

# QIC

## SUBMISSION TO FINANCIAL SYSTEM INQUIRY

QIC

AUGUST 2014



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## 1 SUMMARY

This submission takes an infrastructure investor's perspective on particular aspects of the Inquiry's interim report. We principally address one aspect of the Inquiry's broad scope: infrastructure financing and the Australian corporate bond market. We also respond to an aspect of the Inquiry's discussion of superannuation portability and liquidity implications.

Limitations in the Australian corporate bond market affect infrastructure financing more than general corporate financing: infrastructure issuers prefer longer tenor debt, which the local market does not offer. This is a consequence of Australia's corporate bond market being smaller, less liquid, and not as accessible as that of comparable developed economies. While Australian infrastructure businesses have issued debt offshore to work around this problem, limitations around currency swaps, size and concession deed limitations mean that offshore financing can only be a partial solution.

Several factors contribute to the more limited capabilities of the Australian corporate bond market:

- Superannuation asset allocation disfavours bond investment, compared with cash, as a result of superannuation portability and liquidity requirements.
- Self-managed superannuation funds tend not to invest in bonds, due to distortions from the government's bank deposit guarantee, the limited accessibility of retail bonds and a lack of popular attention from the media and financial advisers.
- Smaller life insurance and annuity markets in Australia; in other markets these entities are important bond market participants.

The bond market limitations are not just a problem for infrastructure investors – by limiting the ability of infrastructure issuers to manage refinancing risks, equity risk increases. This lowers the value of infrastructure assets, and the benefits available to governments from private sector involvement in the provision of much needed infrastructure.

Whilst no single change can “develop” the Australian bond market, there are number of potentially helpful changes:

- Increased incentives for individuals to invest superannuation savings in annuities via default options or compulsion
- Further government support for growth in the retail bond market

We also recommend the Inquiry consider the potential to facilitate super funds offering members investment options that have lower liquidity / portability requirements; this would help offset the current superannuation system's mismatch of requiring high liquidity for long-term savings and expand the universe of investment options available to superannuation fund members.

## 2 BACKGROUND

### 2.1 Who is QIC

The Queensland Government created QIC in 1991 to serve its long-term investment responsibilities. QIC manages \$5.1 billion of infrastructure assets across 18 global investments, including four Australian infrastructure assets. We focus on infrastructure projects in OECD countries exhibiting predictable cash-flows, sustainable competitive advantages and operating in well-defined regulatory environments. We have a sector centric approach and specialisation across transport, utilities and public private partnerships being especially strong areas of interest.

### 2.2 Submission focus

As an active investor in Australian infrastructure, we approach our submission to the Inquiry with this perspective. We focus on a small part of the Inquiry’s broad scope: infrastructure financing and the corporate bond market. In particular, this submission addresses the Inquiry’s following observations and requests for comment:

Inquiry Interim Report reference	Inquiry comments	QIC Submission reference
2-86	<i>“Observation: Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.”</i>	Sections 4-5
2-91	<p><i>“The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:</i></p> <ul style="list-style-type: none"> <li><i>• No change to current arrangements.</i></li> <li><i>• Allow listed issuers (already subject to continuous disclosure requirements) to issue ‘vanilla’ bonds directly to retail investors without the need for a prospectus.</i></li> <li><i>• Review the size and scale of corporate ‘vanilla’ bond offerings that can be made without a prospectus where the offering is limited to 20 people in 12 months up to a value of \$2 million, or for offers of up to \$10 million with an offer information statement.”<sup>1</sup></i></li> </ul>	Section 8.2.2

<sup>1</sup> Interim Report, p



Inquiry Interim Report reference	Inquiry comments	QIC Submission reference
2-91	<p><i>“The Inquiry seeks further information on the following areas:</i></p> <ul style="list-style-type: none"><li><i>• As a greater share of the population enters retirement, would the demand for fixed income products increase in the absence of regulation or other incentives?</i></li><li><i>• Would the development of annuity-style retirement income investment products encourage the growth of fixed income markets?</i></li><li><i>• Could enhanced transparency of transactions improve liquidity in the over-the-counter Australian corporate bond market, including its attractiveness to retail investors? What commercial or regulatory impediments are there to the potential development of improved transparency in the over-the-counter corporate bond market?</i></li><li><i>• Could alternative credit rating schemes develop in Australia and would this help improve the appetite for bonds, particularly those of growing medium-sized enterprises? Could alternative standards of creditworthiness develop in Australia? What are the barriers to such developments, and what policy adjustments would assist such developments?”<sup>2</sup></i></li></ul>	Section 8.2.1

To address these aspects, this submission compares the Australian corporate bond market with those found in other developed markets, and considers the implications of the differences for Australian infrastructure financing. This submission also discusses some of the difficulties found in practice when using off-shore financing as an alternate to long-term bonds that are not available in the Australian market.

The submission will also respond to the Inquiry’s request for views on the subject of superannuation portability and liquidity:

Inquiry Interim Report reference	Inquiry comments	QIC Submission reference
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<sup>2</sup> Interim Report, p 2-91

Inquiry Interim Report reference	Inquiry comments	QIC Submission reference
2-114	<p><i>“The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:</i></p> <p>...</p> <ul style="list-style-type: none"> <li>• <i>Replace the three-day portability rule:</i> <ul style="list-style-type: none"> <li>○ <i>With a longer maximum time period or a staged transfer of members’ balances between funds, including expanding the regulator’s power to extend the maximum time period to the entire industry in times of stress</i></li> <li>○ <i>By moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.”</i><sup>3</sup></li> </ul> </li> </ul>	Section 7

We believe the current superannuation system (liquidity and portability rules) creates a mismatch between the liquidity requirements of superannuation fund members (which are low due to the ‘locked-up’ nature of superannuation) and the liquidity requirements imposed on the fund itself (which are significant due to members right to port or switch their investments at short notice).

### 3 INFRASTRUCTURE FINANCING

#### 3.1 Introduction

The Inquiry’s Interim Report notes that infrastructure financing issues “...relate more to issues covered elsewhere in this report, such as the development of the corporate bond market”<sup>4</sup>. We agree with this statement, although we note that underdevelopment of the corporate bond market may affect infrastructure issuers more than other businesses.

Relative to general corporates, infrastructure businesses tend to seek significantly longer term debt (to match long-life assets) and be on average more debt-intensive (because of the lower cashflow risks associated with infrastructure assets). Similarly, relative to the banks that dominate the Australian non-government bond market, infrastructure issuers seek longer tenor debt and cannot offer investors the same volume of issuance or liquidity. Consequently, under-development of the corporate bond market may be of more concern to infrastructure investors than others.

#### 3.2 Background

Companies looking to obtain debt finance have two broad options to choose from: bank loans (in which a bank acts as a credit intermediary) or bond issuance (in which investors effectively lend directly to the company).

<sup>3</sup> Interim Report, p 2-114

<sup>4</sup> Interim Report, p2-71.

Bank lending and bonds have different strengths and weaknesses but can also compete with one another. This competition has the potential to create a more robust financial system for Australia than if either were a sole option for financing. Indeed, the RBA has identified the corporate bond market as an important fall-back for the economy in the event of a banking crisis<sup>5</sup>. In Australia, bank lending dominates infrastructure financing. However, bank loans are generally limited to seven years or less in term; this is not necessarily suited to financing for long duration infrastructure assets with lives much longer than seven years.

### 3.3 Infrastructure companies prefer long tenor debt

While infrastructure financing is broadly similar to general corporate financing, infrastructure assets have some distinct features that influence their financing strategies.

Infrastructure assets tend to be:

- Long-lived (such as roads with 30-50+ year concession contracts or utilities with 50-100 years asset lives)
- Capital intensive
- Lower risk and return than the market as a whole (i.e. ungeared asset betas of less than one)
- Single-purpose businesses with very limited potential for strategic changes over time.

As a result, the optimal financing tenor for infrastructure assets tends to be much longer than general corporate financing requirements. Shorter debt means taking more refinancing risk<sup>6</sup>, more exposure to future debt market appetite and to future economic uncertainty. This increased risk will ultimately be reflected in a higher cost of equity, and lower value for the asset.

The appetite of infrastructure issuers for longer term debt is evidenced by UK and Canadian infrastructure issuers. In these markets, where long-term debt is available, infrastructure issuers have taken advantage of it to build long maturity profiles.

For example, in Canada, the owner of Toronto’s Highway 407 has a C\$5.4bn debt portfolio, made up almost entirely of Canadian bonds with maturities up to 2053 and an average maturity of around 19 years. This long debt profile significantly reduces the business’s refinancing risk.

Canada also demonstrates that an active project bond market supports long-term financing of the PPP part of the infrastructure market. Recent Canadian PPPs have a weighted average debt maturity of 28 years (Table 4 in the appendix).

Likewise, UK water and electricity networks have shown strong demand for long term debt through corporate bonds. Thames Water, for example, has an average debt maturity of 27 years.

Table 1: Selected UK water utilities weighted average debt maturities

	Total debt (£ m)	Weighted average maturity (years)
Thames Water	4,808	27
Severn Trent	4,631	16
Kelda	4,411	18

Source: Annual Reports, Bloomberg

When long-term local currency debt is available, infrastructure companies will use it. But Australian infrastructure companies do not have the same opportunity to use long-term debt as their overseas peers.

<sup>5</sup> Philip Lowe (Deputy Governor, RBA) speech to ASIC Annual Forum 2014, 25 March 2014.

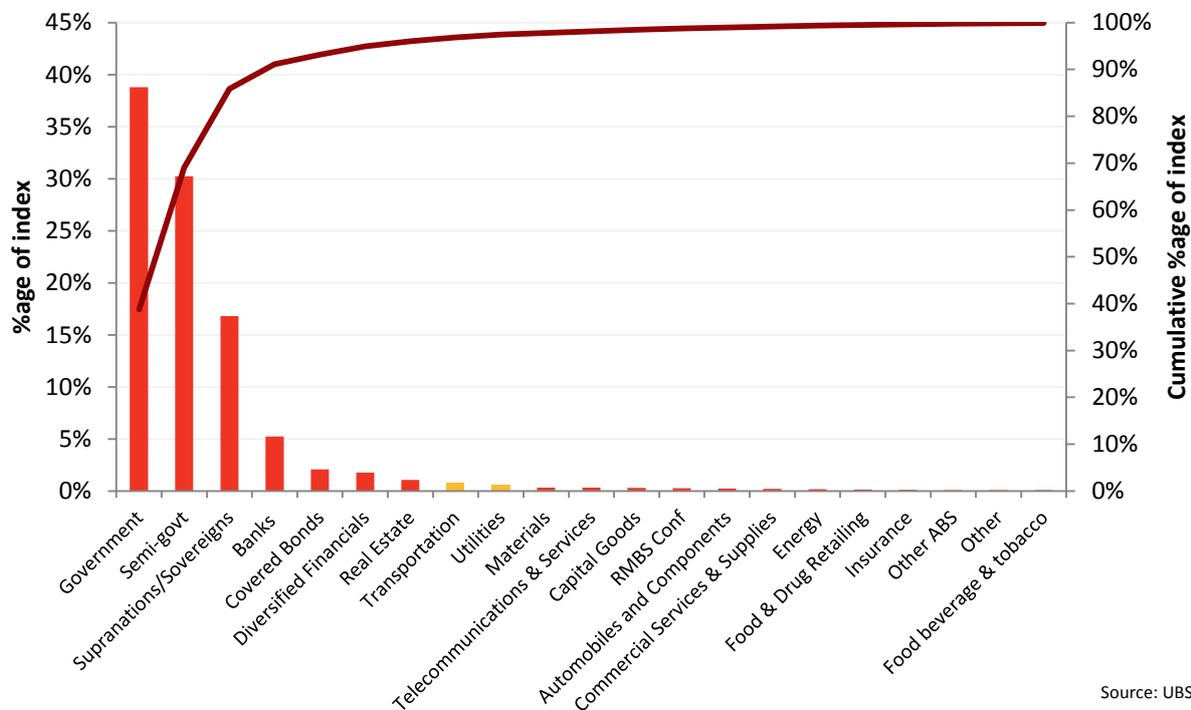
<sup>6</sup> Risk arising from the unknown future cost of debt

## 4 CHARACTERISTICS OF THE AUSTRALIAN BOND MARKET

### 4.1 Corporate bonds a minor part of Australian market

For Australian companies looking to access the local bond market, the options are more limited than those available to their overseas counterparts.

Corporate bonds account for only a small part of the domestic bond market. Using the market-standard UBS composite bond index (against which many fund manager’s bond mandates are benchmarked) as a measure of the broad Australian bond market, we note that it is dominated by government bonds, with non-government bonds being only 15% of the index. Going deeper, financial issuers (banks and covered bonds) dominate the non-government part of the index, with infrastructure issuers accounting for less than 10 per cent of the non-government (i.e. corporate) bond market.



Source: UBS

Figure 1: Composition of UBS composite bond index as of December 2013

As a result, Australian bond fund managers tend to focus primarily on strategies to trade government bonds; there is little focus on the credit skills necessary to trade corporate bonds. This particularly affects infrastructure issuers, which tend to have more complex structures that reward deeper credit understanding.

Liquidity is also a problem for Australian corporate bonds – with only a small share of the index, there is little trading in them so even fund managers with strong credit skills can find it difficult to monetise those skills by buying under-valued and selling over-valued bonds.

The infrastructure part of the UBS bond index had a face value of around \$8bn as of December 2013, split equally between transport and utilities companies. Tellingly, even for this sample of infrastructure companies that are active in the Australian bond market, Australian bonds make up only a small portion of their total debt. Infrastructure companies in Australia tend to be more exposed to bank debt as well as bonds issued overseas (chiefly in the US private placement market) as shown below (Table 2).

Table 2: Select Australian infrastructure companies' financing structure

	Total debt (A\$m)	Of which A\$ bonds (A\$m)	% of Total debt	Average total debt maturity	Average A\$ bonds maturity
Transurban	8,523	1,050	13%	10	3
Sydney Airport	6,200	3,848 <sup>7</sup>	62%	8	7
SP Ausnet	5,300	1,285	24%	5	8
APA Group	4,404	300	7%	6 <sup>8</sup>	8

Source: Company presentations and annual reports

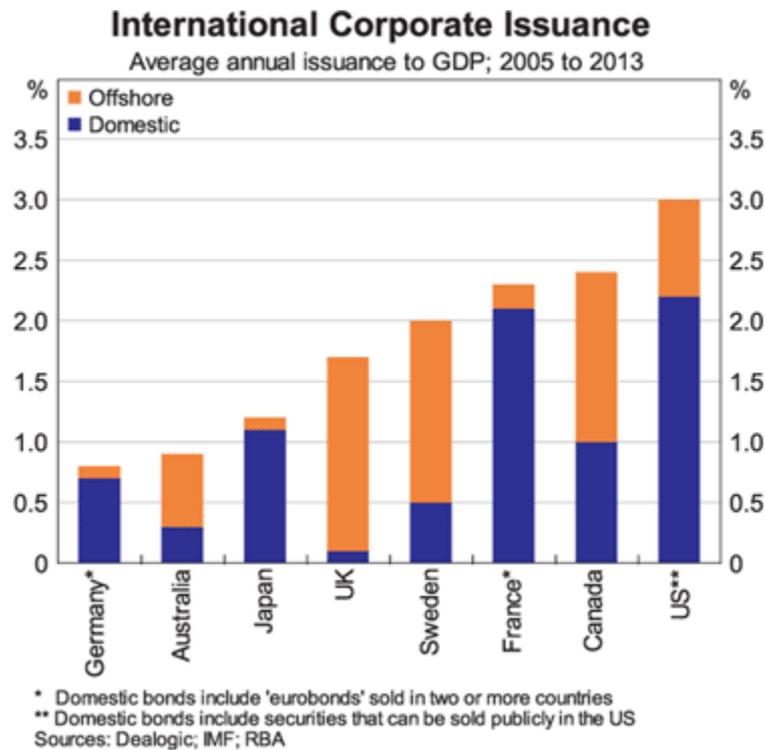
## 4.2 Australian corporate bond market small vs other developed countries

Australia's total corporate bond issuance is less than 1 per cent of GDP, of which only half is domestic bonds. This is low compared with other countries – US corporate bond issuance amounts to 3% of GDP and more than two thirds of corporate bonds are issued domestically (Figure 2). While the Inquiry notes that the US bond market is atypically large<sup>9</sup>, Figure 2 suggests that the Australian domestic bond issuance is smaller (relative to its economy) than a number of other developed economies, including Canada, France, Sweden, Germany or Japan.

<sup>7</sup> This includes \$2,578m of credit-insured bonds issued prior to the GFC. These would not be currently issuable under Sydney Airport's own rating.

<sup>8</sup> Excludes the \$515m long-maturity ASX-listed subordinated floating rate instrument. Including this instrument, APA Group's average maturity is 13 years.

<sup>9</sup> Interim Report, p2-7.



Source: RBA

Figure 2: Australia's corporate bond issuance compared to other developed markets

Canada is a particularly useful comparable – it is a similar-sized economy, with a significant resource dependency and a large pension / superannuation fund system. The Canadian long-term corporate bond market is well developed, with corporate bond issuance reaching nearly 2.5 per cent of GDP. By comparison, the Australian corporate bond market is around 0.25 per cent of GDP. Canada also has a strong market for infrastructure project bonds (Table 4 in the appendix shows some of the recent project bond issuance in Canada).

Acknowledging that the US bond market is a leader globally and therefore provides the widest range of products, it is worth considering the range of capital markets options for debt funding that are offered in the US. These include:

- Public offer bonds
- US private placement bonds
- Public "144A" bonds
- Municipal bonds

The private placement market in particular has proven a popular and reliable debt market for issuers (including infrastructure issuers) that may not want the full obligations of a public-offer bond. The US private placement market offers a wide range of debt maturities, including up to 30 years. The US private placement market is discussed further in section 6.

The United States also has a municipal bond market, offering bonds issued by local governments and government agencies paying coupons that are exempt from state and federal income taxes; the municipal bond market also includes project bonds (whose cashflows come from revenues specifically dedicated from particular projects). The municipal bond market is often used by US local governments to raise funds for infrastructure projects; no equivalent market exists in Australia.

The US’s capital markets provide US companies with a broad spectrum of financing options, a competitive alternative to bank lending and an opportunity to access long-term financing. Australian companies, and the broader Australian financial system, would benefit significantly from any move towards this level of capital market capability.

### 4.3 Tenor of Australian corporate bonds

Most Australian corporate bonds are issued with three, five, or sometimes seven year maturities. Occasional issuers at the upper end of the credit spectrum have been able to obtain nine year funding but these have been the exception rather than the rule. As mentioned in section 3.3, infrastructure businesses would prefer much longer term debt.

### 4.4 Offshore issuance dominates for Australian companies

Given the limitations of Australian debt financing, issuers often turn to offshore debt issuance. Around 40% of non-government debt securities are issued offshore (A\$539bn). For non-financial corporations, this proportion is even higher, with 76% of their debt securities being issued offshore (A\$179bn)

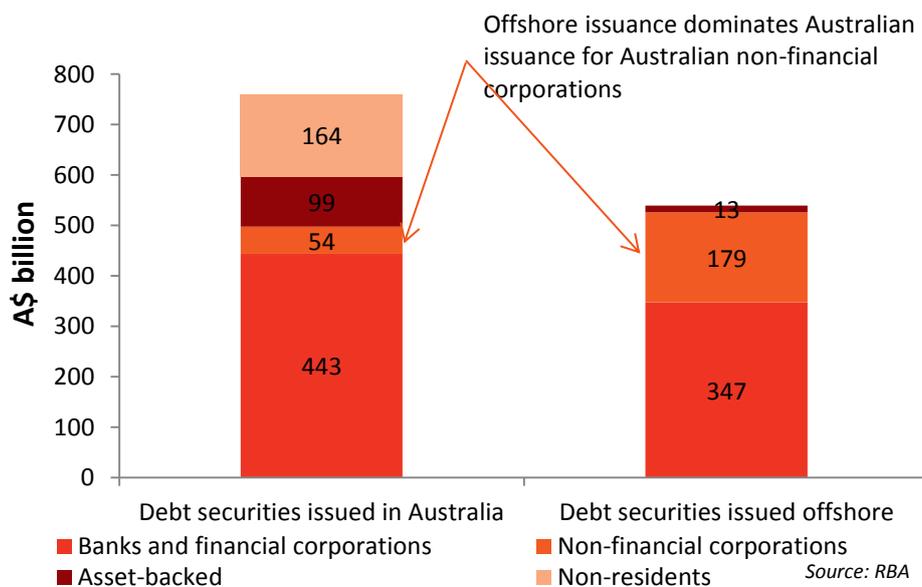


Figure3: Non-Government Debt Securities Outstanding

### 4.5 Outcome for Australian infrastructure companies

As a result of the limitations of the Australian corporate bond and bank lending, Australian infrastructure companies tend to have much shorter average debt maturities than their overseas peers. Unlike their US, UK, and Canadian counterparts, Australian infrastructure companies are unable to secure long-term domestic debt to match their asset lives and reduce refinancing risk.

For example Sydney Airport has a weighted average debt maturity of 8 years, even though the Sydney Airport concession does not end for 87 years, while the Canadian Highway 407 (with 84 years remaining on its concession) has a 19 year average debt maturity.

This mismatch between asset lives and debt maturity is a common theme in Australia -- the Australian bond and bank loan markets do not provide long-duration financing in the context of 30yr+ asset lives. The absence of long-term financing solutions burdens infrastructure assets with significant refinancing risk. In



turn, pricing this risk reduces the value of projects and thus reduces the efficiency benefits available to government from privatisation or private sector financing of infrastructure.

***So what contributes to the Australian bond market's more limited offering of financing options?***

## 5 FACTORS LIMITING THE AUSTRALIAN CORPORATE BOND MARKET

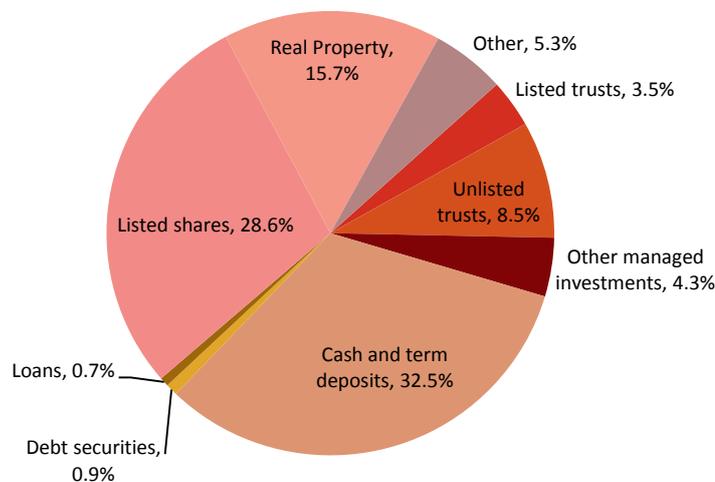
### 5.1 Superannuation asset allocation disfavours bond investment

The structure of the Australian superannuation system results in a bias away from bond investment and towards cash. This is discussed further in section 7.1.

### 5.2 Self-managed superannuation funds tend not to allocate to bonds

Self-managed super funds (SMSFs) play an important part in the pension fund landscape in Australia. According to APRA, SMSFs have grown at 15 per cent in 2013 to reach \$543bn in December 2013, or 30% of total superannuation assets in Australia. Over the last nine years, total assets managed by SMSFs have grown at 17 per cent per annum, as opposed to 11 per cent per annum for superannuation total assets.

As Figure 4 shows, SMSFs asset allocation tend to be allocated to cash, equity, and property, with less than 1 per cent exposure to debt securities. This means the high growth in the SMSF sector is actually contributing to an overall reduction in bond allocation in Australia superannuation savings.



Source: ATO, Self Managed Super Funds, A Statistical Overview 2011-2012

Figure 4: SMSF's asset allocation

This lack of investment in bonds could be due to a number of factors:

- **Government bank deposit guarantee:** The government guarantee of bank deposits less than \$250,000 means that most retail depositors can access an effectively risk-free investment at yields above actual government bond rates. This reduces the attractiveness of bond products.
- **Accessibility:** Retail investors also have limited access to retail bonds – the ASX trading of Australian government bonds has helped increase retail access but monthly turnover on this market has remained in the single digit millions of dollars. There is a limited range of listed corporate bonds (30 bonds with a face value of about \$15bn), most issued by the financial entities. Most corporate bonds trade “over-the-counter” in wholesale markets rather than on the ASX and are therefore not accessible to retail investors.

- **Attention:** Fixed income may also suffer from a lack of popular media coverage compared with shares. Financial advisers are also not as familiar with fixed income as they are with equity and may not generally present them as an option to their clients. This may be associated with retail investors valuing the potential for capital growth more than the potential for capital preservation and security that bonds offers.

### 5.3 Life insurance companies not major fixed income investors

In the US, Canada, and the UK, life insurance companies are major investors in bonds, with them to back portfolio of life insurance policies and annuities. In fact, US life insurance companies dominate the US private placement market (which provides much long-term financing for Australian corporates).

The dominance of superannuation as a form of long-term saving in Australia means that insurance companies are less significant. As the Inquiry's interim report notes, despite Australia's large retirement savings pool in superannuation funds, Australia's annuity market is tiny by international standards<sup>10</sup>. The Inquiry also notes that account-based pensions, the dominant form of retirement income in Australia, are less invested in defensive assets (such as bonds) than the assets backing an annuity.

Without the demand for lower-risk long-term assets coming from life insurance companies looking to match long-term liabilities, the Australian market overall has a lower propensity to invest in bonds.

Given these limitations, Australian companies look offshore to issue longer-dated debt.

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<sup>10</sup> Interim Report, p4-7.

## 6 OFFSHORE FINANCING OPTIONS

### 6.1 Case Study: US private placement market

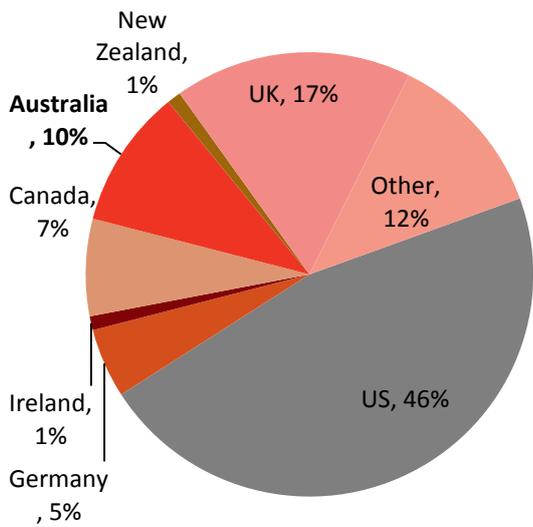
Australian bank loans are not meaningfully available for terms over seven years. Infrastructure issuers in Australia have therefore turned to off-shore markets to attempt to satisfy their requirements for long tenor debt. The most popular off-shore market has been the US private placement (US PP) market, although there are other markets that can be accessed by Australian issuers. This discussion focuses on the US PP market as the largest and most popular of the off-shore markets for Australian infrastructure issuers but the same conclusions would apply broadly to other off-shore financing markets.

Table 3: Recent US private placement by Australian and New Zealand infrastructure companies

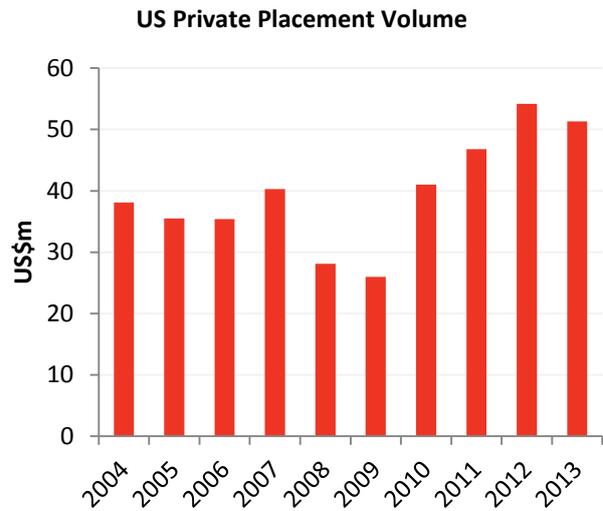
	Date	Principal (USD m)	Maturity (years)
Origin Energy	Feb-14	150	7Y / 10Y
AquaSure	Jan-14	310	10Y
Newcastle Coal Infrastructure	Oct-13	150	7Y / 10Y
Wellington Electricity Distribution Network Ltd	Aug-13	120	7Y / 9Y
Contact Energy	Jun-13	240	7Y / 10Y / 15Y / 10Y / 12Y / 15Y
Brookfield Rail	Mar-13	700	7Y / 9Y / 10Y / 12Y
Electranet	Feb-13	410	4Y / 12Y / 15Y
Powerco Limited	Oct-12	105	12Y / 15Y
Newcastle Coal Infrastructure	Oct-12	325	7Y / 10Y / 12Y
Brisbane Airport Corporation	Jul-12	215	10Y / 12Y
Envestra	Jul-12	200	10Y / 15Y
Port of Brisbane	Jun-12	550	7Y / 10Y / 12Y
Perth Airport	May-12	300	10Y / 12Y / 15Y
TRUenergy	Mar-12	400	5Y / 7Y / 10Y / 12Y / 15Y
Transpower NZ	Sep-11	380	10Y / 12Y / 15Y
Unison Networks Ltd	Aug-11	100	10Y / 12Y
Melbourne Airport	Jun-11	600	10Y / 12Y / 15Y
Powerco Limited	May-11	245	9Y / 12Y / 15Y

Source: Westpac Weekly Bond Wrap

The US PP market has been a reliable provider of financing over the past ten years, providing more than US \$20bn per annum even during the global financial crisis. In 2013, the US PP market raised US\$51 billion of debt, of which 14% came from infrastructure assets. Issuance from Australian companies represented 10% of total issuance in the US PP market.



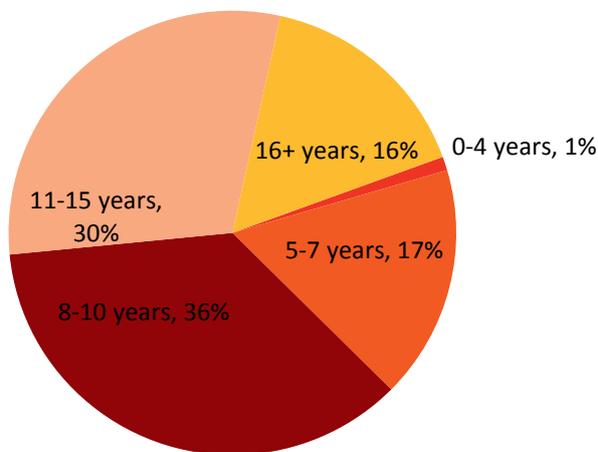
Source: NAB



Source: BAML

Figure 5: US Private Placement Issuance by region

CFOs of Australian infrastructure issuers mention the long tenor of debt available and the need for diversification of funding sources away from Australian banks as the main reasons to issue debt in the US PP market<sup>11</sup>. Figure 8 shows that the tenor of the US PP issuance in 2013 was heavily weighted to more than 10 years.



Source: NAB

Figure 6: US Private Placement Issuance by tenor

## 6.2 Limitations of off-shore financing

While the US PP market has been a reliable source of funding for Australian companies in general and infrastructure companies in particular, there are a number of limitations on the ability of Australian infrastructure issuers to access long-term debt from offshore markets:

- Requirement for cross-currency interest rate swaps

<sup>11</sup> "Debt markets roundtable: Trends and opportunities In US borrowing", AFR, 12/03/2014

- Limitations in concession deeds
- Not available to all issuers.

Of these three limitations, only the third would apply to Australian domestic bond issuance (if it were available at the required tenor).

### 6.2.1 Cross currency swaps

Any Australian borrower using off-shore funding must hedge the currency risk arising from any mismatch between the currency of borrowing and the currency in which the borrower receives its cashflow. Without this hedging, the off-shore loan has embedded foreign exchange risk – a risk few borrowers would choose to take on. Almost all Australian infrastructure borrowers have cashflows entirely in Australian dollars, so hedging is required for foreign-currency borrowing.

Hedging should ideally match the cashflows of the underlying borrowing; this means that the combination of foreign-currency borrowing plus hedging is equivalent to an Australian currency borrowing (i.e. no residual currency risk). Typically, this is accomplished by way of a cross-currency interest rate swap.

There are three potential problems with cross-currency interest rate swaps:

- **Pricing:** Cross currency interest rate swaps come with a cost (the “basis”) which is essentially the difference between the supply for these swaps and demand for them. As the Australian economy requires consistent investment of foreign capital, the basis swap typically increases the cost of an off-shore loan once converted back to Australian dollars. This basis can vary significantly over time, and would be expected to increase if the amount of offshore borrowing by Australian companies increases. Without an effective long-term Australian bond market (which requires no basis swap for Australian issuers) there is effectively no alternative to cross-currency swaps (and paying the basis) for Australian borrowers needing long-term debt.
- **Impact on issuer’s bank credit capacity:** Cross-currency interest rate swaps also reduce the ability to borrow from banks. While swaps are generally matched to the cashflows of the underlying loan, the swaps can experience very large mark-to-market movements prior to maturity. This does not create cashflows but, in the event that the Australian dollar has appreciated against the borrowed currency, the swap will have a large negative mark-to-market value; from the perspective of the banks that provided this swap, this value will represent a credit exposure to the borrower and will reduce the extent to which those banks can lend to that borrower in Australian dollars. To put it another way, a foreign-currency bond with a cross-currency swap could actually reduce a borrower’s ability to borrow from banks.
- **Tenor:** A further issue with cross-currency interest rate swaps is tenor. While banks are sometimes willing to write swaps with a tenor of more than 10 years, they will typically require a break right at 10-12 years. This requires the borrower to pay any mark-to-market value of the swap after ten years. While this requirement reduces the bank’s potential credit exposure, it creates the potential for a severe liquidity problem for the borrower, because (depending on movements in exchange rates) a borrower may be forced to find a substantial payment to the swap provider. The ability to issue long-term debt is therefore constrained by the length of cross-currency swaps available without break rights.

### 6.2.2 Concession deed limitations

Some infrastructure concessions in Australia, such as toll roads, may enforce restrictions on refinancing or issuing additional debt. For example, each refinancing may require state government consent. In addition, a concession deed issuer may be restricted from issuing bonds in domestic and/or international debt capital markets.

Offshore debt capital market issuance provides the greatest concern for governments because of the need for cross currency swaps and the potential volatility caused by negative mark-to-market valuations on the swaps if a concession is terminated and a termination payment is required to be paid.

### 6.2.3 Minimum size

Offshore financing is not available to all infrastructure issuers. In particular, companies with greenfield assets or in construction phase are unlikely to be able to access these markets (although this is likely to be true for Australian domestic bonds as well). Companies with credit ratings below investment grade (or no credit rating) will find their access significantly curtailed. Small issuers with bond requirements of less than US\$500m won't have the ability to create long-term supply of bonds into the US PP market and may find accessing this market difficult.

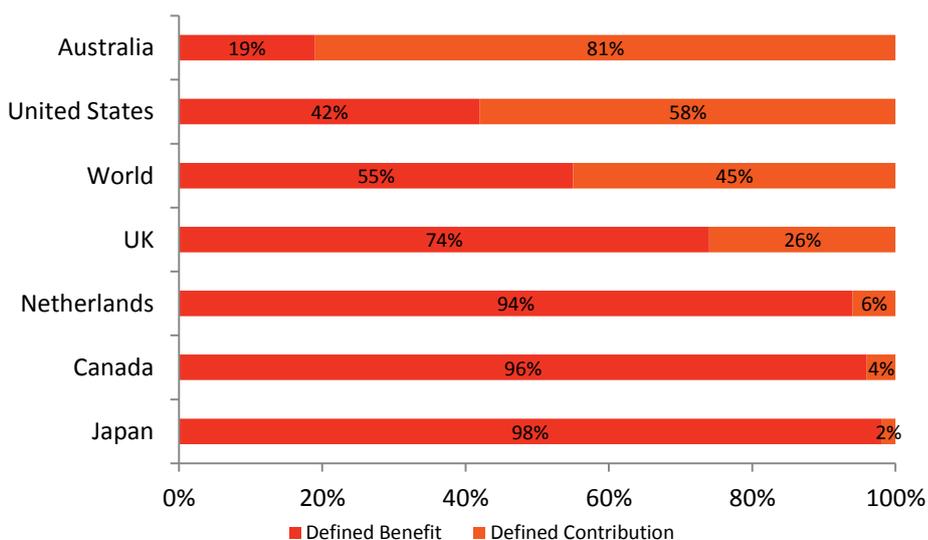
## 7 SUPERANNUATION

### 7.1 Superannuation asset allocation disfavours investments in bonds and illiquid assets

The superannuation system dominates Australia's pool of savings but has a lower allocation to bonds (fixed interest) than the retirement saving systems of other comparable economies. This institutional allocation away from bonds is likely due to a range of factors including:

- The predominantly defined contribution nature of the Australian superannuation system
- Super fund choice / portability

With US\$1.6 trillion in assets, Australia's superannuation system is the fourth largest pension system in the world<sup>12</sup>. However, Australia's pension system is not like other large systems. The Australian retirement savings system is dominated by defined contribution schemes: 81% of total pension assets come from defined contribution schemes, and just 19% from defined benefit schemes. In contrast, Canada only has 4% of its pension assets in defined contribution pension plans, with the vast majority in defined benefit pension plans.



Source: Towers Watson Global Pension Assets Study 2013

Figure 7: Split of defined benefit vs defined contribution plans by country

<sup>12</sup> Global Pension Assets Study, Towers Watson (January 2013)

The implications for pension asset allocation of this split between defined benefit and defined contribution plans are significant. Defined benefit plans place the risk of meeting the obligation to pay a specified pension on the plan sponsor and its fiduciaries. Defined benefit plans are therefore much more likely to drive asset allocation to match anticipated future pension plan liabilities with assets. This asset-liability matching favours bonds (particularly longer-term bonds) whose duration and low cashflow risk provide good matches with the liability profile of pensions.

Defined contribution plans, by contrast, push the risk of investment performance down to the individual saver; typically individual savers have the right (albeit usually unexercised) to manage their portfolio in some way. In Australian superannuation, this right is in the form of choice of fund and choice of investment. In other words, superannuation funds in Australia are characterized by their portability (both by asset allocation and provider); any superannuation fund beneficiary can transfer his or her funds to another investment strategy or another superannuation fund. This right incentivises superannuation funds to invest in more liquid assets than in countries where pension savings are not portable. As **Error! Reference source not found. Error! Reference source not found.** shows, Australian funds hold significantly more cash than funds in other countries, and significantly less in bonds – resulting in the largest pool of savings in Australia having only a limited allocation to bonds.

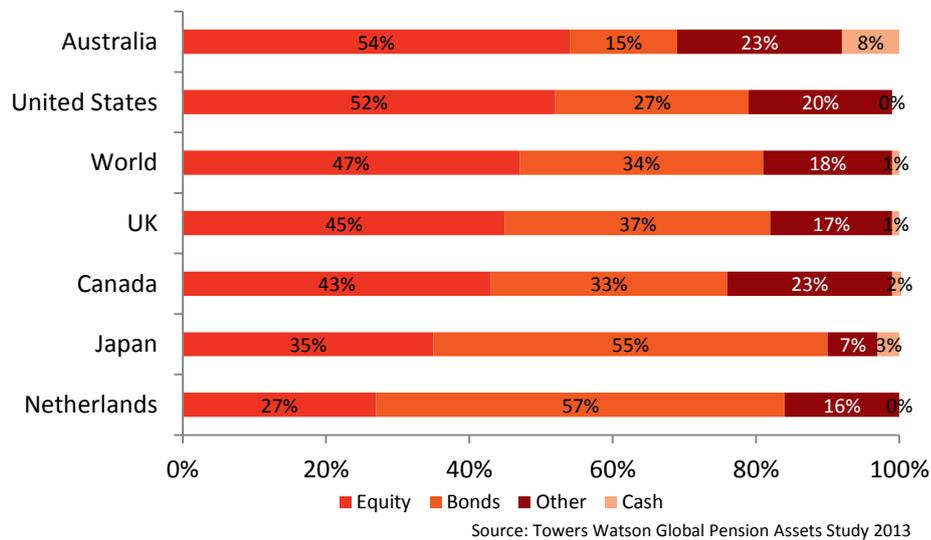


Figure 8: Pension fund asset allocation

## 7.2 Portability and liquidity rules create mismatch between funds and members

The Inquiry highlighted the demand for liquid assets by superannuation funds<sup>13</sup>, noting in particular the effects of the requirement for portability of superannuation benefits between funds, and the allowance for member switching.

We believe that an important consequence of member investment switching and portability of benefits on short notice is the resulting misalignment between the superannuation beneficiaries and the superannuation fund. From a fund perspective, any member can potentially leave the fund at any time; while in practice this does not typically occur, the possibility of a ‘run’ on a fund (especially in the event of poor performance) will require the fund to maintain higher levels of liquidity than it otherwise would to

<sup>13</sup> Interim Report p2-110.

protect against this potential short-term liquidity requirement. By contrast, from the investor's perspective, superannuation benefits are (by law) a long-term investment, with no liquidity available until retirement.

This misalignment, then, is that a superannuation fund is incentivised to treat its members' investments as short-term in nature when they are not. This leads to superannuation funds having a lower preference invest in illiquid assets and a lower ability to harvest any available illiquidity premium, notwithstanding that super represents one of the longest-term savings pools in Australia.

Ironically, the requirements of member choice and portability actually reduce the ability of superannuation members to choose illiquid assets.

## 8 CONCLUSIONS

### 8.1 Motivation for changes

The RBA has identified the corporate bond market as an important fall-back option for the economy (in the event of a banking crisis) as well as a useful institution in its own right<sup>14</sup>. Furthermore, by offering an alternative to bank intermediation of financing, a domestic corporate bond market provides competition to the bank loan market.

For an infrastructure borrower, the development of this alternative is overdue – the bank loan market does not typically provide loans of more than seven years tenor and offshore financing has limitations that prevent it from being more than a partial solution to the problem. Infrastructure issuers need longer duration domestic debt to lower their refinancing risk and cost of equity.

This lack of long-term debt is not merely a problem for infrastructure investors -- by limiting the ability of infrastructure companies to reduce their refinancing risks, equity risk and required return increases. This reduces the value of infrastructure assets and the benefits available to governments from privatisation or private sector involvement in delivering much needed infrastructure.

### 8.2 Recommendations

This section presents our recommendations. In making recommendations, we have been conscious of the Inquiry's interim report, and of the narrow nature of our concerns within the broader scope the Inquiry has been given.

Whilst we recognise that no one factor can "develop" the Australian domestic bond market, we set out below a number of considerations that we believe will assist this over time.

#### 8.2.1 Increase incentives for individuals to seek annuities

Previous reviews have suggested that there might be broad policy benefits to increasing the uptake of annuity products upon superannuation rollover. The Henry tax review highlighted the issue of longevity risk<sup>15</sup> and the need for longevity risk management products in Australia. The Inquiry's interim report devotes considerable time to detailing the current status of retirement incomes and seeking feedback on alternative policy options for the retirement income system<sup>16</sup>, providing a range of outcomes from status quo, incentives, defaults or compulsion.

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<sup>14</sup> Philip Lowe (Deputy Governor, RBA) speech to ASIC Annual Forum 2014, 25 March 2014.

<sup>15</sup> Longevity risk refers to the risk that an individual will outlive its retirement savings coming from defined contribution accumulations, therefore creating a fiscal burden for governments providing pensions.

<sup>16</sup> Interim report, p4-25.

While a full response to this question is outside the scope of our infrastructure-financing focused submission, we believe that any assessment of default retirement income options or compulsion should include some consideration of the ancillary benefits to Australia's overall financial system of a healthier and more vibrant bond market.

More annuity products would generate a meaningful increase in demand for liability-matching assets. This should lead to an overall increase in the demand for bonds, including corporate bonds, as well as an increasing demand for long-duration (>10yrs) bonds. Annuity-products would not be subject to the current liquidity requirements of superannuation funds (driven by portability and switching requirements), so would be in a good position to harvest any potential illiquidity premium from longer-dated corporate or infrastructure bond issuance, as well as other illiquid alternatives.

Clearly, the retirement income policy incentives must be primarily driven by what is best for Australia as a whole. Nevertheless, we believe that the experience from other markets (cited in section 4) suggests that there would be meaningful ancillary benefits for the development of financial markets in Australia from greater uptake of annuities by retiring Australians; this should be considered on the benefits side of any assessment of annuity incentives. In other words – increased take-up of annuities would deliver public policy benefits (reduced longevity risk borne by retirees and the Australian government via the pension), as well as increasing annuity affordability by reducing adverse selection.

## **8.2.2 Retail bond market development**

Self-managed superannuation funds are of growing importance and they should have equitable access to defensive investments (like bonds). Consequently, we support government incentives to develop the retail bond market, including by listing government bonds on the ASX, allow listed issuers to issue vanilla bonds to retail investors (per the , and supporting educational efforts to help SMSFs manage their asset allocation with due care (including an appropriate investment in long-term defensive assets like bonds).

## **8.2.3 Superannuation portability and liquidity**

The Inquiry seeks feedback on potential alternatives to the three-day portability rule, including a longer period or moving to a principles-based approach.

One potential solution is to make member portability a revocable right; that is, to allow superannuation funds to offer illiquid investment choices, on condition that members agree to reduce their rights to switch or port out that part of their superannuation balance. For example, a superannuation fund could offer an "Alternative Illiquids" option to members, but members who select this option would have to accept a longer delay in any switch to another investment option or another fund.

This would allow super funds to offer a wider range of investment options to members (such as loans, property, private equity, infrastructure equity, etc.) which may be appropriate for long-term savings such as superannuation but which are currently disfavoured by the requirement to offer full portability and switching rights for all investments.

## 9 APPENDIX

### APPENDIX 1: PPP PROJECT FINANCING IN CANADA

Table 4: PPP project financing in Canada

Issuer	Credit Rating	Maturity (years)	Amount (C\$)
Acces Recherche Montreal LP (CHUM Research Centre)	A(low)/A3	3.0	59
Acces Recherche Montreal LP (CHUM Research Centre)	A(low)/A3	33.0	332
CSS FSCC Partnership (Forensics)	A(low)/A-	32.0	190
SNC-Lavalin Innisfree McGill Finance Inc.	A(low)/A	34.0	764
Plenary Health Hamilton (St. Joe's Hamilton)	A/A	5.0	115
Plenary Health Hamilton (St. Joe's Hamilton)	A/A	33.0	255
Plenary Properties LTAP LP (CSEC)	A/A	4.8	167
Plenary Properties LTAP LP (CSEC)	A/A	33.0	840
Integrated Team Solutions SJHC Partnerships (St. Joe's London)	A(low)/A-	31.8	212
Health Montreal Collective LP (CHUM Hospital)	BBB(high)/Baa2	38.3	1,371
Hospital Infrastructure Partners (NOH) Partnership (Halton)	A(low)/A-	33.5	544
Plenary Health Care Partnerships Humber L.P.	A/A	3.7	482
Plenary Health Care Partnerships Humber L.P.	A/A	27.7	375
Plenary Health Care Partnerships Humber L.P.	A/A	33.2	149
Capital City Link General Partnership (Henday)	A(low)/A-	34.0	535
407 East Development Group	A(low)/A-	4.6	451
407 East Development Group	A(low)/A-	33.1	120
Plenary Health Kelowna L.P.	-	32.0	73
ABC Schools Partnership (ASAP 3)	A-	31.3	87
Rainbow Hospital Partners	A(low)	1.2	52
Rainbow Hospital Partners	A(low)	30.7	71
Arctic Infrastructure LP (Iqaluit)	A-	33.8	142
Integrated Team Solutions PHC Partnership (ITS) (Providence Care)	A-	3.0	154
Integrated Team Solutions PHC Partnership (ITS) (Providence Care)	A-	32.5	171
InPower BC General Partnership (John Hart)	BBB(high)	19.1	299
Plenary Justice Okanagan Limited Partnership	A(low)	32.1	115
<b>Weighted Average Life</b>		<b>28.0</b>	

Source: TD Securities