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4 April 2014

Productivity Commission
Public Infrastructure Inquiry
infrastructure@pc.gov.au

Attention: Mr Peter Harris AO, Chairman - Productivity Commission

Dear Mr Harris

The National Australia Bank (NAB) welcomes the opportunity to contribute towards the Productivity Commission's inquiry into public infrastructure projects in Australia. NAB broadly supports the recommendations and findings made in the interim report.

NAB is well placed to provide comment on infrastructure financing and the development of the corporate bond market. The NAB Group has market-leading teams with a track record of arranging, financing, managing and coordinating successful high profile debt transactions for clients across the infrastructure sector in Australia, New Zealand, Asia, the United Kingdom, and the United States.

As a lead debt arranger and financier of infrastructure projects in Australia, NAB believes the Productivity Commission's inquiry is particularly timely. NAB supports improvements to the structure of infrastructure projects, an appropriate balance between liquidity and longer-term investing, and the development of the corporate bond market.

NAB also acknowledges that, together with this Productivity Commission review, there are concurrent government activities taking place that address areas NAB sees as fundamental in improving the way infrastructure is planned and financed in Australia. In particular, NAB's submission to the Financial System Inquiry responds to many of the issues highlighted in the Productivity Commission's interim report – namely, (1) increasing the role of superannuation and the broader financial system in funding Australia's long-term growth and infrastructure requirements, and (2) addressing impediments to growth of a deeper and more liquid corporate bond market.

In the midst of significant regulatory change and subdued growth outlooks across some of the world's largest economies, there are few more important tasks than driving Australia's economic growth prospects over coming decades. Without appropriate funding mechanisms for our economy, Australia's economic growth and living standards could potentially be at risk. Fortunately, Australia's financial markets are in a strong position globally, with profitable and safe banks, a well regulated financial services sector, and large pools of funds in the private wealth sector through superannuation savings.

It is imperative that we seize the opportunity that this fortunate position provides, to look at the funding arrangements of this nation, and in particular those that are going to drive growth for future generations.

NAB believes that financing of large scale, long-term infrastructure projects will need to come from a variety of public and private sector sources. This is particularly the case given the need for banks to diversify their loan portfolios, to avoid excessive maturity mismatches between assets and deposits, and to not have excessive exposure to one borrower or project. NAB recognises that this is a complex challenge; there is no easy, single solution and it is vital that there is ongoing engagement between industry, government and regulators.

In being a vocal advocate and active participant in development of the Australian bond market, NAB's focus over the last two years has been on the development of a deep and liquid retail corporate bond market. NAB considers this necessary for financing Australia's future growth.

In particular, over the last twelve months, NAB has demonstrated its commitment to the development of deeper and more liquid corporate bond market through the sponsorship of four research papers authored by the Australian Centre for Financial Services. NAB believes education, through materials such as these, provide for a greater understanding of corporate bonds as an asset class. The aim for this research is to help increase understanding of the asset class, improve financial awareness in this field, and break down misconceptions. These papers focus on the different aspects of the corporate bond market for issuers, investors and the broader community.

While the development of a retail corporate bond market forms an important part of the desired bond market development, NAB's comments with respect to the domestic infrastructure bond market cover the broader corporate bond market and the spectrum of investors, from institutional through to sub-institutional; including high net worth and retail investors.

Included in Appendix 1 are NAB's views on how the Productivity Commission might consider further developing this nascent, but very important market. These positions are responses to specific bond related information requests raised in the interim report.

NAB appreciates the opportunity to make comment on the Productivity Commission's interim report and looks forward to further engaging on this important matter once the final report has been released.

Regards

Rick Sawers
Group Executive, Product & Markets
National Australia Bank

Appendix 1

Information Request 5.1

Point 1:

To what extent are there impediments to the development of the Australian bond market to support investment in infrastructure?

NAB views the following as significant impediments to the development of an Australian bond market, which is able to support infrastructure investment:

- **Complexity of risk:** The analysis of risk may be considered to be complex, particularly in greenfields transactions. Although some institutional investors have developed or are developing in-house expertise to assess these risks, broader buy-in will require selective investment in less complex structures and credits exposures; for example, investment in operational brownfields projects or projects that are not exposed to patronage risk. The procurement of external credit ratings to create risk visibility and/or minimum public financial disclosure (similar to that required under ASX listing rules), thereby ensuring adequate public information for retail investors to understand project risks, would support institutional and sub-institutional issuance.
- **Return mismatch:** Domestic institutional and sub-institutional investors generally require returns that are significantly higher than what the borrower can obtain through the bank debt market or the domestic investment grade rated Medium Term Note (MTN) markets; with returns not being attractive enough to direct funds from other investment choices. In addition, it is noted that investors have demonstrated limited appetite for corporate bonds, partly reflecting the current tax bias against fixed income versus equities.
- **Current bid process:** As the current market requires bids to be submitted with committed financing without price flexibility, it is difficult to develop a market for underwriters to provide firm bond pricing at the time of bid lodgement, which will carry to the time of bond issue at financial close.
- **Structure of the Australian superannuation system:** Although superannuation funds have demonstrated a willingness to invest in infrastructure assets at an equity level, there is no incentive for them to match fund liabilities and invest in longer term assets. Impediments to debt investment include relatively uncertain yields, large and undefined infrastructure assets in the public-private partnership (PPP) pipeline, and regulations that require superannuation funds to be liquid in order to meet member switching and redemption demands. In addition, there are no incentives for superannuants to vest in annuity type products at the time of their retirement.
- **Familiarity with this asset class:** Due to the lack of availability in infrastructure related bonds beyond the domestic MTN market, the broader investor base is not familiar with this asset class and has limited allocation to fixed income product.
- **Accessibility:** Although retail investors can readily access equities, restrictions around selling unlisted bonds to non-wholesale investors mean retail clients are not able to access bonds of the same issuers; despite bonds generally being more secure and stable from a capital structure perspective.

- **Lack of liquidity:** While strong liquidity is observed in the domestic MTN market, domestic bond liquidity is generally limited to 7 years and restricted to investment grade credits and wholesale investors.

Point 2:

To what extent are there barriers to Australian infrastructure firms accessing international bond markets?

The key barrier for infrastructure firms concerns the lack of availability for AUD funding in the international capital markets. Therefore, a cross currency swap is required to swap the alternative currency, such as USD or GBP, back to AUD.

With respect to PPPs, the state is asked to provide consent to borrow foreign currency and swap into AUD. Generally, this is not provided as part of the tender proposal and therefore requires the borrower to seek consent, adding additional process and potential delay to the transaction. There can also be some hesitancy for states to provide the consent, believed to be related to caution around currency risk issues and the termination provisions in the contracts/tenders. Where an Australian infrastructure firm has accessed international markets individually (without state partnership and therefore state terms) they have done so successfully, and there has been no concern with the cross-currency swap (i.e. Newcastle Coal Infrastructure Group, Port of Brisbane, various Australian airports).

While the additional cost of including the cross-currency swap is well covered by the current attractiveness of long term offshore pricing, swap providers are required to obtain significant limits to undertake the swap transaction. Such limits may not always be available, particularly where the bank is being asked to be an 'orphan swap provider' on a deal. In addition, some counterparties do not have the capacity or the required rating to provide such swaps.

Point 3:

The Commission seeks views on the costs and benefits of governments issuing project-specific infrastructure bonds, with the interest rates reflecting the risks of the project and which explicitly do not have a government guarantee

NAB is of the view that governments issuing project-specific infrastructure bonds could help address some of the issues identified in Point 1 above. That is, the issuance of these bonds could address the points regarding flexibility of final price in the bid phase, given the government would be in control of the bond issue process. Bonds could be structured such that there is minimal complexity and clear assessable risk to the investor. The issuance of these bonds would then assist in creating liquidity in the market, particularly if they were issued on a reasonable scale.

It is expected that the difficulty of this proposal will concern determining the appropriate margin for risk on these bonds, and the potential that investors will assume there is implicit or moral support provided by the government to ensure the bonds perform.

Point 4:

The Commission seeks views on the costs and benefits of governments issuing converting infrastructure bonds to finance greenfields infrastructure investments

Although there may be some investors who would have appetite for these instruments, on a scale level and consistent with the comments in Point 1 above, NAB is of the view that governments, industry participants and investors would be best served by the creation of more liquid, less complex and accessible products. In addition, the model for exposure and management of construction risk by the government would need to be properly understood to determine whether this is an effective model. NAB does not currently hold the view that converting bonds would form a significant part of the market in the short to medium term.