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The Hon Josh Frydenberg MP
PO Box 6021
Parliament House
CANBERRA
Canberra ACT 2600

27th May 2020

Dear Sir,

RE: Submission to the Inquiry into the Development of the Australian Corporate Bond Market.

Our names are Dr. Rand Low and Dr. Terry Marsh. We are both Australian citizens and we both have an interest and expertise in corporate bonds.

I, Rand Low, am a graduate from the University of Melbourne in Engineering (Mechatronics) & Computer Science with a First Class Honours. My professional trajectory has led me from being a control systems engineer with Honeywell, to a PhD in Finance at the University of Queensland, receipt of the Australia Award - Endeavour Fellowship at New York University's - Stern School of Business and a career on Wall St in New York City with Bank of America Merrill Lynch and BlackRock. After several years in the US, I am returning to Australia to Bond University in May 2020 as an Assoc. Professor focusing on portfolio management, systemic risk, and quantitative finance.

I, Terry Marsh, am a graduate of the University of Queensland with a First Class Honours degree and University Medal. Subsequently, I earned an M.B.A. and a PhD from the University of Chicago. I have taught at MIT, U.C. Berkeley and the University of Tokyo, and I'm currently an Emeritus Professor at U.C. Berkeley. I was a member of the U.S. Presidential Task Force on Market Mechanisms ("Brady Commission") and a National Fellow at Stanford's Hoover Institution. I have consulted for the NYSE, the Options Clearing Corporation, and the former I.B.J, and I'm a co-founder of Quantal International which focuses on technology for investment management.

It is with the generous support of politicians like yourself with a focus on education that we can reach the goal of having two Australian universities in the Global Top 10 by 2030. We were informed by our professional colleagues back home of the government's interest in developing the corporate bond and decided to take the opportunity to share our expertise. We've not forgotten that the knowledge and skill-sets that we have today are due to the research funding and scholarship opportunities provided by the Australian Federal Government. Responding to this inquiry into the development of the Australian corporate bond market is one way to give back.

Benefits of a well-developed Australian Corporate Bond market

We strongly believe that a well-developed Australian Corporate Bond market can be useful for Australian investors in better structuring their investment portfolios and retirement incomes. Equity holdings alone are too risky as a retirement strategy for an aging population due to their volatility over relevant decision horizons. The ASX is highly concentrated in Financials (24.6%), Materials & Metals (18.7%), and Healthcare (13.8%)[1]. As a result, the Australian economy is highly cyclical (i.e., Mining) and its dependency on the Financial, industrial, and the "Big 4 banks" means that financial stress due to a wave of loan and corporate bond defaults held by these banks mean that the Federal Government and the Reserve Bank of Australia are the lenders of last resort. As a result, any heavy lifting to stabilize the Australian financial system is ultimately borne by future Australian taxpayers, and this is unsustainable.

A strong, functioning Australian corporate bond market means that Australian investors can structure portfolios to generate a stable, and steady income in retirement (although it is likely that the ultimate corporate bond issuers will likely still be concentrated in financials, mining and healthcare). It also means that we share the task of unlocking the intellectual and economic potential of one of the youngest, well-educated, western democracies in the world with international investors. We have personally met so many young, and bright Aussie professionals and entrepreneurs who have left our shores for the US due to the depth and breadth of the US capital markets to fund their ideas. One of the core strengths of the US financial system is that it has the most well-developed and advanced fixed income market in the world.

[1] "ASX Sectors (GICS) - Market Index." https://www.marketindex.com.au/asx-sectors.

Key challenges for the development of the Australian corporate bond market.

Target size for the Australian corporate bond market. It will be useful to have a point of reference for the potential market size for issuers and buyers of Australian corporate bonds that is realistic to aim for. The value of Australian corporates outstanding -- not differentiating between investment grade and lower grade debt -- is about $AUD 1.3 trillion, with about $300B of that issued by non-financial corporations[2]. Globally, there is about $AUD17.9 trillion total corporate debt outstanding[3]. If Australian investors were well-diversified globally and otherwise identical to the average global investor, then they would hold about 10% of all Australian corporate bonds outstanding, with the remaining 90% held by foreign investors. At present, Australian investors are estimated to hold 47% of Australian corporate debt outstanding (Banks, Funds , Insurers - 40.7%; Non-Financial Corps - 0.5%; Other - 1.6%; Central bank and govts - 4.6%)[4]. Reference points need to be refined by introducing the expected targets for the type of issuer (i.e., financial, non-financial), the type of buyer (i.e., insurer, fund, private individuals, international), and the category of debt.

Different categories of corporate bonds. The demand and supply for the credit risk component of the corporate bonds is typically considered in three categories of default risk, with short-term commercial paper and unrated issues in a special category. Categories change over time, e.g. a bond that was issued over time may have transitioned to low grade “junk bond” status due to unforeseen adverse declines in the issuer’s creditworthiness:

I. Investment grade bonds (i.e., issued by the least-likely-to-default corporations)
II. High-yield debt (i.e., junk bonds, low-grade debt)
III. Distressed debt
IV. Asset Backed Commercial Paper
V. Unrated Issues

Policy-making as to market size would be best if it considers the sub-categories. Moreover, an increase in corporate bond issuance will, all else equal, lead to a spillover of higher leverage on the riskiness of equity returns, another factor to be considered.

The segmentation of the Australian corporate bond market is best summarized by the matrix shown in Table 1. At present, we are unable to find publicly available data that allows the matrix to be filled in with sufficient granularity to understand the existing state of play of the Australian corporate bond market. Once the matrix is filled, strategic decisions can be made as to the appropriate re-balancing of the corporate bond market to ensure that risks are more equitably shared across different stakeholders.

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[2] "The Corporate Bond Report 2018 Australia's growing appetite for corporate bonds | Deloitte." 2018, https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf.
[3] "Rising corporate debt: Peril or promise? | McKinsey." 18 Jun. 2018, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/rising-corporate-debt-peril-or-promise.
[4] "The Corporate Bond Report 2018 Australia's growing appetite for corporate bonds | Deloitte." 2018, https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf.

Segmentation		Investment Grade	Asset Backed Comm. Paper	High-Yield Debt	Unrated Issues	Distressed Debt
Issuers	Financial					
	Non-Financial					
Buyers	Insurer					
	Fund					
	Individual					
	International					

Table 1. Targets for corporate bonds issuers and owners.

Lack of public awareness of fixed-income investments. The Australian public remains largely unaware of the possibility and benefits of investing in fixed income and bonds to generate an income. For most Australians, when asked how they would invest their money to generate a steady income, most will respond by purchasing a rental property or dividend stocks. Only a handful of universities in Australia provide specific courses teaching fixed income analysis and valuation. We need to encourage more executive courses or professional development courses on fixed-income investments so that advisors can provide the appropriate fiduciary insights for their clients.

Pricing relative to government bonds and swaps. Before considering taxes and “frictions”, corporate bond payoffs can be represented as a combination of the payoff on a riskless (vanilla government) bond and a put option on the assets of the borrower corporation – default on the bond is equivalent to “putting” the assets of the borrower to credit holders in satisfaction of the face value of their claims. Corporate bonds are thus priced in the market relative to government bonds and swaps. Success in expanding the Australian corporate bond market relies on the “infrastructure” of a well-functioning domestic government bond market, along with the already well-functioning FX market.

Three general ways to increase the size of the Australian corporate debt market. To increase the size of the Australian bond market in terms of financial intermediation, an Australian-based financial industry could:

I. handle more of the issues of bonds to domestic investors;
II. handle more of the issues of Australian corporates to overseas investors; or
III. handle more of the sales and servicing of overseas corporate purchases by Australian investors.

Bank Lending versus corporate bond financing. Bank loans are a partial substitute for corporate bond issue as a source of borrower financing. Thus, a substantial increase in the size of the corporate debt market will likely be accompanied by a decrease in demand of bank loans. If competition between the two forms of borrowing (also other financing like leasing that involves borrowing) is the best policy, a level playing field is needed. The level playing field needs to take into account illiquidity in the corporate bond market in stress scenarios, against implicit lender-of-last resort subsidies and regulatory rule changes in those same stressed conditions.

Importance of parity in tax treatment and regulations. Tax treatment for returns and regulation needs to be harmonized between Australian corporate bonds and competing securities, and across both domestic and international investors. Two examples are withholding taxes, and disclosure regulations for prospectuses. Disclosure in the bond prospectus has already been discussed in detail by the Australian Treasury (2011) – we believe that the guiding principle should be to require disclosure of information that is necessary to valuation and not available elsewhere, and that can be more cheaply supplied to investors as a whole instead of leaving each to do their own discovery.

Unavailable local unbiased corporate bond ratings system. Although there are global ratings providers such as S&P, Moody's and Fitch, the developments during the 2007-2009 Great Recession in the US indicated the potential conflicts of interest between bond issuers and ratings agencies due to the dependency of ratings agencies on credit rating fees paid by bond issuers. Furthermore, the fees charged by these companies can be punitive for small to medium size Australian firms raising capital. Due to the lack of a local, unbiased bond ratings system, there is a growth in unrated issues in Australia.

No exchange with price transparency for the full universe of bonds. At present, Australian Bond Exchange (https://www.bondexchange.com.au/), FIIG (https://fiig.com.au/), XTBs (https://xtbs.com.au/) are the three accessible ways in which retail investors can purchase bonds. No platform exists that provides transparent price visibility to investors for the full universe of corporate retail bonds that are available for purchase or investment. The number of XTBs available are limited, and OTC bonds do not provide full transparency for bond investors. OTC bonds are sold by both the ABX and FIIG; however, ABX is licensed to provide specific advice for retail investors whereas FIIG can only provide general advice.

Tax bias towards equities and real estate. Equities have franked dividends and real estate have negative gearing; however, no favourable tax benefits are given to income derived from bond coupons or to capital losses due to bond default.

Key Financial Infrastructure Recommendations

1. *Building awareness centred around investing in Australian companies.* The Australian government commits funding towards the "Australian Made" campaign to encourage locals and foreign buyers to purchase Australian manufactured goods. In the same manner, Australian investors and pensioners can be encouraged to use a portion of their savings to generate a steady income by reinvesting in Australia and awareness raised of this via an "Invest in Australia" campaign.

2. *Provide funding for universities to create a web-based analytics platform for Australian corporate bonds.* Having an accessible platform freely available to members of the public performs two vital roles for fostering a functional corporate

bond market in Australia. First, it allows small to medium-sized Australian companies to have a baseline understanding of what their expected bond ratings are, and the market expectations in terms of the tenor and coupon of the bonds to be sold for the capital raising. Second, investors who are looking to have an understanding of whether they are obtaining a fair return for the risk in the bonds they are buying have an unbiased credit rating that is free from conflicts of interest. The government should fund more than one university at inception and over time it should be expected that the universities will self-fund this web-based analytics platform either through subscriptions or other revenues. An example of where an accessible web-based analytics platform has been implemented is the National University of Singapore's Credit Research Initiative[5]. These will help alleviate some of the risk for investors purchasing unrated issues of corporate bonds, which is a growing market in Australia (e.g., value of unrated issues were $1.1B in 2017)[6].

3. *Provide tax rebates on the bond coupons of companies from specific industries.* For industries in which the Australian government is encouraging growth and investment (i.e., high-technology manufacturing, agriculture, financial technology, etc) provide a tax rebate on the coupons that Australian investors receive on buying the bonds of these firms (also known as Impact Investing). Such a policy would be similar to Australia's high successful skilled migration program that ensures that specific industries have the labour skills required for that industry to flourish. In the same manner, the government is encouraging public investment in specific industries that need additional capital to flourish.

   Sacrificing some tax revenue is a more efficient and effective method for the government to support certain industries as it allows investors to allocate their capital towards industries they believe in and support. For example, If investors and Australian citizens are truly supportive of ESG industries, they can easily invest in the bonds of such companies and know that the government is supporting their decision by providing them with a tax rebate. Implementing such a policy is an indicator if Australian citizens are willing to put their own savings and invest in their own personal beliefs, and the government is shown to be doing their part by making these investments more tax efficient.

   Providing tax rebates as an incentive to encourage investment and growth in certain industries is a democratic solution compared to providing multi-billion subsidies to the Australian car manufacturing industry that only benefited the precious few. Although the government had the best intentions to protect jobs for high skilled manufacturing, the harsh reality was that most Australians were purchasing foreign vehicles instead of locally manufactured vehicles. Although we can all agree that we want manufacturing jobs in Australia, many were not willing to pay the premium for Australian manufactured products. Expensive government subsidies do not work;

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[5] "NUS RMI Credit Research Initiative." https://rmicri.org/.

[6] "The Corporate Bond Report 2018 Australia's growing appetite for corporate bonds | Deloitte." 2018, https://www2.deloitte.com/content/dam/Deloitte/au/Documents/Economics/deloitte-au-economics-corporate-bond-report-2018-030518.pdf.

however, providing tax rebates on coupons on corporate bonds in industries that we want to retain or grow within Australia is a more democratic solution that allows free markets to support industries that deserve the capital.

4. *Allow capital loss from bond default to be deducted from other income.* To protect investors from losses due to bond investments due to a complete default, 50% of the capital loss should be allowed as a deduction from other income amortized over a period of five years. Developing a healthy corporate government entails risk, and in this manner, both investors and the government share the risk of default. Such a tax policy can be implemented in the first 10 years, and then removed when the Australian corporate bond market reaches a level of maturity that is adequate compared to other developed nations.

5. *Unlocking the potential of Australia's superannuation pool of AUD$3 trillion.* Australia's AUD$3T pool is the 6th largest in the world. The ASFA Superannuation Statistics for May 2019 shows that 46% is invested in equities ($820B), 21% in fixed interest ($374B) and 10% in cash ($178B)[7]. A total of 33% ($579B) is invested in international equities and fixed interest. With Australia's aging population, 46% invested in equities is a high-risk investment and having 33% invested in international assets means that we are less invested in Australian industries and companies. By unlocking the potential of Australia's superannuation pool and diverting some of these funds to the Australian corporate bond market, we succeed in creating a stable source of income for pensioners and are investing in our own future rather than being subject to the volatility of international capital markets.

6. *Provide funding for start-ups focusing on developing financial products & services.* One of our key experiences from working on Wall St is that the US is the preeminent manufacturer and exporter of financial products in the world. Many sovereign funds, institutional investors and retail investors are purchasers of State Street, BlackRock, Fidelity, and Vanguard financial products and funds; examples include bond ETFs and credit default swaps.

   If we are focused on buying or investing in "Australian made", this should extend to Australian made financial products and services. The Australian superannuation industry could support its growth at inception and these financial products can be sold internationally. Financial products and services have the advantage of not being subjected to Australia's "Tyranny of Distance" where exporting and shipping manufactured physical products to developed markets in the northern hemisphere can be an expensive and costly exercise. The development of financial products requires a highly educated populace with expertise in economics, mathematics, and software engineering which Australia has plenty of.

7. *A separate exchange for bond trading.* To avoid confusing investors, bonds should be traded on its own exchange, rather than on the ASX which is equity focused. The IRESS platform can be easily used for routing orders from the OTC bond market.

[7] "Super Statistics - ASFA " https://www.superannuation.asn.au/resources/superannuation-statistics.

8. *Read the findings from a study on the Swedish Bond market.*[8] Due to the current pandemic, there is a liquidity crisis in the Swedish Bond market and investors are unable to sell their bond holdings. Preliminary analysis of the situation indicates an over concentration in Swedish bond insurances in the real-estate sector and unrated issues. It is recommended that the findings of this review of the Swedish bond market be analyzed carefully, and any recommendations be incorporated to legislation in the development of the Australian corporate bond market.

Conclusion

While we do not necessarily believe in “big government”, we do believe in a government that takes care of its people by spending on their education, re-balancing financial resources to address weaknesses in our economy, and investing in industries in areas of potential growth that tie in with our country’s strengths.

- **Provide funding for universities and start-ups to build awareness and education around the fixed income market.** By educating our populace adequately, we are building the market of buyers and sellers of corporate bonds and the technological infrastructure for a bond exchange that is required to develop a healthy Australian corporate bond market.
- **Provide tax incentives & default protections for bond investors.** By providing tax rebates for bonds, we address the tax bias towards equities and real-estate. By allowing bond investors to deduct a portion of capital losses due to default against other income amortized over a fixed period, it is shown that the government shares some of the risk involved.
- **Use the size of Australia’s superannuation industry to best effect.** By having such a large pool of pension funds, a ready base of customers is created for the support and development of the Australian corporate bond market and financial products. Rather than using tax income, we can help connect the pension pool to fund growing industries in Australia. A developed financial industry in Australia that creates financial products to be sold overseas creates more jobs and opportunities for all Australians.

Best Regards,
Assoc. Prof. Rand Low
Professor Terry Marsh

[8] Swedish Central BankHires BlackRock in Feud with Parliament