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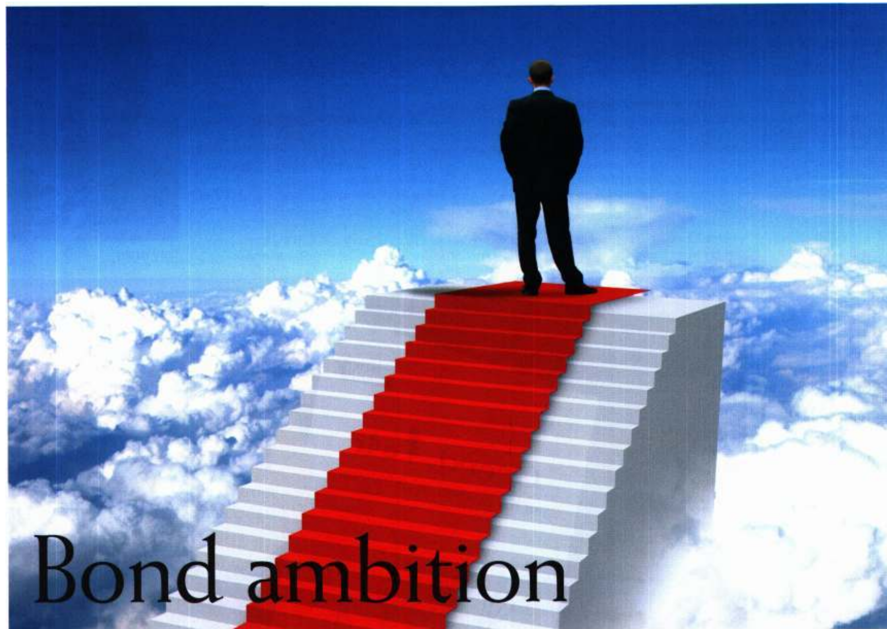

STEPHEN HART examines the recent introduction of ASIC's class order for retail bonds and considers what it means – and what is happening in parallel with its development.

Recently, and timed to coincide with the Federal Budget, the Australian Securities and Investments Commission (ASIC) issued Class Order [CO 10/321] Offers of Vanilla Bonds and Regulatory Guide 213 Facilitating Debt Raising (RG 213). Let's look at what is driving these initiatives, consider some aspects of RG 213 and a number of other market initiatives designed to provide retail investors with direct access to the wholesale bond market.

Before we review RG 213 in detail it is appropriate to mention the issue of tax neutrality between asset classes, as raised by the Henry Review. It can be argued that a lack of tax neutrality is supporting the current high weighting towards equities, relative to other countries, in Australian asset allocation. While the Commonwealth Government has recognised some of these issues, and ASIC is setting up a path for change, it will not be immediate. It is clear though that the fixed income theme is now in the Commonwealth Government's spotlight and will feature in future policy. In the interim, financial planners need a solution for the delivery of fixed income exposure to their clients.

Background to RG 213

My colleagues formally responded to the earlier consultation papers, CP 105 (Facilitating Equity Capital Raising, February 2009) and CP 126 (Facilitating Debt Raising, December 2009), by raising, among other issues:

- Investor allocation – generally, retail investors in Australia have a high equity weighting in terms of investment asset allocation and a very low bond holding. This highlights the need to allow greater access to retail bond offerings, as recognised by ASIC in CP 126, so as to develop adequate investor diversification.
- Issuer funding diversification – Australian corporations do not have adequate retail bond funding, which leads to an over-reliance on bank funding, wholesale institutional funding and/or international bond markets. A viable retail bond market in Australia will increase the options available to companies prudently seeking to broaden their debt funding sources.

A retail bond market would go some way to resolving both issues. The Johnson Report said the development of a retail bond market would be advantageous and the disparity of disclosure standards between equity and bond issuance needed to be addressed: "Further difficulties arise from the inability to offer a debt product to potential retail clients over an extended period of time. Under recent legislative reforms and relief provided by ASIC for certain forms of equity issuance, the gap between requirements on the issuance of debt securities as against listed shares to retail investors

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by an [Australian Securities Exchange] listed company is now even wider. Given the relatively higher risks associated with investing in shares, the forum does not believe this disparity in disclosure standards is appropriate."

Release of RG 213

The relief discussed in RG 213 was designed to address some of the concerns expressed in the Johnson Report and elsewhere. In short, RG 213 should facilitate development of a viable retail corporate bond market, and this is something about which we have been lobbying the authorities for some time. ASIC is attempting, among other things, to align the cost of retail bond issuance with the costs of other forms of issuance. Broadly, the relief to issuers referred to in RG 213 includes:

- the minimum issue size for retail investors of $50 million is appropriate and does not rule out good quality issuers, so there should be good investor appetite;
- the relief will not at this time extend to the issue of subordinated debt;
- ASIC intends to consult further on the issue of subordinated debt, within the next 12 months; and
- the bonds must be 'vanilla'; that is, they are not to have complex or unusual terms and conditions, which is sensible for retail investors.

Investors are encouraged to read and review RG 213 – a significant innovation in the Australian bond market. Going forward, retail investors are likely to find retail corporate bonds attractive,

particularly from household name issuers, when they compare forecast equity returns with the returns available from these lower risk securities. On a risk-adjusted basis, bonds continue to offer an attractive option, with demand for the small number of retail bonds issued in recent years remaining strong.

Tax neutrality

Tax neutrality between the asset classes may impede progress. Tax neutrality is defined as being a situation where the real effective marginal tax rate is equal for income received from the various asset classes.

The Henry Review found a large variation in taxation between the asset classes; for example, the top marginal rate tax payers pay a substantially higher real effective marginal tax rate on income from bank accounts in comparison with domestic shares, foreign shares, owner occupied property and rental property. Such a finding is illustrated in the accompanying chart taken from the Henry Review (see figure 1).

If tax payable on income from deposits and bond investments is higher than tax payable on equities, investors may allocate according to after-tax returns, ignoring asset class risk.

A first move to address this problem was made in the recent 2010-11 Federal Budget. Specifically, in his Budget speech Treasurer Wayne Swan said: "From 1 July 2011 Australians will be able to obtain a 50 per cent tax discount for the first $1,000 of interest they earn, including interest earned on deposits held in banks, building societies and credit unions, and on bonds, debentures and annuity products. This change is expected to make interest-bearing products more attractive to

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savers, which will have positive flow-on effects for competition in our financial system."

Further moves towards tax neutrality should encourage larger allocations to bonds and term deposits, leading to a more conservative and sustainable Australian asset allocation. While I have used figure 2 for illustrative purposes in previous articles, the OECD table of member country pension fund allocations to equities demonstrates, among other things, the impact of inadequate tax neutrality in Australia.

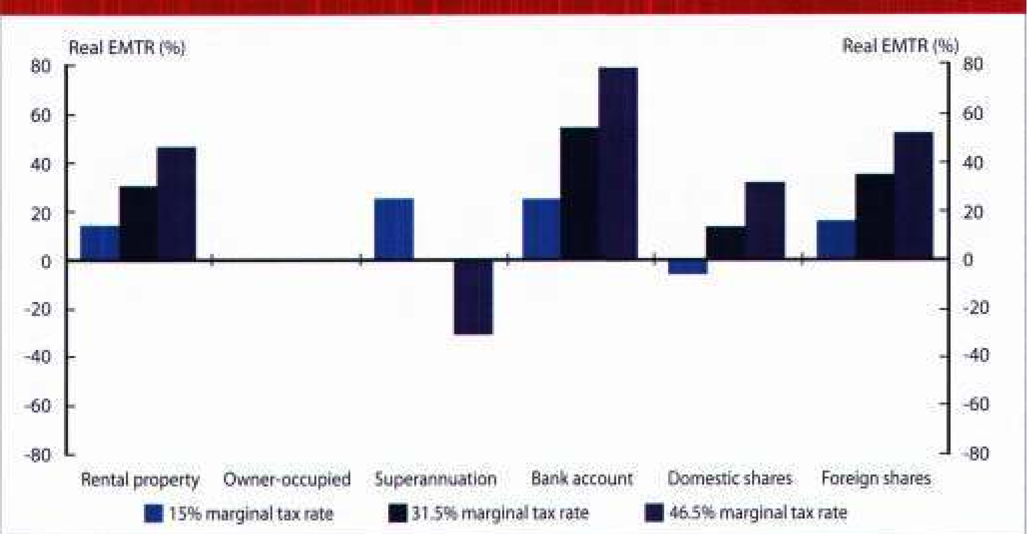
We are of the view that neutrality of taxation across all asset classes should be a policy goal to ensure investments are made on the basis of relative merit and not for taxation reasons. Moreover, if the taxation system effectively supports the existence of an overweight allocation to equities in the Australian superannuation market, this needs to be addressed before the superannuation guarantee is lifted towards 12 per cent. As the Commonwealth Government has indicated, changes to the pool of superannuation savings from the changes announced recently are significant and likely to increase the size of the superannuation funds under management by roughly $85 billion over 10 years.

Interim solutions

In the meantime, organisations listening to the demands of investors are creating interim solutions, and we expect further initiatives from this sector as investors looking down from a higher position in the corporate capital structure continue to focus on de-risking portfolios and taking advantage of moderate returns.

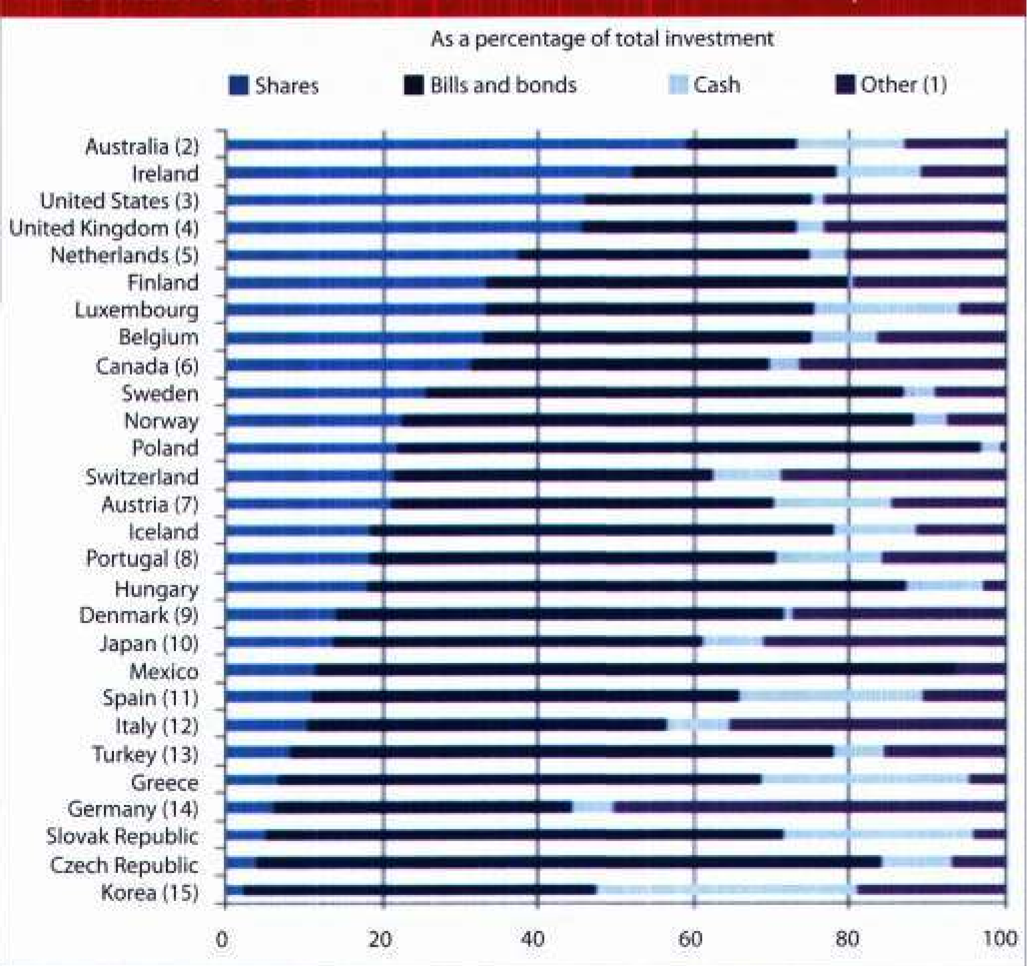
Stephen Hart is director, planner services at FIIG Securities.

FIGURE 1: REAL EFFECTIVE MARGINAL TAX RATES ON SAVINGS DEPEND ON THE ASSET CLASS



Source: Treasury estimates.

FIGURE 2: PENSION FUND ASSET ALLOCATION FOR SELECTED INVESTMENT CATEGORIES IN SELECTED OECD COUNTRIES, 2008



Source: OECD Global Pension Statistics.

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