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28th May 2020

Dear Inquiry Secretary [Dr Melanie Beacroft – Inquiry Secretary],

Re: Standing Committee on Tax and Revenue: Inquiry into the development of the Australian retail corporate bond market

Thank you for the invitation to provide a submission to the Review of the Australian retail corporate bond market.

The topic from the Standing Committee is one that surfaces every now and then and when it does, everyone agrees that Australia would be far better off with a properly functioning Corporate Bond Market, however the only change to date has been immaterial and a tinkering at the edges with no progress made.

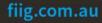
Without the ability to autonomously provide various and flexible debt-funding to Australian companies, we cannot credibly lay claim to best-practice in our capital markets, let alone be described as a centre of financial excellence in the Asia-Pacific region.

We consider this to be a critical development in Australia of the capital markets and also within the fixed income market equally domestically and offshore, as it relates to both individual and corporate investment.

The current global events help to demonstrate the lack of access and investment into protective assets such as government bonds and corporate bonds with very few investors owning any bonds let alone those defined as retail.

In our submission, we put forward that there is a fundamental need for structural changes in the Australian Taxation System that we hope are self-explanatory in nature and serve the purpose for a greater balance in investor allocation.

This is whilst simultaneously easing the burden on the Commonwealth as the baby boomer generation enters the retirement and drawdown phase of their superannuation portfolios.



We have based our response on a self-sufficient approach so that there isn't a wholesale need for assumed knowledge or a need to conduct contextual research for what are necessary policy proposals.

The Inquiry will examine:

The tax treatment of corporate bonds for both issuers and investors to determine whether there are any impediments in the tax system to the issue of corporate bonds compared to other forms of debt financing for business;

Proposition 1

The tax treatment of bonds for Issuers and Investors alike when compared to other debt finance alternatives needs to be favourable to incentivise investment and participation.

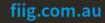
The Australian Taxation System should enable investors to take an equitable approach to investing across the various assets classes available to them such that, the inherent qualities of relevant asset classes can deliver the risk balance required for sustainable investment as that is defined by global best practise asset allocation axioms.

The current imbalance in the tax treatment of the various asset classes has served to dramatically and dangerously distort asset allocation practises in Australia such that they are extremely different to other Organisation for Economic Co-operation and Development (OECD) countries and materially divergent from what is considered to be well documented best practises. This in turn has led to an entrenched advisor, investor and capital seekers' culture, whereby investors are taking unnecessary risk to achieve returns on investments.

This has now become commonplace to a point where what is seen as sensible in terms of asset allocation in Australia contravenes all of the acceptable investment guidelines globally. The flow on from this is that entrepreneurs and many established companies are forced to dilute ownership in order to grow or facilitate growth. This increases the risk for investors and seekers of capital alike.

Advisors are forced to recommend anything else but direct fixed income rather than an investment in the raw materials or the direct securities. There is a deliberate agenda to stop access to quality investment grade bonds in full swing in Australia.

It also means that Australian Companies looking to raise debt capital have little to no opportunity to do so outside of the traditional credit providers, whose appetite for risk may not be consistent, available or suitable. It means that the Borrower and Investor are forced to take greater risk. This distortion should not be present in Australia given the sophistication of the capital markets. It is also symptomatic of an unbalanced approach to investing that is at odds with the leading economies of the world which Australia needs to align with.



FIIG strongly advocates for a domestic Taxation System that supports a balanced approach to asset allocation including one which is absent of preferential treatment of one over the other (for example, equities versus corporate bonds).

We regularly receive feedback from the Australian investing public that they are currently unfairly penalised for investing in the corporate bond market in Australia by virtue of the absence of concessional treatment available with other asset classes, namely equities (or shares) and property. There should be a safe haven for fixed income investors so that they feel comfortable with the tax treatment that is afforded by traditional investment means.

It follows from this that when you have a particular asset class (fixed income in this instance) that has limitations in its investment return and tax treatment, this will impede material progress in the development of that market. In that regard, there should be a level playing field across all the respective asset classes in Australia through a fair and transparent Taxation System that provides equitable treatment for all assets.

This is rather than what has been recently advocated and failed famously at the recent Federal Election, which was changing the treatment to taxation of franking credits and given the impossibility to withdraw or negative gearing taxation benefits. It is important to note that our suggestion is to offer concessions for investors into direct debt securities such that the imbalance allows assessment on a level playing field.

Given the low level of allocation to corporate bonds and fixed income in Australia, it is very unlikely that a favourable change to the taxation treatment of these securities will have any impact on the budget and forward estimates of the Commonwealth, particularly if it were to apply solely to Self-Managed Super Portfolios, where asset allocation is most relevant and should reflect best practise.

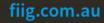
Solution: Tax exemptions on bonds in a self-managed superannuation portfolio up to an allocation of 40% of the portfolio.

There is a high likelihood that the long term benefits of this approach will deliver considerable savings over the long term on the basis that increased allocation to bonds will deliver a reduction in volatility through the economic cycles.

It may also mean that concessions granted in the other asset classes diminish proportionately.

Tax needs to consider the advent of an aging population in Australia which should mean a migration away from high risk assets to lower risk assets i.e. equities into fixed income. The treatment of corporate bonds and other fixed income securities means that this is less likely.

It is also likely that in 20 years of retirement an individual will encounter at least one crash or correction in risk assets. This has been brought home in recent times with the extraordinary set of external circumstances in the global economy which has impacted upon the retirement savings of everyday Australians.



Proposition 2

There needs to be an active and deep liquidity pool of Fixed Income Securities and other investments in Australia for the betterment of both Borrowers (Issuers) and Investors.

Corporate Issuers in Australia need to have confidence in the domestic debt issuance market to access capital which includes removing any potential concerns around 'Execution Risk' - this extends to characteristics such as pricing, tenor, and volume for completeness. By enabling an active domestic debt issuance market it provides Australian Corporates ready access to funds in their native currency which can be done in a timely manner and enables comparables for other market participants.

The more issues that are launched in the domestic market the more transparent the market becomes for Borrowers and Investors. This equally benefits Investors by purchasing debt in familiar domestic names which simultaneously promote growth of the Australian economy. Perhaps a tax on Issuers who source debt capital from offshore (which would act as an impediment) would assist with progress in the development of the domestic debt capital market.

This should also mean that Borrowers will consider Australia before offshore alternatives such as the Rule 144A and Regulation S Markets in the United States. The greater the familiarity of domestic Corporates and Investors in the fixed income or capital markets only improves the overall health of the Australian economy and reduces dependency on the Australian Federal Government and traditional funding models.

Australian Borrowers and Corporates (including Corporate Treasurers) should have confidence in accessing capital in their own domestic market without having to consider offshore alternatives or at least in conjunction with.

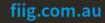
It should be noted that both Arrangers and Originators (and their Advisors) are consciously and deliberately disabling access to the Corporate Bond Market which is preventing growth and access to a critical asset class to Retail Investors, through restricting access to investor classes under the terms of the issue detailed in the issue documents and increasing minimum denominations. This is because of the focus on Wholesale Clients in terms of distribution.

Solution: (1) Tax exemptions on corporate bonds in a self-managed superannuation portfolio up to an allocation of 40% of the entire portfolio; and (2) Implement tax / levy on offshore Australian corporate issuance.

Demand created through this change will provide confidence that domestic issuance is a viable alternative to other jurisdictions. This will translate into Corporates looking to the domestic capital markets in the first instance before considering alternative funding models.

Proposition 3

The axioms or laws (including taxation) which cover asset allocation and investment in Australia should promote a balanced and sensible approach to investing.



Current structural characteristics of the Australian Taxation System such as the Dividend Imputation System (shares) and Negative Gearing (property) do not have an analogous concessional treatment when it comes to corporate bond or fixed income investment.

It follows that investors in fixed income in Australia are already starting from a position that is suboptimal because they are fundamentally disadvantaged from an Investment position. When you overlay this with what are globally considered best practice asset allocation principles and indeed investment principles like positioning a portfolio on the efficient frontier of risk, this is concerning and puts Australians at a disadvantage. It means Australia is less competitive or efficient in providing capital market solutions for Industry now and going forward.

In an ideal scenario, the Australian Taxation System should simply promote each of the asset classes in a simple and equitable manner (which is consistent with balanced portfolio theory) to remove any distortion which has longer term structural and cultural detrimental effects.

Solution: An obvious solution to remedy this imbalance in relation to equities was comprehensively rejected by the Australian voters at the last election and political appetite to address negative gearing in the property sector is also understandably closed-mouthed. The solution to provide a level playing field lies in allowing similar or relevant taxation incentives to investment in corporate bonds.

There is a clear problem apparent when the most deeply liquid and mature asset class is being disadvantaged from a taxation perspective. This places added pressure on the Commonwealth funding models when you have severe market corrections.

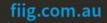
Related impediments within the Corporations Act to the further development of the corporate bond market, including how they interact with the tax system; and

Proposition 1

The Corporations Act 2001 (Cth) already requires that Advisors act in the 'best interests of the client' which by extension should include a prudent approach to asset allocation to cover each of the core asset classes.

The Financial Adviser Standards and Ethics Authority ('FASEA') was established to set the education, training and ethical standards of licensed financial advisers in Australia. The Code of Ethics which commenced on 1 January 2020 means that all Financial Advisers are required to adhere to the Code effective from that date onwards. This is currently aimed at the Personal Advice requirements which the majority of Fixed Income Market participants are not licensed for.

By way of background, the Corporations Amendment (Professional Standards of Financial Advisers) Act 2017 established the Financial Advisers Standards and Ethics Authority ('FASEA') in April 2017.



Best practise asset allocation should be part of the ethical standards set out by FASEA. The argument being that if an advisor is providing prudent advice he or she should be compelled to consider best practise asset allocation as a minimum standard in advising Clients.

A good lens through which to view what is ethical advice, is to consider what happens in other jurisdictions. In Australia, an allocation to blue chip equities is sometimes portrayed as an income solution as is an allocation to bank issued hybrids seen as an allocation to corporate bonds or fixed income.

This wouldn't pass muster in more sophisticated regulatory regimes where asset allocation is well understood by advisors and the market generally.

Solution: Any change to the Act which promotes the Over-The-Counter ('OTC') market would be sensible as this is where the liquidity for the market resides. There is little to no utility in attempting to stimulate the corporate bond market on an exchange where the participants are culturally predisposed to ignore it and the rest of the market's liquidity resides elsewhere.

Proposition 2

The growing Self-Managed Superannuation Fund ('SMSF') Industry in Australia needs a considered and sensible approach from Australian Treasury to ensure that the Taxation System helps growth across all assets classes insofar as appropriate allocation is considered.

We note that the Australian Government Australian Taxation Office ('ATO') publishes a Selfmanaged super fund quarterly statistical report – the most recent being in March 2019. This is part of the broader remit whereby the ATO notes the following:

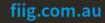
We publish quarterly statistical reports for the self-managed super fund (SMSF) market. This report has been developed taking into account valuable feedback from the superannuation industry.

In particular, the SMSF population and asset allocation tables provides two (2) critical pieces of information:

- i. Population of SMSFs and members; and
- ii. Asset allocation (break-up of assets into various classes).

We have provided a relevant link for completeness here: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fundquarterly-statistical-report---March-2019/

We consider that the current 1.5% of SMSF Allocation to direct Fixed Income is materially misaligned in terms of asset allocation, particularly what is considered to be best practice in nearly all the other developed economies and capital markets in the world. This speaks to the critical level of distortion in the system.



Solution: It helps to demonstrate that the solution is not tinkering at the edges but requires fundamental change. Particularly if you take the view that the SMSF data represents an advised cohort which has the educational and financial means to upskill themselves and be available of advice.

As a final observation, it is worth noting that the Corporations Act (in conjunction with the Banking Act) currently prevents access to many of the Fixed Income securities by virtue of the limitations of availability to Wholesale and Sophisticated Clients, only.

When you consider that equities are readily available in minimum purchase commitments of AUD\$1.00 or less and hybrid securities at \$100.00 or less, it doesn't follow that Retail Clients have no access to more secure investments in the capital structure of the same entity. There are also some embedded prohibitions in the Corporations Act that prevent distribution of Corporate Bonds to Retail Clients.

It also follows that a Retail Investor has unbridled (actually encouraged, if anything) and incentivised access to the equity of an ASX-listed or an unlisted entity in the secondary market but cannot purchase a bond issued by the same Issuer which is a lower risk investment.

More generally, the Corporations Act should not have inherent distortions which mean that particular asset classes have a preferential treatment over others. Particularly if an asset class is disadvantaged from a taxation perspective to begin with.

Proposition 3

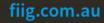
There needs to be a consideration of the Corporations Act and how it currently interfaces with three (3) critical pieces of Taxation legislation including the following: (i) Capital Gains Tax ('CGT'); (ii) the Dividend Imputation Credit System; and (iii) Interest Withholding Tax ('IWT').

We consider that there needs to be similar concessions or incentives to encourage Fixed Income Investment in Australia.

Solution: One novel concept would be to allow up to 40% of a SMSFs Portfolio to be tax free if that capital was allocated into direct Fixed Income Investments. This would make a negligible impact on Commonwealth Taxation overall coffers or revenues while inherently improving the balance and risk of portfolios within Australian Investors. There are other benefits which include allowing companies better access to debt and broadening choice for entrepreneurs.

We also consider that the Banking Act (Cth) requires further review also when you note that there are AUD\$500,000 minimum requirements for the purposes of inbound investment into Australia.

Comparable policy settings in other jurisdictions, with a focus on those jurisdictions that are major sources of debt finance for companies operating in Australia.



Proposition 1

Australia's Future Tax System Review or the "Henry Tax Review" published in 2010 identified many recommendations to position Australia to deal with the demographic, social, economic and environmental challenges into the 21st century which clearly includes domestic Investment, which is inclusive of the Fixed Income asset class.

The Australian Taxation Offices ('ATO') own data shows a perilously low allocation or exposure to direct Fixed Income Investment and therefore the subset of this that represents corporate bonds (currently only \$11 Billion of the \$715 Billion currently in SMSFs).

The experience of the Global Financial Crisis under the Rudd Government illustrated that Australia needs to have prudent asset allocation, particularly against the background of an aging population that has limited capacity to withstand a market correction if inequitably exposed to an asset class such as equities. We have again been witness to severe market corrections recently that are more pronounced than those in 2008 in the height of the GFC.

The Commonwealth Government and Revenue Collection Agencies such as the ATO need to have confidence that the largely self-funded retirement funds moving forward will be able to withstand countervailing economic and market conditions, particularly in the absence of traditional pension schemes in the future.

Proposition 2

Improving the access to corporate bonds and other direct Fixed Income Investment in Australia will reduce reliance on the banking market in Australia and foster greater entrepreneurialism and access to capital for Australian companies.

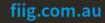
The natural evolution of the capital markets which has already occurred in the North American and European economies shows that there should be a movement from the large banks balance sheet to other forms of funding via the capital markets. This includes funding structures such as securitisation and warehouses which are prominent in overseas capital markets, and are starting to gain momentum in Australia.

The timing for this is good given we have reached the point of acute inflection where the superannuation savings pool is now greater than the banking system and is forecast to be a multiple of same over the coming decade.

This has been reinforced with the material market corrections in recent times which has directly impacted upon the SMSFs of Australians with an overexposure to equities.

Proposition 3

The leading capital markets overseas in the United States and Europe have a fundamentally different approach to asset allocation which is mature and fostered by sophisticated Taxation Systems which don't seek to favour or prioritise one particular asset class over the other.



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The Federal Government in conjunction with Commonwealth Treasury needs to provide a greater incentive for Corporate Bond and other Fixed Income Investment in Australia. There is a clear need to make wholesale changes to help stimulate growth and investment in this space.

Given current investment uptake it would seem there is a negligible impact to the revenue collection aspect to shift the dial in terms of asset allocation.

If anything, a distorted exposure to particular asset classes means that there is greater reliance on the Federal Government for protections when it comes to retirement savings of Australians and any potential fluctuations that can arise.

This in turn places greater pressure on welfare funding requirements for the Commonwealth and the need to provide greater protections when a market correction occurs. A stronger participation rate in Fixed Income Investment in Australia would mitigate that and future proof the economy from misaligned investment allocations across the various asset classes and any reliance on pension funding schemes validating the basic fundamental concept of superannuation.

We consider there to be a common theme throughout the submission that there is need for structural changes in the Australian Taxation System that are self-explanatory in nature and serve the purpose for a greater balance in investor allocation whilst easing the burden on the Commonwealth as the baby boomer generation enters retirement. This will result in a paradigm shift in the reliance on superannuation and retirement savings which has yet to be seen by the Commonwealth Government to date.

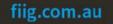
Thank you again for the invitation to provide a submission to the Review of the Australian retail corporate bond market.

We enclose FIIG Securities Limited's ('FSL') submission on this inquiry for your reference and records.

Yours Faithfully,



Jim Stening Managing Director



Appendix

Background information about FIIG Securities Limited

FIIG is Australia's leading fixed income specialist firm. For more than 20 years we've been providing investors with direct access to bond markets, through direct investment or managed services and a range of term deposits and other cash solutions.

We also assist Australian corporates to fund their growth through access to debt capital and bond markets.

FIIG has been a pioneer in the Fixed Income Industry in Australia since 1998 and widely recognised domestically as a leading innovator and independent operator.

With offices in Sydney, Melbourne, Brisbane and Perth; FIIG has a team of over 100 staff providing service and support to our clients across Australia.

FIIG is Australia's largest specialist fixed income provider with over \$8 billion currently under investment.

FIIG's website is available at: https://www.fiig.com.au/

