulation. The bank also recommends the adoption of the Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill which was put before parliament in 2013 but stalled at the change of federal government.

Another submission – from ING Direct – puts forward the idea of developing a retail securitisation market in Australia. The bank says: "We propose the inquiry looks at ways to expand the funding markets to include greater participation from retail customers. Various attempts have been made to establish a retail bond market, however more is required especially in the manner of simplified and straightforward documentation. The opportunity for retail investors to directly participate in the funding of the mortgage market would stimulate competition and product innovation."

> "We note the role played by the Australian Office of Financial Management in the securitisation market. A similar role may be required to facilitate development of the corporate bond market."
>
> MACQUARIE GROUP

MORE NEEDED

However, there is a clear thread of doubt that the retail market can be a panacea. Macquarie itself says: "We believe [reduced retail regulation] will assist in the development of the market but note that there may need to be a greater level of institutional participation. We note that in the US retail investors are a small component of the overall corporate bond market, with the majority of corporate bonds held by institutions."

ASFA echoes this view. Although it notes some reforms in the retail arena it also says: "It is considered that the additional issuance in the Australian market to retail investors will be marginal compared with the overall size of wholesale markets. In practical terms, it is not expected that these reforms will significantly increase the depth and liquidity of the domestic corporate bond market."

Australia Ratings' FSI submission offers a challenge to the established division of retail and wholesale markets by questioning the whole system of sophisticated investors. It argues that "there is a need to rebalance the listed corporate bond market away from being the domain of higher-yielding but higher-risk subordinated and hybrid instruments". As such, Australia Ratings says familiarity with senior corporate bonds as securities that can preserve capital and minimise downside risk needs to be promoted in Australia.

In this context, Australia Ratings argues: "The current definition of a sophisticated investor, as it appears in the Corporations Act, is anachronistic. Today, an annual income of more than A$250,000 or the possession of investable assets greater than A$2 million does not make one a sophisticated investor. Any reasonable test of sophistication would be knowledge based."

TAX ACTION

Macquarie calls for external assistance. "To develop a broader and deeper corporate bond market, a greater level of participation by government may be needed," it says. This could include measures on the debt issuance side – for instance a greater range of maturities – to provide benchmarks to the market.

The BCA believes a more-developed government curve would help facilitate corporate issuance. It argues that it is difficult to issue and trade corporate bonds in Australia in part because of "the absence of a proper risk-free rate curve from which to price new issues". And it adds: "This could be solved by the issuance of longer-dated government bonds to create a proper risk-free rate or encouraging the use of the credit default swap rate."

More significantly, Macquarie also proposes government investment in private debt. "We note the role played by the Australian Office of Financial Management in the securitisation market," Macquarie's submission says. "A similar role may be required to facilitate development of the corporate bond market."

More common are calls for the taxation system to be reformed to reduce perceived incentives to equity ownership. AFMA argues that, from a tax perspective, there remains an asymmetry between the treatment of debt and equity financing from both an issuer and an investor perspective. For issuers, it says, debt financing may give rise to deductible returns and

consequently reduce the cost of issuance. "However, such returns will not allow for franking credits to flow to investors, unlike returns on equity financing instruments, such as shares, which are also eligible for the capital-gains tax discount when held by individuals or complying superannuation entities."

In the institutional investor sphere, AFMA continues: "The current taxation settings offer no incentive for wholesale investors to invest in corporate bonds vis-à-vis equities...Accretions in the value of equities are taxed advantageously in the hands of superannuation entities through the capital-gains tax discount, where by definition any yield on bonds is paid out as a fully assessable coupon. In addition, superannuation entities are able to obtain a refund of any excess franking credits attached to dividends."

Retail investors, meanwhile, see interest income from bonds taxed at a higher marginal rate than franked dividends. And AFMA also notes the popularity of hybrid securities with franking credits attached, with retail buyers. So AFMA recommends that "the taxation treatment of returns from different asset classes could be made consistent when considered on a risk-return basis".

> "Currently, SMSF capital is precluded from financing and participating in many areas of investment that would contribute to the wellbeing of Australia, such as direct investment in large infrastructure projects and the corporate bond market."
>
> SMSF PROFESSIONALS' ASSOCIATION OF AUSTRALIA

HSBC also focuses on tax in respect of the bond market, and the bank goes further than asking for a level playing field in the retail arena. It recommends that "tax concessions be investigated/introduced to encourage greater diversification of Australian retail investment into interest-income investments".

CommBank, meanwhile, requests the FSI to: "Support demand through tax system initiatives to encourage debt investment as well as investor education about the risk-return trade-off between fixed income and other asset classes."

The bank continues: "Specifically, [CommBank] believes it is necessary to CPI-adjust long-dated income earnings from fixed income, where debt investment is most disadvantaged from a tax perspective. In 2010, Australia's Future Tax System Review recommended introducing a tax discount of 40 per cent for interest income, net residential rental-property income, and capital gains, with the specific aim of ensuring a more consistent outcome across these asset classes. [CommBank] suggests that this discount be introduced for long-term fixed-income securities. By limiting the measure to long-term instruments, the impact upon the government revenue would be minimised."

EDUCATION FOCUS

The other area where FSI submissions recommend action to promote debt investments is that of investor education. Many submissions acknowledge the behavioural preference of Australian investors for equity, and with mandatory asset allocation clearly disliked by most market participants an educative approach is considered more appropriate.

CommBank, for instance, says: "There is an Australian investor preference for equities. [CommBank] believes that this preference may change if retail investors understood that higher yields are a return for taking higher risk. Retail investors should have a firmer grasp of the risks of investing in equity, including the discretionary nature of dividends and that both dividends and capital appreciation are subject to the risks of the underlying business."

The bank continues: "Investors should understand the risks of investing in debt but also the relative benefits. Issuers attempt to assist by explaining the differences between equity and debt in prospectuses and this type of disclosure has significantly improved over recent years. However, these are limited opportunities and only the government is in a position to take on a broader responsibility."

AFMA also focuses heavily on education, pointing out that all its other suggested initiatives "will amount to little if investors are not interested in the product". AFMA says the wholesale market will likely not benefit from education – suggesting that the low weighting to fixed income in institutional Australia is "a perplexing issue" – but it does advocate industry and government efforts to educate retail investors as to the pricing, characteristics and benefits of corporate bonds.

RATING ROLE

AFMA also requests a review of Australia's licensing arrangements for credit rating agencies, which have seen all the major agencies decline to seek retail accreditation. It argues that credit ratings on retail bonds would "greatly assist retail investors' capacity to understand the relative creditworthiness of various bond issues and apply an appropriate credit risk premium".

Unsurprisingly, Standard & Poor's Ratings Services makes the same plea. It claims: "A requirement in Australia for credit rating agencies to be a member of an external dispute resolution [EDR] scheme if their credit ratings are available to retail clients is inconsistent with regulatory regimes for credit rating agencies in other jurisdictions. In our view, the EDR scheme requirement is inappropriate for credit rating agencies, and the Australian market will be best served if all investors, including retail investors, can have access to the credit ratings of global credit rating agencies, as is the case in other countries." •

FSI SUBMISSIONS PART TWO: STRUCTURED FINANCE

A number of submissions to Australia's financial system inquiry (FSI) encourage the government to play a role in the further development of the country's structured-finance market. They note the important role of securitisation in particular as a supporter of competition in the financial sector.

Master trusts, the covered-bond issuance cap, Australia's limited range of regulatory high-quality liquid assets (HQLAs) and capital relief for securitisation also feature.

The starting point for most structured-finance content in FSI submissions is the role the market plays in funding Australian financial institutions (FIs) – and therefore its relevance to the banking-sector competition debate (see p27).

The Mortgage and Finance Association of Australia (MFAA), for instance, argues: "It is significant to note that the swings in market share in the early years arose directly from the innovation and energy of the wholesale – non-bank – lenders, assisted by the tool of securitisation. The subsequent rise of the big four's market share during the financial crisis occurred not as the result of any innovation or competition by them, but because of the collapse of the securitisation market funding their non-bank competitors and two significant acquisitions."

The Australian Securitisation Forum (ASF) also argues in favour of the importance of the asset class. It says: "Securitisation is an important funding tool for a wide range of financial institutions and helps to fund a wide range of asset classes, particularly lending to retail borrowers and SMEs. [ASF's recommendations] will help to increase the capacity of FIs to lend to these sectors as well as other sectors critical to the growth of the Australian economy such as infrastructure financing, while also fostering a stable and efficient financial system."

National Australia Bank (NAB), meanwhile, suggests that a vibrant securitisation market can help banks address regulatory demands in an efficient and cost-effective manner. The bank tells the FSI: "As Australian banks consider the potential impacts of the net stable-funding ratio, longer-term, matched funding options will become more important. Securitisation of banks' assets provides one solution."

Third-party submissions appear to back the view that a healthy securitisation market supports FI diversity. Australia's federal Treasury says: "The cost of securitisation increased markedly during the financial crisis, leading to the exit of many non-bank lenders and the removal of an important source of competition."

> "All repo-eligible bank paper...should be treated as level-one HQLAs by the RBA. Further, eligibility criteria could be adjusted to include all banks regardless of their rating – including unrated entities – and RMBS."
>
> SUNCORP BANK

While many FSI submissions note the revival of securitisation issuance in recent years, many industry participants believe there remains justification for more action to promote the asset class.

"The Australian market is limited currently by the low frequency and small size of issuance of many programmes, both of which limit investor interest," argues the Australian Bankers' Association (ABA). "Coordination to facilitate larger and more frequent issues that can compete with some of the larger programmes offshore should be encouraged."

One outlier to this view is ANZ Banking Group (ANZ), which claims: "ANZ considers that markets for bank funding

operate efficiently and there is no intervention required to facilitate the ongoing funding of Australia's economic growth. The structure of banks' balance sheets and fund profiles are largely a function of management choice, driven by a combination of strategy, market positioning and financial considerations."

MASTER TRUSTS

A feature of many submissions on securitisation is a desire to see the development of an Australian master-trust regime. Many market participants support the view that master trusts would facilitate securitisation issuance of the scale and type which would unlock significantly greater demand for the product – specifically from international markets.

Commonwealth Bank (CommBank), for instance, points out the potential advantage the master-trust structure would give over traditional residential mortgage-backed securities (RMBS). "In Australia, each tranche of RMBS must be issued through an individual corporate structure (this is referred to as a 'closed pool' RMBS)," the bank explains. "The Australian banks could more efficiently issue RMBS by issuing multiple tranches through a single master trust."

Master trusts will be addressed in the Australian Prudential Regulation Authority (APRA)'s forthcoming update to the APS 120 prudential standard covering securitisation – and an early-May regulatory update confirmed APRA's willingness to allow the asset class. While they debate the precise implications of regulatory proposals, market participants are also keen that the issue be resolved both quickly and in a way which provides the most helpful asset to securitisation issuers.

The ASF says: "Coordination to facilitate larger and more frequent issues that can compete with some of the larger programmes offshore should be encouraged. Allowing master-trust structures would assist this, while also addressing some specific investor concerns such as with the term of investment. To facilitate this, government should finalise regulatory settings for securitisation, including the use of master-trust structures, as quickly as possible."

> "Coordination to facilitate larger and more frequent issues that can compete with some of the larger programmes offshore should be encouraged. To facilitate this, government should finalise regulatory settings for securitisation, including the use of master-trust structures, as quickly as possible."
>
> AUSTRALIAN SECURITISATION FORUM

This request was clearly formulated in collaboration with the ABA, which uses exactly the same wording as part of its request for measures to facilitate the securitisation market.

While NAB notes that APS 120 is in the pipeline with master trusts under consideration, it also raises the concern that an Australian master-trust regime might not be optimally efficient. Specifically, the bank mentions the possibility that some "critical structural features" relating to the use of seller shares and date-based calls could be excluded from APS 120.

COVERED BOND LIMITS BY JURISDICTION

COUNTRY	COVERED BOND LIMIT
Australia	8% of assets in Australia
Canada	4% of total assets*
Denmark	No limit
Netherlands	No limit
Finland	No limit
France	No limit
Germany	No limit
New Zealand	10% of total assets
Norway	No limit
Singapore	4% of total assets
Sweden	No limit
UK	No limit

* The Canadian government also operates a scheme under which residential mortgages can qualify for a government guarantee.

SOURCE: COMMONWEALTH BANK APRIL 4 2014

COVERED-BOND CAP

While master trusts could open up demand avenues offshore, Australian structured-finance market participants also see potential to increase their access to global covered-bond investor pools. Specifically, a number of FSI submissions argue that the current 8 per cent cap on balance-sheet assets which can be used for covered-bond pools is too low.

CommBank points out that Australia's regulatory covered-bond issuance cap is lower than a number of peer nations (see table on this page) and recommends "that the 8 per cent limit should be increased, particularly if the Australian banks are to issue covered bonds to contribute to the development of domestic debt markets".

To date, the big-four banks and Suncorp Bank (Suncorp) are the only Australian FIs to have issued covered bonds – with capacity being a significant issue for smaller institutions. Suncorp also tells the FSI that an 8 per cent cap severely curtails its own issuance of the product – especially given the buffers it deploys to ensure headroom beneath the cap.

"The 8 per cent limit on assets funded from covered bonds does not provide sufficient headroom to fund growth," Suncorp asserts. "Due to internal risk and compliance buffers in place

to ensure the 8 per cent cap is not exceeded (and penalties are avoided), covered bonds are providing only 4 per cent of Suncorp's overall funding."

The bank continues: "A change to allow banks to reach the 8 per cent either through an increased overall cap, or flexibility to buffer the 8 per cent cap, would be welcomed. In Suncorp's case, this would allow an increase of A$2 billion [US$1.9 billion] in covered-bond issuance which would materially enhance the bank's ability to lift mortgage competition."

Westpac Banking Corporation (Westpac) also addresses the covered-bond issuance cap, albeit in a more measured tone. It argues: "An increase to the cap on the covered-bond pool from 8 per cent to 10-15 per cent would be a positive expansion to the funding available to banks. However, covered-bond issuance is more useful as a contingent funding tool (ie for use in difficult market conditions) than a primary funding source."

The ABA is more careful still. It merely says: "Covered bonds potentially have wider application and could serve as an even greater source of funding. The current legislation sets a cap on the use of covered bonds, in recognition of the primacy of depositor protection. This cap should be reviewed periodically to ensure the right balance between depositor protection and funding-source stability and diversity is maintained."

> "The Australian market is limited currently by the low frequency and small size of issuance of many programmes, both of which limit investor interest. Coordination to facilitate larger and more frequent issues that can compete with some of the larger programmes offshore should be encouraged."
>
> AUSTRALIAN BANKERS' ASSOCIATION

GLOBAL REPO

Yet another option for opening up international demand is the possibility that Australian-origin structured-finance securities might be added to the lists of repo-eligible product at international central banks. This, some market participants say, could substantially increase the Australian investor base offshore by making product more appealing to bank liquidity book buyers in particular.

The ASF asks that the Australian government: "Press, through Australia's G20 presidency, reciprocity among central banks' repo frameworks. Specifically, to permit Australian securitisation notes and covered bonds denominated in the relevant local currency to be repo eligible at the US Federal Reserve (Fed), European Central Bank (ECB), and Bank of England (BoE). This would deepen international-investor demand and reduce the liquidity premium presently charged by investors for Australian collateral not being repo eligible."

Westpac makes the same request for Australian authorities to push for international recognition. It asks for "lobbying for reciprocal international central bank repo treatment, that is, Australian asset-backed securities [ABS] and covered bonds becoming repo eligible at the Fed, ECB and BoE which would increase international investor demand."

HQLA POSITION

Liquidity-book buyers are also targets in the domestic arena. Local banks are already substantial buyers of Australian dollar covered bonds and RMBS, but the ASF points out that this bid could be developed further if structured-finance issuance was given enhanced treatment under APRA's high-quality liquid-asset (HQLA) regime.

"In offshore jurisdictions, RMBS are eligible as HQLAs," the industry association notes. "This encourages banks to hold RMBS in order to satisfy their Basel III liquidity requirements and is consistent with the fact that such RMBS are repo eligible for cash liquidity at the central banks."

APRA cannot be told what to include in its HQLA list, but the ASF requests the FSI to "provide APRA with a cost-benefit framework that gives rise to a reinterpretation of Basel III liquidity standards such that it reverses its decision not to grant RMBS and ABS HQLA level-two status".

CommBank points out the potential within the HQLA market. "If [structured-finance assets] were HQLA-eligible in Australia, the Australian banks would have an incentive to invest more in this asset class as part of their overall liquidity portfolio mix. The potential capacity within the major banks' liquidity portfolios for additional HQLAs is substantial given APRA's estimate that there will be a market-wide Australian dollar level-one HQLA shortfall of A$282 billion."

Australia currently has no level-two HQLAs, so the inclusion of covered bonds or securitisation in this category would likely give the asset class an edge in demand terms over all other non-government and semi-government issuance. However, with level-two securities likely to be treated less favourably than level-one assets in liquidity-coverage ratio calculations, Suncorp elects to aim high with its recommendation on HQLAs.

The bank says: "Suncorp believes all repo-eligible bank paper...should be treated as level-one HQLAs by the Reserve Bank of Australia. Further, eligibility criteria could be adjusted

CANADA AND AUSTRALIA, FUNDING AND LENDING SOURCES (%)

	CANADA	AUSTRALIA	
Deposits	59	60	
Securitisation	28	5	
Other	13	35	
SHARE OF LOANS	**CANADA (OUTSTANDING)**	**AUSTRALIA (OUTSTANDING)**	**AUSTRALIA (NEW)**
Banks	75	88	94
Other lenders	10	8	2
Mutuals	15	3	5

SOURCE: AUSTRALIAN BUREAU OF STATISTICS, CANADA MORTGAGE AND HOUSING CORPORATION, MORTGAGE AND FINANCE ASSOCIATION OF AUSTRALIA APRIL 4 2014

to include all banks regardless of their rating (including unrated entities) and RMBS. Such changes could be introduced quickly and easily, and they would go some way to restoring competition by providing a funding boost to non-major banks."

CAPITAL POSITION

On the other side of the balance sheet, some issuers tell the FSI they would like to see a more accommodative regulatory approach to RMBS for capital relief. Most large banks do not seek capital relief in their RMBS transactions – instead retaining subordinated tranches while selling top-rated notes for funding purposes. CommBank would like to see this situation change.

It says: "Under APRA's standards, the Australian banks are encouraged only to issue RMBS for funding reasons. Although the securities are dependent upon the underlying pool of residential mortgages and the risk of those mortgages is effectively transferred to investors, the Australian banks' ability to obtain relief from holding regulatory capital for those assets is reduced by technical rules and caps. If the Australian banks were allowed full capital relief, there would be more ABS issuance. Therefore, Commonwealth Bank recommends that there be a review of the need for the technical rules and caps."

Westpac, by contrast, is more guarded on this issue. Indeed, it comments: "Other factors underpinning the stability of mortgage lending in Australia include...the use of securitisation in Australia for funding rather than risk transfer, leading to an ongoing incentive for lenders to originate high-quality mortgages."

> "An increase to the cap on the covered bond pool from 8 per cent to 10-15 per cent would be a positive expansion to the funding available to banks. However, covered-bond issuance is more useful as a contingent funding tool than a primary funding source."
>
> WESTPAC BANKING CORPORATION

CANADIAN MODEL

One FSI submission raises an option which has all but disappeared from the securitisation debate in Australia: the Canadian model for providing a government guarantee on mortgage-bond issuance. This was mooted in the financial crisis period but appeared to have faded from market consciousness following the Australian government's decision to have the Australian Office of Financial Management (AOFM) invest directly as its means of supporting the RMBS market.

This approach was markedly different from the idea of introducing an Australian equivalent of the Canada Mortgage and Housing Corporation and, with AOFM support having more recently been supplanted by a revival in the private-sector RMBS market, the Canadian approach has been little-mentioned in recent times.

The MFAA, however, still sees value in the concept. It points out that Canada's mortgage market has both a larger reliance on securitisation as a funding tool and a larger market share in the hands of non-bank lenders than Australia (see table on this page). And it suggests that the link between the two is causal rather than merely correlative.

"MFAA has appeared before a number of Senate committees and other Parliamentary inquiries since 2008 in which we have advocated the Australian government analysing the benefits of the Canadian system," the MFAA says. "On most occasions the reports of these committees have made favourable recommendations regarding the Canadian system but there appears to have been no action."

The Canadian model is just one potential approach, the MFAA explains. Its submissions continues: "At the very least it should be a strong recommendation from this inquiry that all that can be done to encourage and enhance Australia's revitalising securitisation market should be done and that any regulatory hurdles or roadblocks should be dismantled. Whether or not a Canadian-type system is adopted, the Canadian experience and Australia's prefinancial crisis experience demonstrate that a prerequisite for a more competitive market is a thriving securitisation market." •

FSI SUBMISSIONS PART THREE: ASSET ALLOCATION

A number of submissions to Australia's financial system inquiry (FSI) discuss the issue of asset allocation within the country's superannuation system – including the perception that allocation to income assets is too low.

Proposals mainly focus on taxation and investor education, while Industry Super Australia (ISA) lays out a root-and-branch assessment of the superannuation system with a raft of proposals designed to facilitate longer-term investment.

There appears to be broad acceptance in the FSI submissions that asset allocation in Australia is not working perfectly. ISA, for instance, says: "Compulsory superannuation has been very successful at generating savings available for investment that otherwise would not exist...However, the savings accumulated are not optimally stabilised and pooled to facilitate long-term investment in capital."

Australia's federal Treasury is measured in its submission but acknowledges the same point. While noting that there are "sensible reasons to support the Australian system currently having a higher proportion of equity investments", it notes that the equity component of asset allocation in Australia is high compared with many overseas pension systems.

"Given the volatility of share returns, the weighting of funds' investment portfolios towards equities potentially exposes individuals to increased risk, particularly when they are nearing their retirement drawdown phase," Treasury continues. "The sector is responding to these concerns by developing 'lifecycle' products that alter members' asset allocation over their lifetime."

SUPER'S ROLE

Some submissions from the superannuation industry itself advocate a 'hands off' approach to asset allocation. The Association of Superannuation Funds of Australia (ASFA), for instance, argues that the perception that the Australian industry is inadequately allocated to local long-term assets is not correct.

"There is evidence that superannuation funds are investing in infrastructure debt," ASFA argues. "However, superannuation funds will not invest in infrastructure debt where they are already holding equity. The reason for this is that, in the event of a dispute in relation to the asset, superannuation funds would be in a conflicted position, having to represent the interests of both debt and equity."

In short, ASFA continues, the Australian infrastructure sector should continue to look outside the domestic superannuation pool for the bulk of its debt-funding requirements. ASFA's submission suggests: "For an infrastructure bond market to function efficiently it is important that Australia is open to global investment. There is a growing appetite among pension funds and insurers to invest in long-duration infrastructure debt. The conflict between debt and equity at an asset level means that Australia needs alternatives to a small number of superannuation funds to finance the nation's infrastructure interests."

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>
> ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA

By contrast, submissions from the self-managed superannuation fund (SMSF) sector appear to be asking the FSI to facilitate greater allocations to long-term assets. The SMSF Owners' Alliance (SMSFOA) says: "Given Australia's appetite for capital, particularly for infrastructure investment to drive development of a resource-based economy, SMSFs would seem a logical source of capital with some A$520 billion [US$482.7 billion] of assets. Yet SMSFs invest a relatively small proportion of their assets in government, semi-government, corporate and infrastructure bonds."

Two of Australia's official institutions – Treasury and the Reserve Bank of Australia (RBA) – appear wary of any measure designed to direct asset allocation in favour of nationally important projects. Indeed, Treasury is not yet convinced that a problem exists.

"Assessing the allocative efficiency of the superannuation sector is a difficult task given the variety of preferences of individual members and the complexity of taxation and regulatory arrangements affecting the asset allocation decisions of funds," its submission argues. "The allocative efficiency of the sector cannot be assessed by a single metric such as the proportion of funds invested in equities."

Treasury suggests a review of the structure of the superannuation sector to assess whether barriers exist to the efficient allocation of capital. Should none be identified, it continues, "it is important that trustees should continue to act in the best interests of their members rather than any perceived 'national interest'".

The RBA echoes this view. "Some have proposed superannuation as a potential pool of funding for infrastructure investment. In the reserve bank's view, it would not be appropriate to mandate superannuation funds to invest in particular assets to meet broader national objectives."

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>
> **RESERVE BANK OF AUSTRALIA**

Other market participants are also wary of potential moves to bring superannuation assets into the infrastructure sector in particular. The Australian Securitisation Forum, for instance, requests that the FSI "avoid new distortions by preferring certain securities, such as infrastructure assets".

An alternative take on the infrastructure issue comes from AMP, which somewhat challenges any assumption that the promotion of infrastructure allocations would inevitably also be a boon for the wider bond market. AMP suggests: "Institutional investors are increasingly viewing infrastructure as an alternative to fixed income. Infrastructure is seen as a particularly good fit for pension funds and insurance companies, given their long-duration liability profiles. This should be welcome news for Australian governments, provided the capital can come here."

TAX MEASURES

None of this is to say, however, that FSI submissions believe there are no measures that could be put in place to improve Australian asset allocation. One of the most commonly cited areas which market participants claim is not working as well as it could is the local taxation system. Many submissions claim the system systemically disadvantages fixed-income investments among others, by offering structural incentives to hold, in particular, equity and real-estate assets.

For instance, National Australia Bank (NAB) mentions the 2008 Australia's Future Tax System Review (the Henry tax review). It states: "As outlined in the [Henry tax review, there is currently a significant tax advantage for investments other than interest-bearing investments. For interest-bearing investments, including deposits, tax is calculated at marginal tax rates on nominal returns. By contrast, there are significant tax benefits afforded to other investment assets (ie franking credits, capital gains tax discounts [and] negative gearing)."

The Australian Financial Markets Association (AFMA) agrees with NAB's interpretation of the tax situation. It suggests: "It is particularly important to acknowledge that there are different tax treatments for what may represent economically the same gain."

This specifically disadvantages direct fixed-income holdings. AFMA continues: "By way of example, any incremental gain in a share held in a company for more than 12 months will benefit from the capital-gains tax discount, even where the company did nothing more than hold fixed-income securities and accumulate any income received. This can be contrasted with the position where the investor held the same assets directly, where any income arising...would be assessable income and ineligible for any discount."

NAB and AFMA both advocate reducing what NAB calls the "tax bias" against interest income. AFMA specifically recommends the adoption of a Henry tax review measure which the previous Australian Commonwealth government initially watered down and then completely abandoned.

The Henry tax review recommendation is: "A move to a broad 40 per cent discount for income from bank deposits, bonds, rental properties, and capital gains and for certain interest expenses would address these problems by providing more-consistent tax outcomes. Savings would be allocated more productively, distortions to rental property and other markets would be reduced and household investment and financing choices would better suit their circumstances and risk preferences."

ISA's take on the tax situation in Australia adds another level of nuance. The association notes that capital gains tax is "intended to create incentives for investment" and therefore naturally has a lower rate than income tax. "However," ISA continues, "its design does not ensure that the gains are related to real economic investment, ie in capital."

ISA suggests that capital gains tax be redesigned to differentiate between primary- and secondary-market investments, with the latter only receiving concessional treatment "if there is a post-acquisition funding injection".

Furthermore, ISA's submission continues: "It may be worth considering extending the period of time before the full [capital-gains tax] concession is available to reflect something more akin to a long-term investment, and providing the concessions on a sliding scale."

Treasury is unconvinced by the arguments on tax-based incentives, however – but largely because it wants to see more evidence that they exist in the current system. Its FSI submission says: "Noting the complexity of the tax systems' treatment of debt, equity and various hybrid instruments...real-world effects of dividend imputation are extremely difficult to ascertain. Accordingly, this issue is more appropriately left for consideration in the broader context of the Taxation White Paper."

SYSTEM LIQUIDITY

The bulk of ISA's submission as it relates to asset allocation refers to the issue of liquidity in the superannuation system. Its view that superannuation savings are not optimally allocated rests on four observations, all of which come down to the ease of switching allocations in the Australian system and the short-termist nature of behavioural finance.

As a consequence of the need always to be prepared for liquidity events, ISA says: "The superannuation system as a whole will hold excess liquidity for a systemic event. If there is a systemic event, if there is switching, for every outflow from a fund there will be an inflow to another fund, but no funds will be able to include that inflow in their stress testing. This argues in favour of a system-wide liquidity framework, ideally including participation by the central bank to ensure public goods are captured."

In effect, ISA adds, the very tools given to superannuation investors are preventing the system from achieving the benefits many believe it should offer. "Much has been said about the fact that superannuation funds are the natural investors of long-term investments such as infrastructure assets," it acknowledges. "Long-term investments, with an illiquidity premium, can benefit superannuation members' retirement incomes. However, Choice of Fund can distort the focus and incentives of super funds – or their investment managers – towards 'short-term thinking' rather than long-term investment."

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>
> INDUSTRY SUPER AUSTRALIA

The idea of system-wide liquidity support to facilitate long-term superannuation investment receives some support in other FSI submissions. NAB, for example, recommends the adoption of a "liquidity backstop facility for superannuation funds", and asks that "at a minimum" the FSI investigates who might provide such a facility, what it would likely cost and what would be the legal structure of assets held within it.

The RBA does not put itself forward as a liquidity facility provider for superannuation – as it is to the regulated banking sector in Australia via the repo market. However, the central bank does say it would "support consideration of whether the [superannuation] system could be improved" including an exploration of "whether superannuation funds are appropriately balancing the liquidity of their liabilities and their investment profiles".

As well as a "public liquidity facility for the super system", ISA puts forward two further proposals designed to assist the perceived liquidity and asset-allocation challenge in Australia. One is that new members be committed to a specific superannuation fund and investment option for several years before being permitted to switch. Members anticipating a switch could opt in to a "liquid account" with appropriate charges to reflect the cost to the fund of providing this option.

Secondly, ISA suggests that all superannuation funds be required to offer a "stable account" with much more limited switching facilities, to which members could opt in "presumably in exchange for a reward".

EDUCATION OPTIONS

As with the development of Australia's fixed-income market, a number of submissions to the FSI focus on education as a means of altering Australia's asset-allocation dynamics. Commonwealth Bank, for instance, advocates that Australia should "educate the public about the risk-return trade-offs and tax implications across different investment options and emphasise the importance of a lifecycle investment strategy".

The bank continues: "Retail investors should understand that high yields are a return for taking high risk and that equity returns (capital appreciation and discretionary dividends) are subject to the risks of the underlying business. People should be informed to formulate their risk appetite and make investment decisions. The concept of a lifecycle investment approach to protect sequencing risk should be understood."

NAB also raises the issue of investor education, recommending the development of "national education programmes for retail investors, retirees and SMSFs on diversification, sequencing and risk-return trade-offs".

From the SMSF sector itself, the SMSFOA argues that education may be the main barrier to higher fixed-income allocations in its industry. It says: "We speculate that the relatively low amount of SMSF assets devoted to debt securities may be because SMSF owners, and investors generally, may be more familiar and comfortable with investing in equity rather than debt. The share market is better known to investors than the bond market. This is reflected, for example, in the daily focus of the financial and other media on the share market with little coverage of bond markets."

The SMSFOA suggests: "It would be useful to conduct research among SMSFs to gauge their level of understanding and preparedness to invest in debt securities. It would also be worth surveying financial planners and advisers as to the extent to which they advise their clients of the option of investing in debt and the general response of their clients."

The potential solutions put forward by the association are largely based around increasing product supply to the retail investor base. This could include more listed semi-government securities, and infrastructure and privatisation bonds "to give volume, depth and choice to retail investors".

> "A fiduciary needs to provide each individual or member with an inflation-protected income in retirement for their whole lives. Significant also is the description of the goal – an income stream. It is not a pot of wealth that is the target."
>
> DIMENSIONAL FUND ADVISORS

The SMSFOA also proposes the reintroduction of underwritten retail debt issues via brokers and financial planners. It says: "While initially there will be a cost to this nevertheless it will be a major factor in the success of issues particularly in the early stages of establishing the market. Retail investors (and SMSF trustees in particular) are conservative and may initially need an adviser to point out the benefits."

NEW THINKING

A different voice comes from Dimensional Fund Advisors (Dimensional), which uses its submission to the FSI to challenge a number of common assumptions about the purpose and execution of a national superannuation system, and the resulting asset-allocation norms.

Chief among the notions Dimensional disputes are the primacy of accumulation in a defined-contribution system and increased member engagement as a holy grail. The firm says fulfilling the criteria that should be at the heart of the superannuation industry "will require changes in philosophy, approach and support of the superannuation industry".

On wealth accumulation, Dimensional says: "To be seen as successful, a fiduciary needs to provide each individual or member with an inflation-protected income in retirement for their whole lives. Significant also is the description of the goal – an income stream. It is not a pot of wealth that is the target, rather an income stream from which the participant will fund their lifestyle in retirement."

Dimensional, which champions the work of Nobel laureate and distinguished professor of finance at the MIT Sloan School of Management, Robert Merton, rejects the notion that improved financial literacy and member engagement is the only way to achieve the goal of stable retirement income for all superannuation contributors. "Better engagement has been the catch-cry for government and industry for some time, but we should recognise that the majority of people will want to have little to do with their superannuation savings until very late in their working life. This means we should build a superannuation default system that manages the achievement of each member's goal on the assumption that engagement will be minimal."

Dimensional advocates a new approach for superannuation funds and trustees, which holds as the key risk to be managed that of not achieving the goal of an inflation-protected, satisfactory income in the retirement phase. As a consequence, the firm suggests: "Targeting retirement income implies that the main risk to be managed will be the risk of not realising the targeted level of income. Members should be exposed to (investment) risk only insofar as this increases the estimated probability of achieving their targeted income. Consequently, we believe that exposure to equity risk should be reduced when it is no longer needed to meet that target which may or may not coincide with their age."

Dimensional's technique in response to the issues Merton identifies, the firm says, is not simply lifecycle investing. Its FSI submission explains: "The reduction of equity exposure and asset-liability matching techniques have been referred to as 'lifecycling' or lifecycle investing. Most users of these techniques use just one factor – age – as the determinant of asset allocation for a cohort of members of a superannuation fund. Our approach uses age and other factors, which allows a fund trustee to create individual goals and manage members' assets in a way that improves the estimated probability of good retirement outcomes for all members." •

FSI SUBMISSIONS PART FOUR: RETIREMENT-PHASE PRODUCTS

Many submissions to Australia's financial system inquiry (FSI) include some discussion of what is perceived in many quarters to be a problem with the country's superannuation system: its failure to provide a product suite to support the increasing cohort of savers in retirement.

Proposed solutions are multifarious, but many are based on a request for superannuation-sector innovation to be promoted rather than hindered. Some of the proposals recommend further development of the local bond market to underpin products hedging against longevity risk, but others say the fixed-income market can only be a small part of the solution.

A number of submissions in this area also hint at one of the potential weaknesses of the FSI, by referring to recommendations made in the 2008 Australia's Future Tax System Review (the Henry tax review) but not adopted by the government. While a change of administration may increase the likelihood of FSI recommendations being adopted, nothing the FSI puts forward will be binding, and there are numerous precedents for inquiry proposals to fall by the wayside.

IDENTIFYING THE ISSUE

Australia's federal Treasury provides one of the clearest descriptions of the apparent problem with retirement provision. Its FSI submissions suggests: "The superannuation sector is focused on supporting saving through the accumulation phase, but neither it nor the insurance sector has sufficiently developed the range of products necessary for individuals to manage their financial affairs through retirement."

It is not just the Treasury, however, which identifies the issue. Submissions from the superannuation sector itself acknowledge the weakness of the domestic industry in the area of retirement provision.

For instance, the Association of Superannuation Funds of Australia (ASFA) writes: "We are moving from a system in accumulation phase, to a mature pension system, which will ultimately be paying benefits in excess of contributions. We must ensure that Australians are investing more of their retirement savings into sensibly designed... retirement products. This means adjusting the choices and incentives available to Australians in... retirement. Our current system has not resulted in individuals buying...retirement products in any meaningful way."

UniSuper, meanwhile, tells the FSI that it "offers a full suite of pension products but could offer even more" with the right conditions in place.

The Actuaries Institute includes a whole section on longevity risk in its FSI submission, in which it claims: "Policy focus at the moment is concentrated on the retirement fund accumulation process but attention needs to be refocused on the impacts of the de-accumulation phase as retirees begin to draw down from their superannuation assets...It is in the community's interest to have effective retirement products that ensure de-accumulation is orderly and retirement goals continue to be met."

Part of the problem is that Australian superannuation contributors are effectively incentivised to take their balances as a lump sum on retirement, with no subsequent natural progression to an income-stream product. One of Australia's most prominent providers of annuity product – Challenger – notes: "Australia's pension system is unusual by international standards because it allows retirees to take lump sums without a major tax penalty."

Outside the superannuation industry, some of Australia's banks take up the charge. ANZ Banking Group (ANZ)'s FSI submission says: "ANZ considers that, with the appropriate policy framework, the market can develop better products and services to meet the needs of older Australians. The market for annuities is underdeveloped in Australia. Annuities can provide an efficient and stable source of income for retirees."

PRODUCT INNOVATION

Developing innovative retirement products – and having the appropriate regulatory landscape in which to do so – is the real focus of many industry submissions on post-retirement. UniSuper argues that the regulatory environment in Australia continues to act to stymie innovation.

It claims: "The modern superannuation industry has been influenced by a number of factors, including financial innovation

driven by industry, industrial negotiations driven by employers and employee representatives, and government policy. As such, the normal process of product experimentation and innovation has been less prominent. Government regulation over the past 20 years has had as much, if not more, influence on product design than industry-led ideas."

To illustrate its point, UniSuper refers to the regulatory obligations for superannuation products to be marketed on the basis of return targets and for granular data on investment strategies to be provided by funds. While these are not of themselves problems, UniSuper suggests they force products into externally defined boxes – thus making product innovation harder to achieve and to market.

On the issue of strategy reporting, UniSuper claims: "This creates problems for products which have novel investment strategies which are not capable of being explained using the 'boxes' or terminology which appear in the forms sent to the regulator. This...discourages innovation of new products with novel investment strategies, as a consequence of what essentially began with a data collection form."

UniSuper gets support from the Australian Institute of Superannuation Trustees (AIST), which tells the FSI: "Regulations should be drafted in an enabling fashion rather than having specific features listed, thus enabling product design innovations."

AIST says it particularly supports regulatory amendments designed to facilitate products such as variable annuities, income-stream packages and with-profit annuities.

Challenger highlights a Henry tax review comment on the subject of innovation. The Henry tax review's final report notes: "Products are not available in the market to cover the broad range of preferences of retirees in achieving security of income. This is a structural weakness in the Australian retirement-income system...Given the diverse preferences of retirees, a single product is unlikely to satisfy all people who wish to manage their longevity risk. This suggests a need for product innovation within the Australian market."

Commonwealth Bank (CommBank) identifies a raft of regulatory headwinds to further development of income-stream products in Australia, including measures relating to the tax system, Australian Prudential Regulation Authority prudential standards and means testing (see table on p26).

In terms of the form products should take, several FSI submissions discuss the development of risk pooling between superannuation plan members as a means to reduce individuals' sequencing and longevity risk. For instance, Mercer says: "Within Australia, there is an urgent need to find a better balance between the individual orientation of a defined-contribution superannuation plan and a collective (or pooled) approach where there is some sharing of risks within and between generations. Such developments should not just focus on adequate incomes but also ensure the system is sustainable and has integrity over many years."

UniSuper takes a similar line, referring the FSI back to recommendations in the Henry tax review that "the government should support the development of a longevity insurance market within the private sector". And the superannuation firm adds: "New forms of collective risk pooling, such as collective defined-contribution schemes, should also be considered a priority because they can help address longevity and sequencing risk."

> "The modern superannuation industry has been influenced by a number of factors, including financial innovation driven by industry, industrial negotiations driven by employers and employee representatives, and government policy. As such, the normal process of product experimentation and innovation has been less prominent."
>
> **UNISUPER**

THE ROLE OF BONDS

Some submissions suggest a more developed local bond market could help. UniSuper itself refers to yet another Henry tax review recommendation, that "the government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance".

The banking sector weighs in on the fixed-income aspect, too. ANZ argues: "An important reason why the annuities market is underdeveloped is that risks associated with providing these products, principally interest-rate risks, cannot be hedged...Deepening the market for long-term debt securities would help financial institutions to offer long-duration products."

CommBank also sees a role for the bond market, leading it to recommend that the Australian government work with the finance sector, including annuity and income-stream providers, to issue Commonwealth government securities (CGS) with tenor out to 30 years. "For the annuity and income-stream market to reach the depth it requires to provide flexible and competitively priced products for all future retirees, a deep and liquid long-term bond market is required," CommBank explains. "Currently, there is a reasonable level of liquidity across short- and medium-term CGS and swap curves, but not for longer terms. This will require the government to issue longer-dated securities."

Challenger also refers extensively to the bond market. But it reverses the causal flow suggested by other submissions on the issue, suggesting that rather than a more-developed bond market helping the development of post-retirement product it could in

IMPEDIMENTS AND POTENTIAL SOLUTIONS FOR DEVELOPING INCOME-STREAM PRODUCTS

IMPEDIMENT	POTENTIAL SOLUTION
Deferred annuities are ineligible for tax exemptions available on pension products for persons over 60 years old.	Set out qualifying characteristics for longevity products in legislation rather than mirroring the characteristics of existing products.
Deferred annuities are not recognised in the SIS Act.	Provide equivalent tax treatment of retirement products offered by life-insurance companies and superannuation funds.
Tax legislation does not accommodate deferred annuities.	Investment savings supporting deferred annuities and other longevity products within a superannuation fund or life insurer to be made tax exempt.
Deferred annuities do not fit into the structure of the APRA prudential standard on minimum surrender values of pension and annuity products, making their pricing in the market less attractive.	Amend the APRA prudential standard applying to minimum surrender values of pension and annuity products to reflect the special characteristics of deferred annuities.
Deferred annuities are assessed against the means test in the deferral period even though income payments have not yet commenced, reducing a retiree's eligibility for social security benefits.	Consider exempting non-commutable deferred annuities from the assets test during the deferral period, or ration the assets test exemption to say a value of A$50,000-100,000. Apply a similar exemption to account-based pensions where access to capital is also restricted to equalise treatments between account-based pensions and deferred annuities.

SOURCE: COMMONWEALTH BANK APRIL 4 2014

fact be growth in the Australian annuities business which spurs bond progress.

Challenger claims: "The growth of life-office assets as Australia's ageing population moves into retirement would provide long-term funding for infrastructure and other long-tenor investments. It would also grow the domestic corporate bond market."

In fact, Challenger disputes the oft-expressed belief that the superannuation sector is, as currently construed, a ready-made source of investment funds for long-dated assets including infrastructure and corporate debt.

"Superannuation funds have an appetite for infrastructure but, in a choice environment, face liquidity constraints which limit their capacity to invest in less-liquid assets including infrastructure and domestic corporate bonds," Challenger argues. in its FSI submission. "To the extent that retirees choose annuities as the defensive component of their portfolios, life offices will seek investments in long-term assets such as infrastructure and domestic corporate bonds, and are not subject to the same liquidity issues faced by superannuation funds."

> "The growth of life-office assets as Australia's ageing population moves into retirement would provide long-term funding for infrastructure and other long-tenor investments. It would also grow the domestic corporate bond market."
>
> CHALLENGER

ASFA is also quick to point out that bonds are not a cure-all. It says: "Investment in fixed-income securities is only one way to generate a steady income stream, and it can be argued that the cost of the Age Pension will be higher if all retirees invest in conservative (cash and fixed-income) investments. Other investment solutions, including a systematic approach to the drawdown of capital, should be considered. We want to ensure we have the best products developed for our retirees."

TAX BREAKS

An area which ASFA highlights as one for potential progress is the tax regime surrounding retirement-income products. It highlights "the benefit of having a...retirement-approved product category that is consistently regulated across all product manufacturers and that would receive a consistent tax treatment".

The association also requests the FSI explore both "the relative tax treatment of arrangements on investments which are not 'retirement friendly'" and "the tax consideration and treatment of superannuation and retirement incomes in relation to health and aged-care costs".

Annuities in particular should attract a more favourable tax treatment, AIST argues. It recommends "amending taxation legislation so that if a deferred lifetime annuity is taken out in drawdown phase, it is viewed as a pension and therefore exempt from income tax".

Treasury's FSI submission also mentions tax in the context of the retirement market – but in a much more general sense, with no specific proposals and in concert with a range of other factors. It suggests: "The inquiry should identify any industry, taxation or regulatory impediments to developing cost-effective products, taking into account the proposed government review of regulatory barriers currently restricting the availability of income-stream products." •

FSI SUBMISSIONS PART FIVE: BANKING SECTOR COMPETITION

Arguably the hottest debate in submissions to Australia's financial system inquiry (FSI) concerns competition in the banking sector. While the four pillars system helped Australia survive the financial crisis, an argument is now raging around whether it is time to move from a focus on stability to instead bring competition to the fore.

A raft of documentation submitted by smaller banks and non-bank financial institutions (FIs) seeks to demonstrate to the inquiry that the Australian system provides unfair advantages to the big four. The major banks themselves, meanwhile, largely insist the system has no need for major change designed to promote competition.

The argument for pro-competitive change is not just about being fair to all players, submissions insist. Four of Australia's leading regional authorised deposit-taking institutions (ADIs) – Bank of Queensland (BoQ), Bendigo and Adelaide Bank, ME Bank and Suncorp Bank (Suncorp) – commissioned a joint submission to the FSI from Pegasus Economics. In a covering letter to this document, the four banks note what they see as the value of a competitive environment.

"Banks are a major component of the financial system and best placed to assist in managing the flow of capital to consumers and business in support of Australia's economic growth," the regional banks say. "These outcomes are best achieved through an efficient and competitive multi-tiered banking system in which each tier brings a different perspective and vigorously competes for customers on a level playing field."

> "Australia's financial system has served the economy well in terms of stability during and since the crisis. We think the time is right now, though, for the inquiry to review whether efficiency of the financial system has suffered as a result of this focus on stability."
>
> BANK OF QUEENSLAND

THE UNCOMPETITIVE CASE

Claims of an uncompetitive banking sector draw on a number of themes, most of which have their foundations in the idea that the Australian regulatory regime is too heavily weighted towards promoting stability and, as a consequence, is effectively stamping down on innovation and competition.

BoQ's own submission, for instance, argues: "Given the events of the [financial] crisis...regulatory forces have been aimed at ensuring stability of the financial system. Indeed, Australia's financial system has served the economy well in terms of stability during and since the crisis. We think the time is right now, though, for the inquiry to review whether efficiency of the financial system has suffered as a result of this focus on stability."

The Customer-Owned Banking Association (COBA) – an industry body for the mutual sector – echoes the sentiment. Its FSI submission suggests: "The Australian banking market has shown itself to be resilient through the financial crisis. Despite this resilience, the financial crisis had profound impacts on competition, as efforts of government and regulators to stabilise the financial system during the financial crisis favoured the major banks over smaller lending institutions."

Claiming that structural reform is "urgently needed", Suncorp's submission refers to two specific areas where it does not believe competitive neutrality exists. These are cost of funds

POTENTIAL SOLUTIONS TO THE PERCEIVED MAJOR BANK FUNDING COST ADVANTAGE

PROPOSAL	EXPLANATION
Apply a levy on too big to fail banks to the value of the implied benefit of government support.	"We should force these institutions to internalise the externality they are creating...While firms are free to choose their business models, they should be compelled to pay for the externalities they create."
Higher capital charges only.	"There is a concern that the imposition of capital surcharges at modest levels would leave a large chunk of the systemic externality untouched...At 1 per cent, APRA appears to be at the lower end of international experience."
Let non-too big to fail banks pay for a government guarantee.	"The access to the government guarantee is in effect what is implicitly provided to the D-SIBs for no fee...It would be a strong provider of liquidity to the regional bank sector given the regionals are not able to tap wholesale funding markets on an equal footing to the D-SIBs."
Divestiture.	"History suggests that divestiture has generally not proven to be effective as a remedy in monopolisation cases in terms of increasing competition, raising industry output or reducing prices for consumers."
Contingent-capital instruments.	"The contingent-capital solution suffers from a important limitation. Beneath contingent capital will remain debt that is implicitly guaranteed by the government."
No bank can fail.	"The government could consider making clearer its likely actions in case of any bank failure...This would have the advantage of entirely removing the funding advantage currently received by the D-SIBs and thus levelling the playing field."

SOURCE: PEGASUS ECONOMICS APRIL 4 2014

and capital holding requirements, in which areas Suncorp says "the continuing disparity threatens to drive further consolidation and a diminution in competition".

FUNDING ADVANTAGES

The view that major banks have a systemic funding advantage over second-tier ADIs is based on the belief that an implicit government guarantee exists for the big four banks.

The four regional banks' joint submission explains: "Banks that are deemed systemically important enjoy implicit taxpayer support which allows them to secure funding cheaper than other banks. An obvious example is that Standard & Poor's [S&P], an international rating agency, increases the ratings of systemically important banks by two rating notches in recognition of the implied government support, providing a significant funding advantage in domestic and offshore capital markets."

This is the contemporary face of 'too big to fail', the Pegasus Economics-penned submission argues. And it adds: "The too big to fail funding subsidy has a pervasive impact on the competitive playing field. Large banks already enjoy the cost advantages of scale and scope in production, but having taxpayers underwrite lower funding costs for the major banks gives them a decisive advantage."

Another smaller ADI submission, from the customer-owned Bankmecu, insists that there is no opposition to large banks' natural advantages. "We do not consider the market power that comes from scale is a real problem," Bankmecu claims. "Rather, the major banks' protected status creates competitive distortions in the market, and moral hazard."

As a consequence, it continues: "We accept we have to compete, to run our own race, and in no way do we look to handicap the major banks. We do not suggest cutting off the normal competitive advantages that come with scale. Neither are we looking for regulatory exemptions that favour small banks. Rather, we seek competitive neutrality as far as possible. Such a position includes the government committing to make policy that encourages negative neutrality."

A range of potential solutions to the perceived problem of major banks' cost-of-funding advantage are proposed by both the regional banks and other market participants. The Pegasus Economics report puts forward no fewer than six ideas – some of which it clearly rates more highly than others (see table on this page).

The first of these options – that major banks should be asked to pay for the benefit of the implied government guarantee – receives some support from outside the ADI sector. For example, in part of its extensive FSI submission, Industry Super Australia (ISA) comes out strongly in support of the smaller ADIs' arguments on the funding advantages afforded to the majors, for instance.

ISA claims: "The government subsidises the funding of the four major banks. Eliminating this subsidy would improve the competitive environment in banking, improve prices for businesses and consumers, and result in either reduced contingent government liabilities...or increased government revenue. The most straightforward way to do this would be an ex-post annual levy on each of the four major banks reflecting the value of the subsidy to them."

COBA, meanwhile, says a levy on domestic systemically important banks (D-SIBs) designed to recognise their implicit government guarantee would only need to be temporary. The association says it would only need to be in place until "a credible resolution regime is in place for D-SIBs so they no longer benefit from an unfair funding-cost advantage derived from an implicit taxpayer guarantee."

CAPITAL PLAYING FIELD

On the capital side of the ledger, a bevy of smaller lenders and their industry associations tell the FSI that current rules provide a significant competitive advantage to the majors. Regulatory requirements on risk weighting of assets are particularly punitive, the smaller ADI sector claims.

P&N Bank, for instance, says: "The minimum [risk weighting] for mutuals using the standardised approach as defined by Basel III is almost twice that of the major banks. This creates an anomaly whereby two houses of similar value standing side-by-side in the same street in suburban Perth have vastly different risk weighting of asset models applied to them. Home A, funded by a home loan from a major bank, requires about half as much capital to be held against it compared with home B, next door, funded by P&N Bank."

Wide Bay Australia adds further detail to the claim in its FSI submission, saying it applies a 35 per cent risk weighting to home loans under the standardised regulatory capital approach. By contrast, it adds, major banks use the alternative internal-ratings-based (IRB) approach – which enables them to apply a risk weighting as low as 16 per cent to similar assets.

The Pegasus Economics report asks that the FSI "consider whether a risk-reflective capital treatment for residential mortgages under the standardised approach should be implemented". It adds: "This suggests 20 per cent as opposed to the 35 per cent under the existing standardised approach."

> "The concentrated structure of the banking sector leaves no room for complacency about its capacity to meet the future needs of the Australian economy."
>
> **FEDERAL TREASURY**

OFFICIAL RESPONSE

Third-party submissions on the relationship between capital and funding issues and banking-sector competition are guarded in terms of the support they give the smaller ADIs. Australia's federal Treasury notes that "the concentrated structure of the banking sector leaves no room for complacency about its capacity to meet the future needs of the Australian economy".

Indeed, Treasury asks the FSI to address a handful of issues relevant to this debate. These include "the implied guarantee for banks considered too big to fail, recognising the emerging global response to this problem and being mindful of the costs of developing an idiosyncratic Australian system", and "the impact of the differential application of global banking prudential standards, balancing the impact on competition against the objective of ensuring that capital requirements imposed on banks are sensitive to the risks borne by those banks".

Treasury also posits the idea that increased competition might not of itself be a threat to sectoral stability. Acknowledging that the link between competition and instability is the "traditional 'charter view'" it adds, however, the alternate possibility that "competition assists stability by removing less-efficient banks from the financial system, making the overall system more resilient, adaptive and efficient over time".

Whether Treasury would support the types of measures suggested by the regional banks is doubtful, however. For a start, it refuses to draw a conclusion on whether or not the Australian system is optimally competitive. It accepts that "the sector is clearly more concentrated than before the financial crisis", yet also notes that "four parliamentary inquiries have reached no firm conclusions on the level of competition".

Market structure of itself is not indicative of the level of competition in banking, Treasury adds. And it concludes: "Many indicators suggest that competition in the sector is relatively robust – net-interest margins [NIMs] are near 30-year lows and measures of consumer satisfaction are near record highs – albeit the level of competition varies in intensity across market sectors over time."

The banking regulator, the Australian Prudential Regulation Authority (APRA), clearly sees little need for change in the way it manages the purported balancing act between banking sector stability and competition. It says: "Australia and its financial system were not immune from the [financial] crisis. It has provided a stern test of Australia's financial regulatory arrangements, and they stood firm – Australia's arrangements have proven to be robust and effective. Arguments for changes to these arrangements should take this conclusion, widely supported globally, as their starting point."

APRA says its original mandate – "to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality" – remains appropriate, including the 2006 addition of an overarching requirement to promote financial system stability in Australia.

While acknowledging that adhering to this mandate "requires a careful balancing act", APRA adds: "The crisis has dispelled any simplistic notion that there is a 'trade-off' between financial safety and sustainable competition. Strong FIs make strong competitors. APRA's prudential requirements may affect the relative position of competitors in particular regulated industries by imposing differential capital costs, but other factors – such as scale, business models and operating and funding costs – are likely to have larger impacts on the competitiveness of smaller institutions."

Perhaps unsurprisingly given its membership from across the banking sector, the Australian Bankers' Association takes a

pointedly on-the-fence position on competition. It tells the FSI: "There will be some issues, such as the advanced IRB approach to capital and the impact of some banks being seen as 'too big to fail', where individual banks will have different views. These issues are more appropriately left to individual bank submissions."

BIG FOUR POSITION

Even less surprising is the universal view of the big-four banks that the Australian sector is not uncompetitive and that they do not receive any unfair advantages. Commonwealth Bank (CommBank), for instance, insists that the idea of an implicit government guarantee for the majors is nothing more than a misperception.

It notes, for instance, that the rating upgrade afforded the majors by S&P as a result of the agency's view on likely government support is not unique to Australia. It mentions banks in the US, Canada and Sweden which receive a one-notch upgrade from S&P on the same basis, and points out that OCBC Bank in Singapore and Deutsche Bank in Germany receive the same two-notch uplift as the Australian majors.

Indeed, CommBank implies that S&P's view on government support may itself be erroneous. It says: "CommBank believes that rating agency methodologies which incorporate assumptions about the existence of and different degrees of an implicit government guarantee are subjective and not supported by historical market observations."

The bank insists that financial markets "did not recognise measurable value from a perception or otherwise of an implicit government guarantee" during the financial crisis, while credit-risk correlation between the majors and the Australian Commonwealth government was less than 10 per cent during the same period.

Furthermore, even if there is a perception of government support for the majors CommBank says it "believes that there is a questionable relationship between sovereign support (perceived or explicit) and the cost of funding".

To illustrate this point, it highlights the divergence between the credit-default swap pricing of two financial institutions, Royal Bank of Scotland and Lloyds Bank, from that of the UK government despite the latter's ownership of 83 per cent and 43 per cent of the respective banks' equity following their financial-crisis travails. "This suggests that the two banks receive little funding cost benefit despite the explicit government support," CommBank concludes.

ANZ Banking Group (ANZ) also denies any link between sovereign support and cheaper funding for the majors. "The major Australian banks achieve a lower cost of funding and capital due to their strength and diversification of their balance sheets, funding and liquidity, and their strong credit and other risk-management capabilities," the bank says. "ANZ rejects the view that its ability to access capital more cheaply than smaller banks is because of a perceived government guarantee."

> "The crisis has dispelled any simplistic notion that there is a 'trade-off' between financial safety and sustainable competition. Strong FIs make strong competitors."
>
> AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

CAPITAL RESPONSE

The majors are also quick to point out the reasons behind the apparently favourable capital treatment they receive from the IRB approach to mortgage risk weighting. Westpac Banking Corporation (Westpac) argues that the IRB approach is available to all ADIs – and its advantages are an appropriate reward for taking on the challenges inherent to its adoption.

"The purpose of the advanced IRB framework is to create an incentive for banks globally to invest in analytics capability to enhance their risk-management capability, and that of financial systems," Westpac reminds the FSI. "We note that advanced IRB accreditation is available to any bank that can meet APRA's prudential requirements."

While the advantages in capital terms of adopting the IRB approach are clear, Westpac adds that it is not a cost-free option. "To achieve advanced IRB accreditation, Westpac undertakes significant investment in credit-risk management, modelling and reporting, which is ultimately reflected in the quality of Westpac's credit-risk processes and decisions. Banks operating under the standardised approach are able to operate with simpler, cheaper risk processes."

DATA DENIAL

The majors also seek to disprove the notion that bank customers are being disadvantaged by the status quo. According to ANZ, there is nothing in the data on bank sector NIMs, fees or the profitability of the big four to suggest the competitive landscape is damaging consumers of banking services. It says big-four NIMs have declined to 2.1 per cent from 2.6 per cent over the past decade, and also claims that total fees paid by households in Australia have fallen by 22 per cent since 2009.

And ANZ adds: "The Reserve Bank of Australia [RBA] governor has stated [in February 2012] that rates of return on bank equity are in line with returns for listed companies in other industries. In our view, the rates of return reasonably reflect the risk the market attaches to investing in banking. If returns are below the expectations of domestic or international investors then our ability to invest in Australia's financial infrastructure and support ongoing growth will be [affected]."

Rather, ANZ insists, profits have increased with asset growth. Between 2003 and 2013, the bank notes, the four major banks saw their aggregate interest-earning asset books treble in size to A$2.5 trillion (US$2.3 trillion) from A$826 billion. Over the same period combined cash earnings for the sector grew almost in line – to A$27.4 billion from A$8.1 billion.

There is an international comparison to be made on the profitability side, too. While noting that Australian banks' return on equity (RoE) have been well above those of banks in the most crisis-affected nations, Westpac insists that an appropriate peer-group analysis shows the Australian majors to be in line with banks from comparable nations.

"The profitability of the Australian major banks is not out of step with banks of other countries that successfully navigated the financial crisis," Westpac says. "The Australian major banks delivered RoEs of 13-19 per cent in 2013, compared with, for example, Canada's bank RoEs of 14-23 per cent in the same period."

National Australia Bank (NAB) sums up the 'nothing to see here' position of the majors, saying: "Australia has a vibrant and competitive banking system allowing customers to benefit in terms of price and value, choice, innovation and flexibility. Within the constraints of a highly regulated financial system, market forces should be allowed to operate to drive greater efficiency and better outcomes for customers."

> "Rating agency methodologies which incorporate assumptions about the existence of and different degrees of an implicit government guarantee are subjective and not supported by historical market observations."
>
> **COMMONWEALTH BANK**

SHADOW BANKING

In fact, NAB's FSI submission suggests the bank believes that a much greater concern than competition within the banking system should be the potential role of unregulated FIs outside it. While acknowledging that Australia has a small shadow-banking system by international standards, and that the players which do exist "often bring innovation to the market", NAB says shadow banks "can also increase risk in the financial system".

NAB counsels: "If financial-sector regulation is focused solely on ensuring the stability of the regulated-banking sector without also considering risks inherent in the shadow-banking sector, then systemic risk will not be reduced. Similarly, imposing excessive restrictions on the activities of the regulated-banking sector simply creates arbitrage opportunities that see risks moving into the shadow-banking sector."

NAB gets some support from the RBA on this issue. Discussing post-crisis regulatory changes, the reserve bank suggests: "As with any reforms...regulators will need to closely monitor the effectiveness of the combination of new measures, including the potential for enhanced bank regulation to promote a shift in financing to the shadow-banking sector."

Despite the apparent woes of the second-tier banks, at least one unregulated FI is asking the FSI to help it ascend to the ranks of ADIs. Firstmac says it would like to become a regulated bank but is prohibited from doing so by APRA's insistence that no single shareholder have a stake of more than 15 per cent in an ADI. Firstmac is 100 per cent privately owned.

"True competition will not come from the existing ADI sector just as it wasn't the ADIs that drove home-loan competition in the 1990s," Firstmac argues. "The few non-bank home-loan lenders in Australia are all either owned by individual entrepreneurs or small groups of entrepreneurs. The Banking Act and its shareholder limitations is stifling much-needed competition in the banking sector. It is the entrepreneurs that drive innovation and reduce consumer costs in the marketplace through the introduction of technological advances that drive down cost of delivery, improve service and provide greater choice for customers."

IWT APPEAL

Outside the regional ADI and non-bank FI sectors, another area which comes up in regard to banking competition in FSI submissions is the role played by offshore banks in Australia. The most notable request in this sector is that offshore-domiciled banks be allowed to fund local ADI subsidiaries without having interest-withholding tax (IWT) levied on interest payments made in return.

For example, HSBC's FSI submission argues: "IWT is a real cost for Australian borrowers as the foreign lender requires compensation for the IWT because they do not receive full tax credits in their own jurisdiction. It effectively discourages ADIs and foreign bank branches from bringing surplus funds held by their parents in other markets into the Australian economy to fund their loan books. With the global mobility of capital, it has to date been the key impediment to the growth of foreign banks in Australia."

HSBC notes that both the Johnson report and the Henry tax review recommended the abolition of IWT, while the 2010 federal budget set out a plan to reduce the rate of the tax to 7.5 per cent in 2013/14 and 5 per cent in 2014/15 – with "an eventual aspiration of zero per cent". This plan, however, was shelved in 2013.

The bank now says: "HSBC recommends making Australian ADIs and foreign bank branches exempt from IWT as soon as possible to allow them to better service Australian borrowers without being penalised for lending in Australia those savings held by their parent company in other markets." •