NATIONAL AUSTRALIA BANK LIMITED (NAB) SUBMISSION

Inquiry into the Development of the Australian Retail Corporate Bond Market

National Australia Bank Limited
A National Australia Bank Group Company
800 Bourke St
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28 May 2020

Committee Secretariat
Parliament House
Canberra
Canberra ACT 2600

Dear Sir/Madam,

National Australia Bank Limited (NAB) Submission – inquiry into the development of the Australian Retail Corporate Bond Market

National Australia Bank (NAB) welcomes the opportunity to make a submission to the House of Representatives Committee on the inquiry into the Development of the Australian Corporate Bond Market.

NAB's response covers the matters the bank wishes to highlight as a leading arranger and an advocate of the development of the Australian Corporate Bond Market. NAB is well positioned to respond to the Inquiry on the current state of the domestic debt capital market from the perspective of all relevant stakeholders.

NAB agrees it is appropriate for the Committee to consult on the ways the Government can continue to facilitate a deeper and more active retail corporate bond market. This will help Australian-based businesses make greater use of the domestic bond market and will ensure the level of retail investor participation into the asset class is consistent with a number of other global capital markets.

NAB has actively promoted the development of the Australian Corporate Bond Market by providing a consistent presence arranging and distributing credit to institutional funds and fund managers. In the past 10 years, NAB has also demonstrated market leadership and actively promoted sub institutional participation in bonds, creating a market for higher yielding growth capital for Australian corporates and a broader range of income generating securities for investors.

NAB is proud of its significant contribution which includes providing strength and support during the Global Financial Crisis.

The issues outlined in this submission have considerable implications for the future development of the Australian Corporate Bond Market, and the overall financial system. NAB is open to further discussion with the Committee on any aspects of this submission.

[redacted]

Sincerely,

[redacted]

Connie Sokaris

Executive General Manager, Corporate Finance

National Australia Bank

1. SYSTEM BACKGROUND

1.1 Current State of the Market

The Australian debt capital market remains resilient, although investor demand continues to be supplemented by offshore, particularly for longer dated funding.

While modest from a global perspective, the Australian debt capital market now provides a consistent and reliable source of funding for investment grade borrowers for tenors generally up to 10 years. Recent transactions have demonstrated some capacity for longer tenors. However, given the structure of the local superannuation industry, longer dated funding is generally unavailable and likely to remain so without a material policy change. Overall volumes are also limited by the challenges faced by large Australian corporate entities in achieving investment grade credit ratings.

Longer duration funding is not readily available to a large group of domestic corporate borrowers although their options are increasing.

Australian corporate borrowers in need of unrated and/or longer dated funding have traditionally needed to source this from offshore markets. The US Private Placement (USPP) market has consistently offered tenors greater than 10 years and is increasingly providing Australian Dollar (AUD) funding which helps remove challenges related to foreign currency hedging. NAB's Corporate and Institutional Bank (C&IB) has been active in increasing the depth of the domestic syndicated loan market including the Institutional Term Loan (ITL) private placement structure. This provides corporate borrowers access to longer dated funding, typically from Asian, UK and US life investors via a standardised local law format for the first time in Australia. Australian investors are limited participants given the return profile generally does not meet the requirements of these investors.

Retail participation is low given various market features that reduce attractiveness of fixed income as an asset class.

Given the relatively attractive notional risk-free rate as well as the difficulties in accessing credit directly, retail and non-institutional investor participation in fixed income has been limited to higher yielding corporate debt including listed bank capital issuance.

1.2 Banking System Challenges

The Australian banking system remains dependent on wholesale funding which in turn underpins demand for bank deposits.

Australia maintains a strong and well-regulated banking system. Unlike almost all other developed economies, the Australian banking system assets are significantly larger than the bank deposit base (~70% deposit funded only), leaving the Australian system dependent on foreign capital inflows. Given this dynamic and the various regulatory settings to ensure minimum stable funding levels, the natural demand for bank deposits in Australia is strong and competitive, with banks consistently pricing these deposits above funding benchmarks to attract relative market share.

This higher than usual deposit rate combined with the added protection of the government deposit-guarantee for bank deposits creates a naturally higher observed risk-free rate for Australian retail investors, being the return achievable on government guaranteed bank deposits. This impacts the demand for fixed income in Australia with guaranteed bank deposits forming a large part of fixed income exposure in the minds of retail and non-institutional investors.

Higher notional retail risk free rates are not reflected in wholesale markets and form another barrier to retail participation in high quality Australian fixed income markets.

Unlike retail investors, institutional asset managers do not benefit from the retail risk free relativity given the limit on the government guarantee for deposits as well as the overall volume of funds under management needing to be deployed. Wholesale credit is therefore usually priced at only a small premium to retail investors notional “risk free rate”. Therefore, the risk return benefit for investors moving from bank deposits to corporate debt is poor.

Understandably, corporate borrowers favour the lowest cost funding and have shown limited willingness to pay a premium just to attract retail investors where a higher return is generally required. This acts as another inhibitor to retail participation for fixed income in Australia, in addition to some other key impediments currently embedded in the simple corporate bond regime.

A lack of investor education has also contributed to the overall demand for Corporate debt in Australia.

In comparison to other asset classes, the level of investor education in fixed income has historically been quite limited. This includes a general understanding of the seniority that debt has relative to a borrower’s overall capital position as well as technical differences in the pricing of bonds and various credits.

1.3 Superannuation System Challenges

There is likely a lack of incentives for superannuation funds to pursue longer dated assets given the overall size of the system and retail contestability for funds under management.

Unlike other global savings systems, the Australian superannuation system lacks a long-dated liability feature with superannuants able to withdraw funds at retirement and use them at personal discretion. Global debt markets that provide longer duration funding for their local corporate borrowers typically feature a sizeable insurance market or defined pension scheme that provide certainty for long dated liabilities. This in turn requires these investors to liability match with long dated, fixed income generating assets like corporate debt.

Additionally, retail contestability for superannuants, while enacted with best intentions of superannuants in mind, likely drives a focus from fund managers on shorter term performance to protect and actively attract additional funds under management. Seeking outperformance under these circumstances is likely inconsistent with the investment in large amounts of longer dated fixed income which is not usually associated with the goals of maximising shorter-term portfolio returns. This ultimately creates a deviation of yield expectations when compared to a borrower’s funding costs. Unless investors are further incentivised by some other means or borrowers become more willing to pay a premium, the imbalance will continue to deter demand for the asset class.

2. KEY OBSERVATIONS

This section relates specifically to the items outlined in the inquiry's Terms of Reference, which NAB agrees are critical issues. However, there are also a number of additional factors raised in this submission for consideration by the inquiry which NAB believes have a fundamental impact on the development of the Australian Corporate Bond Market.

2.1 Tax Treatment

There seem to be limited barriers in the current system driven by tax.

While Australia maintains a generous dividend franking regime, it is difficult to draw a direct connection between this and the lack of participation in fixed income. It is likely this creates some preference towards equity investments which is further reinforced by the ease of access to the share market through online trading systems and exchanges. Furthermore, most retail investors in Australia have historically had high levels of equity exposure or are actively encouraged to increase their investment in the asset class.

Through the use of potential tax incentives, the government could encourage further investment in fixed income as an asset class. This could also potentially support key government policy initiatives such as infrastructure investment through incentivising private sector funds to more heavily participate in debt directed toward government policy initiatives.

2.2 Additional Impediments

The overall cost of retail targeted issuance remains significant and is a key deterrent for borrowers issuing debt under a simple corporate bond regime.

The cost of issuing a retail targeted listed simple corporate bond format is significant. This actively discourages borrowers from listing debt to help facilitate retail consumption and therefore broader adoption of fixed income. A borrower faces costs in undertaking any debt issuance and will seek to balance the benefits of issuance against the costs of undertaking that transaction.

Borrowers face legal and other operational costs of approximately A$100,000 for a wholesale investor targeted transaction in the local bond market. For investment grade rated borrowers this transaction typically delivers strong volume and diversity of investors. By comparison, legal and process costs for issuance of simple corporate bonds usually exceed A$500,000 with little or no incremental benefit in funding cost. Unless there is a need for significantly more volume, beyond the capacity of the wholesale markets, borrowers are unlikely to invest these additional amounts.

Simple corporate bond issuance rules act as a disincentive to borrowers versus wholesale markets without actively increasing investor protection.

While originally implemented to simplify debt issuance, the current simple corporate bond rules are onerous and relatively time consuming to adopt. The time and effort required to prepare prospectus documentation is also disproportionate to the risk being borne by the investors in purchasing senior debt instruments, particularly where borrowers have existing ASX listed instruments and are therefore subject to continuous disclosure requirements.

Wholesale markets use lighter and more debt relevant disclosures, including debt metrics that are customised to the specific issuance and relevant to the credit risks presented by the instrument. Wholesale offering documents are simpler to understand, easier to prepare and focus on the relevant transaction features in assessing the investment opportunity.

For borrowers that maintain listed equity and are under continuous disclosure obligations on the ASX, the value of a detailed prospectus seems low, especially given the prescriptive risk discussion requirements, pre-specified disclosure credit metrics and other requirements often do not relate to actual risks of investing in the instrument. It can also potentially cause confusion that needs clarification in further disclosures and investor updates.

Enhanced due diligence provides no additional investor protections above continuous disclosure and creates a process cost which discourages issuance in simple corporate bond format.

While an understandable consideration, the required due diligence calls and protocols are expensive and time consuming to process and seemingly provide little additional protection to investors. The extra time, cost and complexity involved is an active disincentive for issuance in simple corporate bond format versus wholesale market options. Borrower management time is also significant in terms of the preparation of issue documentation. NAB notes borrowers have raised this problem, along with costs, as a material disincentive.

Lack of format flexibility, particularly regarding early callability, removes optionality for borrowers without removing any apparent risk to investors.

Borrowers require flexibility to manage debt maturities and in loan and bond markets typically use early, pre-emptive refinancing to manage maturity risks and roll over debt. Without early call provisions for bonds, borrowers must use bank standby credit or other facilities to manage refinancing, which adds cost and complexity compared to the typical wholesale approach of using an early call option in wholesale bonds to proactively refinance existing debt prior to legal maturity.

This type of early call flexibility provides no additional risk to investors. It also facilitates re-investment and rollover options for investors that would allow debt to be easily and seamlessly transitioned between instruments where the investor retains appetite to maintain that credit exposure to the borrower.

The current assessment of Australian companies against global peers by rating agencies limits the number of rated entities eligible to approach the wholesale bond market.

The lack of domestic rating agencies or research firms to provide ratings in the context of the Australian economy creates barriers for broader corporate issuance. While it is within an agency’s rights to set its own rating criteria, “scale” and other matrix tests that global wholesale rating agencies use tend to penalise Australian companies solely operating in the smaller Australian market. For example, companies that are smaller in scale (revenues for instance) but maintain a strong market position in Australia do not compare well to global peers operating in other larger markets, often resulting in sub investment grade rating outcomes that make issuance in the Australian market difficult and relatively expensive.

As a result, borrowers often elect to remain un-rated and approach credit providers such as banks and private funds that are familiar with the company, in the context of the Australian market, for loans that are priced on a notional “investment grade” basis. This redirection therefore restricts supply of rated wholesale corporate issuance that could be fractionalised and distributed to wholesale and smaller retail investors.

Restrictions on using wholesale ratings in the sale of retail debt are not helpful to fractionalising and distributing wholesale debt offerings more broadly through retail markets.

In addition to the limited number of rated companies in Australia, the inability of major rating agencies to provide ratings research to retail investors limits the amount of third party curated information and research available to retail investors. This includes information on outstanding debt issuances that would assist in the analysis and investment decisions to provide an overall uplift in information available to assess credit. Effectively, because of this limitation, those investors that would benefit from ratings research of the major agencies cannot access it, while those that do not necessarily need the research (institutions & wholesale investors) can access it.

Market infrastructure and regulatory restrictions create barriers to retail investors accessing existing wholesale credit issuance.

While amending the simple corporate bond rules to facilitate additional flexibility would enhance market access, existing settlement and bond format fungibility complications discourage even currently defined wholesale purchasers from accessing wholesale debt issuance.

The current minimum tradeable parcel in the clearing system Austraclear is a material amount for smaller investors, which usually forces these investors to gain access via custodians or other market participants that fractionalise larger parcels of bonds, hence removing transparency and increasing complexity.

The disclosure requirements for financial products and services in Australia are driven by the distinction between retail clients and wholesale clients rather than the inherent riskiness of the relevant product or service (riskiness being reflected in the nature of the required disclosure). At a general level this disclosure framework also reduces supply of debt securities available to retail, despite them being less risky as an asset class than readily available listed equities. The restrictions around making wholesale debt available on the ASX using relevant depository interests (technical and format incompatibility between simple corporate bonds and wholesale issuance) add to the barriers to simplified participation in fixed income by smaller investors.

A lack of ready fungibility between simple corporate bond and wholesale issuance overall reduces liquidity available to all investors. Simple corporate bond tranches risk being trapped in small liquidity pools with limited trading which does not serve investor or borrower interests and discourages issuance using this format.

2.3 Other Considerations

New Zealand Retail Bond Market

The Financial Markets Conduct Act 2013 provides New Zealand borrowers with a streamlined non-prospectus disclosure for most equity and debt issuance by listed borrowers. Product disclosure statements for initial issuance in New Zealand are now more streamlined documents, focussed on retail investors. The New Zealand system also makes significant use of cleansing notices for re-issuance and refinancing where existing outstanding instruments exist. The revised disclosure regulations allow for simple, flexible and easy to understand documents (basic term sheet and presentation slides focussed on the specific issuance), improving accessibility for investors and streamlining the process for borrowers. Investor protections are provided by the initial PDS disclosures and continuous disclosure obligations.

The New Zealand regulations also include different categories of “wholesale” investors (including self-certification), exclusions for small businesses and crowdfunding, new provisions for employee offers, crown offers and simple bank products.

The combination of these features and the resulting fungibility of retail and wholesale credit issuances in the New Zealand market has resulted in significant issuance of fixed income through retail investors.

3. RECOMMENDATIONS

As identified in the System Background section, there are some structural characteristics specific to the Australian market that result in the Australian capital markets operating differently to some global markets.

Stimulating more fixed income issuance will reduce reliance on the banking system for funding in Australia in the longer term and assist in moving this balance. NAB believes the following changes would simplify the process for issuance and help increase available product for sale.

3.1 Simple Corporate Bond Standardisation and Simplification

NAB believes simple bonds should mirror the features of institutional level wholesale bonds. This would create fungibility to existing wholesale debt markets to maximise liquidity and provide price discovery for both borrowers and investors.

Rather that prescribing in detail mandated criteria of a 'Simple Corporate Bond', regulation should instead focus on disclosure variation away from what is prescribed as the standard form of corporate debt issuance. NAB's view of standard form issuance would be:

- Senior unsecured debt instrument;
- Unsubordinated except by security to secured debt (i.e. bank loans) with clear disclosures on the nature of subordination;
- Benefits from company guarantees from at least 80% of the Subsidiaries (as defined in the Corporations Act) of the listed issuing entity. Alternatively benefits from a restriction on other debt within the Subsidiaries (as defined in the Corporations Act) of the listed issuing entity;
- Restriction on complex corporate structures including partial ownership and subsidiary debt structures that have the effect of reducing recourse or introducing other creditors, seeking to prevent any structural subordination;
- Pay a basic interest rate with no deferred interest and no step-downs that is fixed of floating rate for the life of the instrument;
- Have a fixed tenor with allowance for a single borrower early call right on a fixed future date that allows borrowers to redeem bonds in full; and
- No mandatory conversion rights (but for clarity permitting holder roll over or other provisions where the holder retains a right to elect to participate in a refinance or other substitution for a similar bond).

A borrower could retain the right to vary from these terms, but would need to clearly disclose and justify this variation. Minimum institutional participation may ensure due diligence of any proposed variations by suitably experienced parties that are co-investing in the securities.

3.2 Issuance Flexibility

NAB believes corporate Australia, particularly borrowers that maintain existing wholesale debt offerings, would benefit from the simplification of the issuance procedures for allowing retail access to their existing debt programs.

For simple bonds, the issuance process should remove the current complex and duplicative prospectus documentation and allow issuance using existing wholesale style disclosure documentation and a cleansing notice where bonds are being issued by a public company which has its ordinary shares listed on ASX.

For simple bonds where the borrower is not listed, the issuance process should require a single, detailed prospectus for the inaugural simple bond issuance, followed by continuous disclosure and financial reporting obligations consistent with those applying if the entity has listed its ordinary shares. Follow on issuance would use wholesale style disclosures complemented by a cleansing notice.

Extending this type of wholesale debt product to retail investors would increase transparency and remove the cost of current intermediate platforms. The fungibility of product also extends wholesale level liquidity and price discovery into the retail market.

3.3 Prospectus Changes

For inaugural issuance for issuers with no existing equity listing, NAB believes debt issuers should still be required to provide a prospectus to retail investors prior to first issuance. However, NAB believes material amendment should be made to debt prospectuses to encourage simplified issuance, including:

- Ratio Flexibility – borrowers should be able to nominate the relevant ratios for their company, and describe the relevant formulae. Strictly prescribed ratios and formulae create inflexible outcomes and could lead to meaningless and confusing disclosure;
- Single Document – given the prospectus becomes a one-time document, the base prospectus and specific prospectus requirements should be blended into a single document; and
- Pricing Supplements – prospectus should be issued with blanks for pricing, and updated with pricing information following lodgement, using pricing supplements or letter consistent with wholesale market practice to avoid lodgement of a supplementary or replacement prospectus following a market price discovery process.

Disclosure document flexibility would allow arrangers and borrowers to focus on the relevant risks of the transaction and freely incorporate other information by reference to ensure clear and easy to comprehend disclosures.

3.4 Other Considerations

NAB believes greater disclosure and transparency of information would ultimately generate more interest in fixed income and greater availability of product. As a result, NAB encourages the inquiry to consider the following structural and infrastructure barriers to additional fixed income participation:

- Market Data – Australian stock exchanges should consider including common debt metrics in their information pages. Yield in addition to price is an important example which would allow investors to easily assess and compare debt investment options versus their assumptions on risk;
- Research and Report – the current restriction on providing retail investor access to credit rating reports limits the access of those who would arguably benefit most from that professional level research. Other forms of professional research and debt specific market data (such as reporting on common debt market ratios and debt covenant levels) should also be considered; and
- Clearing Infrastructure – the current minimum trading parcel size of A$500,000 on the Austraclear trading system is large for anything but the biggest wholesale and institutional investors. Consideration should be given to lowering the minimum parcel size to simplify access to existing eligible small wholesale investors that are currently legally entitled to purchase wholesale credit.