

31 March 2014

The Chairman
Financial System Inquiry
100 Market Street
Sydney NSW 2000

Dear Mr Murray

Submission to the Financial System Inquiry

1. Introduction and background to Australia Ratings

- History of Australia Ratings;
- Licensing requirements;
- ASIC's rationale for distinguishing between wholesale and retail rating licences.

Australia Ratings Pty Limited ("Australia Ratings") was established in 2010 and holds a retail Australian Financial Services Licence ("AFSL") issued by the Australian Securities and Investments Commission ("ASIC") to issue credit ratings to both retail and whole sale investors in the Australian financial market. Australia Ratings was established for a number of reasons including recognition by the G20 Group that governments should encourage greater competition among credit rating agencies.

The regulatory environment for credit rating agencies in Australia was also changing. Following a review of the Australian regulatory framework for credit rating agencies conducted by ASIC and the Treasury, and consistent with changes being implemented by securities regulators globally, ASIC announced in 2008 that the AFSL exemption held by credit rating agencies would be removed. Credit rating agencies would be required to hold an AFSL from 1 July 2009, although this was subsequently extended to 1 January 2010. In addition, credit rating agencies intending to give credit ratings for investment products offered to retail investors would also need to comply with a general licensee obligation under the Corporations Act to have a dispute resolution system in place.

The dispute resolution system comprises of:

- An internal dispute resolution procedure; and
- Membership of an approved external dispute resolution scheme, such as the Financial Ombudsman Service (“FOS”).

This is an added protection for retail investors which other credit rating agencies operating in Australia, remain unwilling to provide. As an alternative to court actions, an external dispute resolution scheme provides a quick, low-cost, independent resolution of disputes between retail investors and AFSL holders up to \$280,000. Australia Ratings offers rating services to facilitate the evaluation of the creditworthiness of organisations, government borrowers, debt securities and fixed income investment products.

Credit ratings provide a benchmark that investors can use to evaluate a debt security or issuer’s creditworthiness, the yield required for such an investment, and its appropriateness in an investment portfolio. The credit ratings of Australia Ratings are recognised by the Australian Securities Exchange (“ASX”) under its listing rules for debt securities.

The Australia Ratings analytical team has over 50 years of combined experience in the assessment of credit risk in Australia, New Zealand and international markets. The current five person analytical team are all former analysts of Standard & Poor’s. The experience and calibre of the analytical team is complemented by the experience and skills of the two non-executive directors on the Board of Australia Ratings who bring deep experience in banking, capital markets, funds management and the financial planning sectors. Australia Ratings’ rating scale uses the same symbology as that of Fitch Ratings and Standard & Poor’s.

To date Australia Ratings has issued credit ratings on bonds listed on the ASX by non-listed mutual organisations. It has also assigned credit ratings to fixed income managed funds.

2. Need, benefits and constraints to developing the retail bond market

- Improve access for retail investors to invest in debt securities;
- Importance of retail debt market to Australia’s growing retiree sector;
- Retail investors are operating in an information vacuum, they need access to information; on issuer credit risk and other risks attached to particular bond issues;
- Bring the wholesale and retail debt markets together as is the case for the equity markets;
- Success in other markets e.g. New Zealand, U.S., and U.K.

One of the terms of reference of the Inquiry is to consider the allocation of capital within the financial system. Australia Ratings considers the domestic corporate bond market to be under-developed relative to other advanced economies such as the United States, United Kingdom and even New Zealand. Philip Lowe, Deputy Governor of the Reserve Bank of Australia (“RBA”) has highlighted the low use of the domestic corporate bond market compared to other developed financial systems¹.

¹ Philip Lowe Deputy Governor RBA “Opportunities and Challenges in market based financing” ASIC Annual Forum 2014

In particular, we consider the absence of a functioning and active listed debt market through which retail investors and self-managed superannuation funds (“SMSF”) can invest is a shortcoming of the current financial system and should be addressed in this Inquiry.

Former US Federal Reserve chairman, Alan Greenspan, observed it is important to have a number of alternative means for converting a nation’s savings into capital as such alternative channels that can act as a “spare tyre” when the primary forms of intermediation of savings and investment becomes dysfunctional.

A number of problems exist in the current financial system inhibiting the development of a listed or retail bond market including:

- 1) The dominance of the four major banks as providers of term debt funding to non-financial corporations;
- 2) Limited familiarity and knowledge of debt capital markets by brokers, financial advisers and retail investors;
- 3) Limited and difficult access to debt securities; and
- 4) Market inefficiency caused by the current design of the Financial Claims Scheme (“FCS”).

Deregulation of the banking system since the 1980s has been focused on encouraging increased competition in banking. For large Australian non-financial companies this has resulted in an intensely competitive banking market populated not just by the major Australian banks, but also by many of the largest banks in the world. There is little need or incentive to look for alternative sources of term debt funding, even though these may be cheaper and provide funding for periods longer than banks are prepared to lend.

Future policy initiatives should be focused on encouraging competition to banking to address this imbalance. While corporate bond markets function outside of the regulatory system applied to banking and this may be considered an undesirable fostering of shadow banking, it is necessary if corporate bond markets are to function as a “spare tyre”. It is also necessary, if corporate bond markets are to provide a competitive check on the banking system.

Issue 2 can be addressed by the market continuing to provide education and training to develop a greater degree of familiarity with fixed income as an asset class and increase the knowledge and skills of financial advisers and brokers. Indeed, there is a need to re-balance the listed corporate bond market away from being the domain of higher yielding but higher risk subordinated and hybrid instruments. Familiarity with senior ranking corporate bonds as securities that can preserve capital, generate income and minimise downside risks, needs to be promoted. To this extent the current definition of a sophisticated investor, as it appears in the Corporations Act is anachronistic. Today, an annual income of more than \$250,000 and or the possession of investable assets greater than \$2.0 million does not make one a sophisticated investor. Any reasonable test of sophistication would be knowledge based.

Retail investor familiarity with senior ranking corporate bonds and ease of access will be assisted by the ASX's current proposal to list bonds lodged in Austraclear via a transmutation process to CHES. This will help retail investors access debt securities, albeit only "simple corporate bonds". However, an artificial constraint on the adoption of senior ranking corporate bonds by retail investors is the competition posed by the high yields offered on some bank term deposits; not to mention the availability of a Commonwealth government guarantee.

With respect to issue 4, the original concept for the FCS was to provide enough liquidity to retail depositors for them to avoid serious hardship for the period between an Authorised Deposit-taking Institution's ("ADI") failure and its wind up. The problem with having a \$250,000 guarantee on a per person per institution basis, which allows an individual multiple access to the guarantee by spreading cash around a number of ADIs, is that it becomes a de facto guarantee for investments. Rather than considering the risk return trade-off across the spectrum of potential investments available, retail investors accept lower returns because they focus on the government guarantee. This has resulted in a significant distortion of retail investments at the expense of non-ADI investments and the business activity which those non-ADIs would otherwise fund. The FCS needs to be reviewed with the intention of limiting its distortionary effects.

3. Need for appropriate licensing of credit rating agencies to be retained

- ASIC's rationale for retail licences has not changed;
- Credit rating agencies holding a retail AFSL should be required to be members of the FOS to provide retail investors access to a dispute resolution scheme in circumstances where the internal dispute resolution schemes of an AFSL provider don't settle a matter;
- The flow of reliable and comprehensive information to investors needs to be increased both at the time of making investment decisions and afterwards;
- This information should only come from providers that are members of the FOS;
- Such a requirement would go a long way towards creating well-informed investors and promote a listed corporate bond market in the form originally intended.

The requirement for credit rating agencies to hold an appropriate AFSL must be retained. Financial market participants need to be confident that credit rating agencies are appropriately vetted, supervised and regulated by the securities regulator, ASIC. With the benefit of hindsight, the previous exemption granted to credit rating agencies was a mistake, particularly in light of the losses suffered by Australian investors in certain structured investments, such as constant proportion debt obligations. The added protection currently afforded to retail investors is also essential while familiarity and understanding of debt instruments, as an essential component of a well-diversified investment portfolio, needs to be built.

The requirement for providers of financial services including advice and research to retail clients to belong to an external dispute resolution scheme such as the FOS, provides both a discipline to service providers to be mindful of their obligations to retail clients, and confidence to retail investors that there is a body they can appeal to, in need.

Retail investors will not be denied access to credit ratings while other credit rating agencies refuse to join an external dispute resolution scheme. Australia Ratings is currently negotiating with the ASX and others to rate all simple corporate bonds transmuted from the wholesale market.

In considering the future regulation of Australia's financial system, Australia Ratings sees no justification for an exemption being considered for credit rating agencies, in the context of a global drive to put in place better oversight and regulation of credit rating agencies.

4. Need to remove competitive barriers arising from regulatory reliance on only selected credit rating agencies

- Australia should comply with G20 and IOSCO policy by increasing competition amongst credit rating agencies and to reduce overly mechanistic reliance on ratings in regulations.

The G20 Summit in St Petersburg in Russia in September 2013 considered a report from the Financial Stability Board² and adopted a Declaration calling on national authorities and standard-setting bodies to accelerate progress in reducing reliance on credit rating agencies. They also called for further steps to enhance transparency and competition among them. Specifically, the declaration noted the oligopoly of Fitch Ratings, Moody's and S&P and the challenge facing smaller and new-entrant credit rating agencies. The FSB highlighted transparency's role in market competition.

Australia Ratings, as a new-entrant, faces challenges such as these in breaking into the Australian credit ratings market. One of the impediments faced is the rejection of its ratings by the RBA and its ineligibility as a start-up agency to qualify as an External Credit Assessment Institution ("ECAI") under the rules of the Australian Prudential Regulatory Authority ("APRA"). Such regulatory impediments are contrary to the spirit and direction of the G20 and the Financial Stability progress report of 20 August 2013.

Australia Ratings suggests the Inquiry recommends that Government agencies adopt a neutral stance towards the use of ratings from established and new-entrant credit rating agencies to comply with the agreement of the G20. Specifically, it is suggested that Government agencies not reject the ratings of ASIC licensed credit rating agencies. As the rating scales of all credit rating agencies reflect different and distinct definitions, regulators and Government agencies should decide what credibility to give to a particular agency's ratings rather than impede competition by not recognising small or new-entrant credit rating agencies. The importance of this point is that if a regulator does not recognise ratings from an ASIC licensed credit rating agency, why would a constituent of that regulatory body engage a new-entrant agency? In short, the stance taken by the RBA and APRA is anti-competitive.

² Financial Stability Board 29 August 2013 "Credit Rating Agencies – Reducing reliance and strengthening oversight"

5. Recommendations

A. *Development of the Retail Bond Market*

- 1) Future policy initiatives of government and market regulators should be focused on encouraging competition to banking, rather than in banking. Development of a deep and liquid market for bonds issued by non-financial companies is essential, if an alternative source of term debt funding is to be available and a competitive check imposed on the banking system.
- 2) There is a need for familiarity with corporate bonds as securities that can preserve capital, generate income and minimise downside risks, to be promoted. Furthermore, the definition of a sophisticated investor should be revised and based on an investor knowledge threshold.
- 3) The prospects for developing the retail debt market would be improved by addressing the current distortion of investment flows created by the Financial Claims Scheme ("FCS"). The current form of the FCS has created a disincentive for investment in fixed income funds, retirement income products and listed debt securities. Possible actions to consider:
 - i. Reduce the benefit of the current Government guarantee of \$250k per deposit to a maximum of \$100k per depositor (to bring the level in line with other OECD countries);
 - ii. The Government should levy a fee for the guarantee as suggested by the RBA Governor. This would provide a consistent approach to the retail bank funding market to that adopted by the Government when it guaranteed certain issues of wholesale debt of ADI's in the period between 2008 -2010; and
 - iii. Depositors with ADIs seeking the benefit of a Government guarantee under the FCS should only receive a yield similar to that prevailing in the market for Commonwealth Government Securities ("CGS"). Depositors who accept bank credit risk can receive market rates such as term deposit rate etc.

B. *Regulation*

- 4) The current regulation of credit rating agencies holding an Australian Financial Services Licence is appropriate and should be retained.
- 5) Regulators and Government agencies should take steps to remove mechanistic reliance on credit ratings in regulations and policies. Government and its agencies should promote greater competition among credit rating agencies in Australia to add to the amount and diversity of information and research available to fixed income investors.

We would be happy to meet with you to further explain the views expressed in this submission.

Yours sincerely

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