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The Treasury
Langton Crescent
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Dear Ms Calder

Discussion Paper: Development of the retail corporate bond market - streamlining disclosure and liability requirements

Challenger's submission in response to the Discussion Paper is set out below. We support the Australian Government's efforts to develop the retail bond market and are providing our views on some of the matters raised in the Discussion Paper.

While the scope of the Discussion Paper is principally development of a domestic retail bond market, we note this is part of a broader policy objective of developing Australia's domestic bond market with both wholesale and retail investor participation. We are therefore also providing some observations with respect to those broader objectives.

In Challenger's view, a retail bond market should readily follow development of a transparent and functioning wholesale institutional market, and so initially there needs to be a strong focus on the domestic wholesale market. Consistent with market practice in Australia's equity capital markets, institutional investor participation in domestic bond markets is key to providing price discovery which retail investors can follow. Market-based institutional validation will afford retail investors an additional element of protection to supplement regulatory measures such as the prospectus regime and disclosure. Absence of institutional participation was a feature in all of the recent debenture collapses in Australia: Fincorp, Australian Capital Reserve, City Pacific and Westpoint where retail investors lost hundreds of millions of dollars.

1. RETAIL BOND MARKET CONSIDERATIONS

Unless stated otherwise, all paragraph and page references are to the Discussion Paper.

1.1 Short-form prospectus and disclosure requirements

Conditions related to the Issuer

We note the main proposed eligibility requirement under the short-form prospectus provisions will be that the issuer is a listed entity, and subject to the conditions noted in paragraph 24. In response to the Discussion Questions on page 5 and 6:

- The short-form prospectus provisions should be optional. The short-form prospectus provides useful guidance, however issuers will, at least initially need flexibility to tailor content to develop market practice.
- Either a single or two-part prospectus should be permitted.
- Eligibility should extend to any wholly-owned subsidiary of a body with continuously quoted securities provided they are unconditionally and irrevocably guaranteed on a senior unsubordinated basis for the life of the bond by the listed parent and group companies.

Conditions related to the bond

It is proposed to relax the existing conditions in ASIC Class Order [CO 10/321] (ASIC Class Order), however, we have reservations about extending the short-form prospectus regime to subordinated bonds (page 7). Our concern is that it could open the door for non-investment grade issuers to issue unrated subordinated debt under a short-form prospectus to retail investors, without any substantive institutional participation to provide independent validation.

The existing exclusion of subordinated bonds should in our view be retained. Alternatively, if it is permitted, the short-form prospectus provisions should only be available for contractually or structurally subordinated bonds if:

- the bond issue has a public credit rating; and/ or
- institutions either underwrite or take no less than 20% of any book build and final allocation.

Subordination increases risk substantially and makes the assessment of relative value more difficult. This warrants greater protection for retail investors, particularly if the bonds are non-investment grade. If less content and disclosure is to be provided under a short-form prospectus for a subordinated bond, then some additional investor protection is appropriate. The availability of a credit rating assists investors to identify non-investment grade bond issues and notching applied for subordination. Market-based validation from institutional investors introduces independence, expertise and rigour in the assessment of terms and relative value.

We note that subordinated debt can in any event be issued under a full prospectus in the absence of a rating, institutional participation or an ASX listing.

Other requirements that could be imposed

- **Minimum $50m issue size:** A minimum $50m issue size condition is not necessary, in our view, provided the risk factors disclosed make it clear that smaller issue size results in a higher risk that the bonds may be less liquid in the secondary market.
- **No subordination:** See conditions related to the bond above.

- **Deferral of interest:** Deferral of interest should be prohibited as such securities are not vanilla bonds and should not be encouraged within the short-form prospectus regime. If bonds are contractually subordinated, then any interest suspension period should not exceed 180 days, beyond which investors should have the right to accelerate and enforce.
- **Maximum tenor:** We propose a maximum term (tenor) of 10 years for the bonds issued under a short-form prospectus so that investors are not locked into longer terms (as noted in paragraph 32). Longer tenors are and should continue to be available under a full prospectus.

Use and availability of credit ratings

Eligibility should not, in our view, be limited to investment grade issuers or issuance. Given the current situation noted in paragraph 33, in which only one of the six Australian Financial Service licensed credit rating agencies in the Australian market are now licensed to provide credit ratings to retail investors, a universal ratings requirement (while an ideal outcome from a number of perspectives) would not be workable, and would likely discourage issuers from utilising the short-form prospectus provisions.

The ability of issuers to provide ratings information to retail investors would complement the short-form prospectus regime. The availability of ratings information to retail investors is particularly important given that both investment grade and non-investment grade bond issues are eligible.

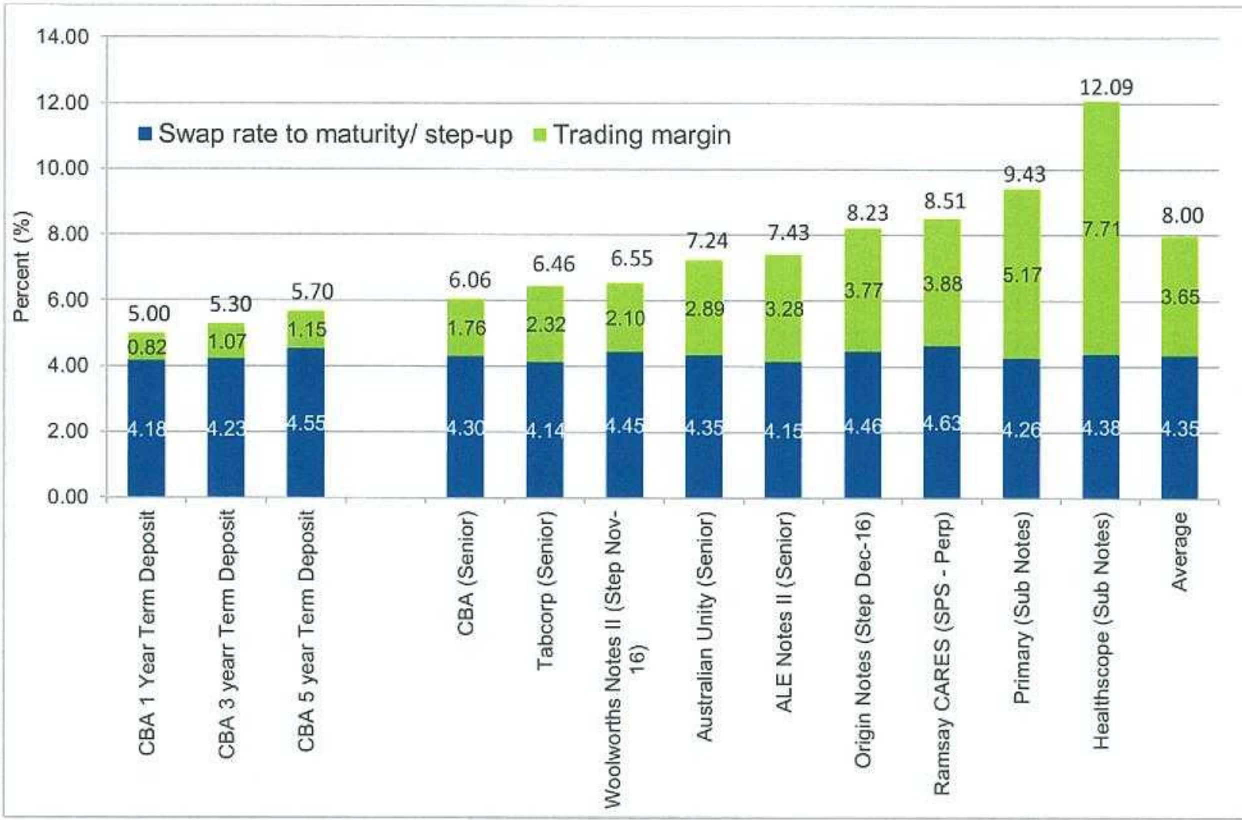
We agree with the comments and concerns raised by stakeholders noted in paragraphs 34 and 35. The current inability to provide retail investors with ratings information and the asymmetry of information where ratings are available to institutions, brokers and planners, but not their retail clients is clearly undesirable. These deficiencies will, unless resolved, prove to be a significant obstacle to the development of an efficient and well-informed domestic bond market.

1.2 Competition for retail demand from ADI deposits

While it has not been raised in the Discussion Paper, competition from ADI deposits is an important factor which is currently detracting from retail demand for vanilla corporate bonds.

As shown in Table 1 below, issuers that would otherwise target bond issuance at margins below ~200bps currently compete head-on with term deposits offering highly competitive rates, enhanced with a "government guarantee" under the Financial Claims Scheme (FCS). This is proving to be a formidable combination. The latter component is neither an intended or desirable consequence of the FCS.

Table 1: Selected Term Deposit Rates versus 'Retail' Bond and Hybrid Yield-to-Maturity[1] and Trading Margins



Source: Commonwealth Bank of Australia website (http://www.commbank.com.au/personal/accounts/term-deposits/rates-fees.aspx), UBS Hybrid Rate Sheet (10 Feb 2012), Bloomberg

Notes:

1. In the case of step-up notes such as the Woolworths and Origin notes, Yield-to-Maturity and swap rates are calculated to the step-up date.

Vigorous competition from term deposits reflects the current high-cost-of-funds environment. Bank funding costs have spiked as a result of continuing global volatility and risk aversion driven by the European debt crisis and weak economic growth outlook. Consequently, banks are presently competing vigorously for term deposits, to reduce their reliance and funding requirements from expensive wholesale capital markets.

Retail funds are being drawn inexorably to ADI deposits; and away from competing investment opportunities which include investment grade corporate bonds. The FCS has broader implications for Australia's financial system than maintaining the confidence of depositors.

While these conditions continue, the domestic retail market may see less supply of higher quality investment grade vanilla bond issues, and a bias may be perpetuated towards riskier issuers and/or riskier instruments sold to retail on higher yields.

1.3 High cost of retail distribution:

Retail bonds and hybrids generally rely heavily on a broker-firm component of the offer, targeted at the distribution networks of wealth management firms, financial planners and retail brokers. Fees are significant, adding materially to the all-in costs to issuers, which is another factor which discourages issuers and makes retail distribution less competitive relative to competing bank and international capital markets.

For example, the fees disclosed in the Tabcorp Subordinated Notes Prospectus (Feb 2012) are around 3.0%. We note also the fees disclosed in the Tabcorp Bonds Prospectus (April 2009), comprised Arranger/Joint Lead Manager fees of up to 2.25% of the proceeds of the offer; and a further broker firm selling fee of 1.00% (the latter fee payable only on volume distributed through syndicate and third party retail broker firms). Based on a 5 year maturity, this equates to around 65bps p.a. of additional costs to the issuer in respect of retail volume (45bps arranger/JLM fees; and 20bps for retail distribution), which does not include legal, accounting, tax and other costs of the offer.

We believe that current fee levels are a legacy of the development of the market from the more complex hybrid market, where issuers have accepted higher fees for complex structures and this has resulted in a higher cost of capital, particularly for equity-like hybrid capital.

Vanilla bonds are simpler instruments with straight forward documentation reducing content, complexity and workloads for adviser/arrangers and broker firms involved in distribution.

As more vanilla bonds emerge, we expect to see some commoditisation and a reduction in advisory and distribution fees over time. This will be assisted by the proposals in the Discussion Paper to simplify documentation and disclosure requirements through the short-form prospectus regime, although we suspect that those other costs have been a far more relevant factor than costs relating purely to disclosure documentation. Even where a retail bond issue is made under a total exemption from the prospectus requirements, substantial documents are nonetheless still produced. An example of this is the 56-page offer document prepared by CBA in November 2010 for its retail bond issue where, by reason of section 708(19) of the Corporations Act, no prospectus was required.[1] This might be evidence that the prospectus requirements themselves have relatively little impact on what a large issuer chooses to produce by way of offer documentation. In other words, commercial issues, marketing needs, the need to describe the offer and so on, mean that a substantial document is needed whether or not it's a prospectus.

1.4 Disclosure document exemption for prudentially-regulated entities

Challenger submits that the status quo should be maintained and subsection 708(19) should *not* be amended in the context of these reforms. Paragraph 87 notes that "the basis for this exemption is longstanding, and is related to the fact that ADI's are prudentially regulated".

The argument in paragraph 87 that s708(19) should be removed to 'ensure a level playing field' is misplaced in that s708(19) is not an impediment to other issuers. Issuers which are not prudentially regulated will have greater variation in credit quality and risk for investors than prudentially regulated issuers. It is proposed that both investment grade and non-investment grade issuers are to be accommodated in the short-form prospectus regime. Removal of a longstanding exemption for prudentially regulated entities would be counterproductive and potentially makes it more difficult for these high quality issuers to access the market. We fail to see

[1] http://www.commbank.com.au/about-us/shareholders/pdfs/securities/CommBank_Retail_Bond_Offer_Document_(ASX_release_no_links).pdf

how this would assist in developing the market or assist any corporate or other issuers to access the market.

Further we do not believe it is appropriate to aim towards a policy outcome where (see paragraph 88) "the benefits of subsection 708(19), including the ability for banks and insurance companies to issue certain types of fixed income securities without prospectus liability, quickly and easily, is the position that should ideally be achieved for all issuers." This would result in too little emphasis being placed on investor protection, particularly in the case of non-investment grade bonds for entities that are not prudentially regulated. We believe s708(19) should remain limited to ADIs and life offices prudentially regulated by APRA.

We note that some prudentially regulated entities that may be exempted under s708(19) may not be eligible within the short-form prospectus provisions as proposed, and removal of the s708(19) exemption would mean they would then not have the benefit of either s708(19) or the short-form prospectus provisions. For example, an entity may not be listed, or may be a subsidiary of a listed entity but may not satisfy the proposed first issuer condition referred to in paragraph 24 if the issuer is not guaranteed by the listed entity and group companies (see Section 1.1 of this letter above).

It is important that the entities and bonds that presently have the benefit of s708(19) are not disadvantaged by any legislative changes relating to retail bond issuance and that at least their current rights under the legislation are maintained.

One rationale for the exemption is discussed in Ford's Principles of Corporations- Law at [22.130]:

> *"The policy underlying the exemption is connected to the extreme breadth of the definition of 'debenture' in s 9 (see the discussion of the definition in Ch 19). In particular banks and other deposit-taking institutions, and life insurance companies, frequently accept money on deposit or loan, and issue undertakings to repay it, in circumstances where it would be impossible in practice to prepare a disclosure document on every occasion. Where the transaction is in the ordinary course of a banking business, it is exempted from the definition of "debenture", but there is still a need for an exemption from the disclosure requirements of Ch 6D where routine transactions occur outside the scope of a banking business."*

1.5 Wholesale bond market considerations

As noted in paragraph 26, the Johnson Report identified 'structural' factors discouraging domestic bond issuance including:

- *The large Australian banks' significant share of shorter maturity corporate lending (typically up to 5 years); and*
- *'To the extent that companies require longer maturity or additional debt beyond bank loans, that Australian companies can access more liquid corporate bond markets in US and Europe – however smaller and lower credit rated companies generally find it more difficult to access.'*

The perception of most Issuers and arrangers/advisers is that Australia's domestic wholesale debt capital market lacks the necessary depth and liquidity to compete effectively with Australian bank loans and international capital markets. There are too few institutional investors and insufficient domestic capacity to provide the pricing tension, volume and, perhaps most importantly in the current environment, execution certainty available in markets such as the US and Europe. Domestic capacity is limited for non-investment grade generally and particularly for both investment grade and non-investment grade maturities beyond 5 years.

The allocation of funds from superannuation and pension funds to fixed income in Australia is substantially lower than other developed countries. In Challenger's view this is the real obstacle to the development and expansion of Australia's domestic wholesale bond market. While these structural issues are beyond the scope of the Discussion Paper we have commented on them below. They should be the focus of additional policy initiatives aimed at developing the wholesale domestic bond market as a prerequisite for developing a deep, transparent and liquid retail bond market. Measures directed at increasing the allocation of superannuation fund assets to fixed income investments, particularly those with retired members or those approaching retirement, should be examined.

1.6 The potential contribution of fixed income in the superannuation system

Australia needs a deep and liquid domestic corporate bond market. The largest pool of private savings to fund it is the superannuation system. This will require a structural change in the way those funds are invested. There are a number of market forces which over time are likely to drive that change.

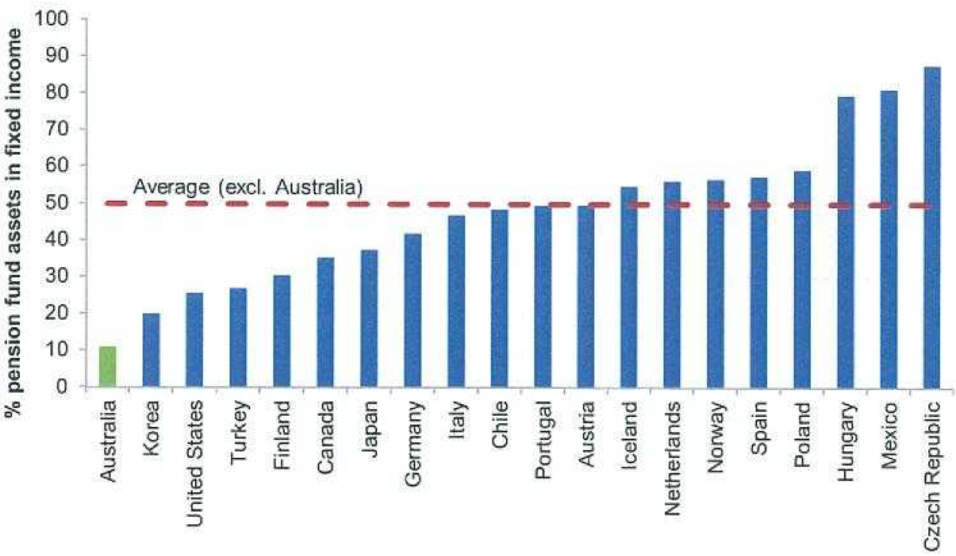
Asset allocation

Our super system is relatively immature and largely an accumulation system with a high allocation to equities and low allocation to fixed interest. This allocation can be explained by three factors: a long bull market, the preponderance of defined contribution (DC) funds in the Australian system and limited offerings of guaranteed income streams.

At 11% Australian superannuation fund allocations to corporate debt, notes, bonds, bills and annuities is low relative to the rest of the OECD, this is:

- the lowest allocation of any OECD retirement system;
- one-half of the next lowest OECD member; and
- about a quarter of the OECD average.

Figure 1: Super/pension fund fixed income allocations for selected OECD countries, 2010



Source: OECD Global Pension Statistics, Pension Markets in Focus July 2011, Issue 8

Demographic shift

Currently, super fund members aged 45 to 65 years old, own 61 per cent of the assets in the system. There is $850bn on the verge of, or moving towards, retirement.[2] Roughly $520bn of this is owned by people aged 55 and older. This has profound implications for a retirement system that has so far seen itself as an accumulation system. The pressure on the asset allocation of the system with the weight of money held by this demographic cannot be underestimated. It is likely to shift to more secure and less volatile assets as the baby boomers move through into retirement.

Accumulation and retirement require different asset allocations

A recent Towers Watson survey found the average default allocated pension in 2011 had a 67 per cent allocation to growth assets, compared with a 74 per cent allocation for comparable funds in accumulation, only a 7% difference.[3] However, the demands of the accumulation and pension phases are quite different with those in pension phase being much more vulnerable to volatility, particularly close to retirement.

As the market for post-retirement products develops it will drive a significant increase in the superannuation industry's appetite for domestic corporate bonds. Annuities offer a solution to the three key retirement risks; market risk, inflation risk and longevity risk. Rather than sacrifice safety for returns, annuities have demonstrated that they can provide superior returns to the average balanced fund, particularly on a risk-adjusted and post-fees basis. Life companies providing annuities are well placed to facilitate this shift in asset allocation. As credit intermediaries life offices' growth in liabilities means more wholesale capital available to invest in domestic corporate bonds, including RMBS and infrastructure debt. In this role they will also make a substantial contribution to the stability of the financial system by reducing the frequency of refinancing requirements and diversifying the sources of funding.

Diversification

Some might come to the conclusion that the Australian superannuation system should buy long-term major bank paper and that the banks could then on-lend the proceeds to Australian businesses and households. However, the superannuation system would have a material concentration risk if it increases its allocation to long term bank paper. It already has an exposure of approximately 20 per cent to the banking sector through deposits, bonds, shares and bank certificates of deposit.[4]

However, there are two material issues with this proposition:

- The superannuation system is already over-exposed to the banking sector; and
- The Government should limit its exposure as a guarantor of the superannuation system through the FCS.

[2] APRA, ATO, Challenger estimates.
[3] http://www.towerswatson.com/assets/AP/pdf/mailings/TowersWatson-PRS-February2012.pdf
[4] ABS, Managed *Funds Australia: Superannuation Funds Unconsolidated Assets Table 4*, December 2010

Infrastructure funding

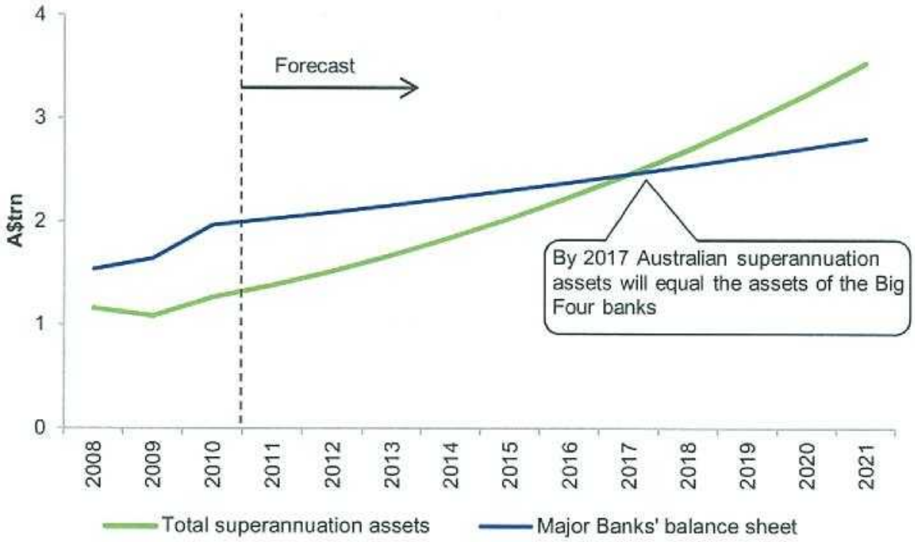
According to Infrastructure Australia,[5] there exist $86 billion worth of road, rail, port and other infrastructure projects requiring private sector funding. But, the diminished ranks of financiers will now only lend lesser amounts for shorter terms and there is not a developed route for super funds to lend to this sector.

Potential sources of longer-term domestic funding

By 2017, it is forecast that today's $1.3 trillion in superannuation assets will grow at a compound annual rate of 10% to reach approximately $2.5 trillion, meeting then exceeding the domestic assets of the Big Four banks which today stand at $2.0 trillion and are set to grow at about 3.8% per annum.

If the super system grows at a compound annual growth rate of 10 per cent for the next ten years (i.e. at less than its actual. growth rate over the past decade)[6] and the allocation to fixed income products rose from its current 11 per cent to 26 per cent (equal to the US and still almost 50 per cent below the OECD average) it would create a new source of long term finance for investment in long-term assets of approximately $525 billion.

Figure 2: Super system to exceed major banks' balance sheets



Source: Banks balance sheet growth 3.8 per cent (UBS Research July 2011), Superannuation FUM: Rainmaker, Super Projections Dec 2010, Roundup report, Major Banks Latest Annual Financial Statements

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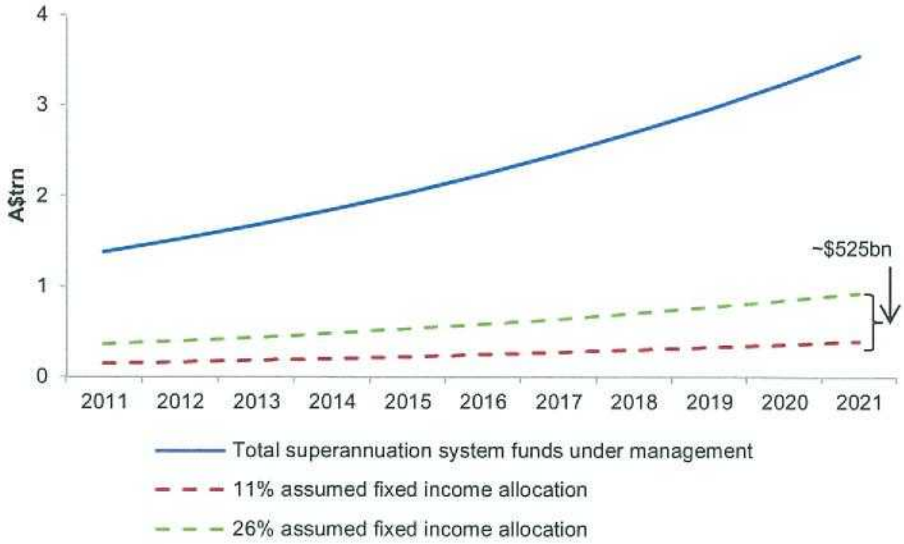
[5] Infrastructure Australia, Report to COAG - Communicating the Imperative for Action, June 2011

[6] The Towers Watson Global Pension Assets Study 2012 shows that the super system had a 17% CAGR for the 10 years from 2001 to 2011.

Figure 3: Super system's potential fixed income asset allocation



Source: Rainmaker, Super Projections Dec 2010 Roundup report and OECD Global Pension Statistics July 2011, Issue 8

There is no other source of stable, long-term funding in the Australian financial system of this size or liquidity.

Growth in the domestic bond market would be facilitated by reforms to the superannuation system which focus on post-retirement incomes which are likely to facilitate a shift in asset allocations towards more fixed interest investments. The relevant policy changes would not involve any direction in relation to asset allocation but do include removing the current regulatory impediments to providing a greater range of suitable post-retirement products and requiring superannuation trustees to consider the principal risks for retirees when developing post retirement offerings. These policy changes would drive significant growth in wholesale demand for domestic paper and provide the price discovery and liquidity which is needed to support an active retail bond market.

Yours sincerely

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