Submission to the Commonwealth Debt Management Review

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Introduction

The federal government is planning to reduce the amount of federal government debt to zero by 2005. The rationale for this decision is based on continued budget surpluses and sound economic performance of the Australian economy. Treasury officials and market participants are at odds as to the benefits or wisdom of this decision given the role that federal government bonds in particular play in pricing and risk management and for funding portfolio strategies in Australia.

This submission supports the need for a developed capital market where capital can be raised from equity markets, debt issuance and banks. The submission canvasses the alternative of the federal government assisting in the development of a more liquid high credit quality corporate bond market that will attract international investors and grow at rate to meet the predicted increase in demand from superannuation funds for high quality medium term debt/coupon securities in their balanced portfolios.

Background

The Commonwealth Government's Review of the Commonwealth Government Securities Market Discussion Paper (2002) summarises the key roles of the Commonwealth Government Securities (CGS) in Australia as being the basis of pricing financial products; a reference point for benchmarking other financial products; a useful tool in managing financial risk; providing longer term investment vehicles; having a role in the implementation of monetary policy; providing a safe investment haven in times of financial instability; attracting foreign capital inflow to Australia; and when promoting Australia as a global financial centre, that there exists a liquid CGS market as part of the overall capital markets structure in Australia. In spite of these important functions, the Australian Office of Financial Management has a policy to reduce debt to zero by 2005 (Baker 2002a).

The issues at hand therefore are not simply the impact on Australia's capital markets should the CGS market cease to operate, but also how can the key roles outside of the raising of debt for federal government expenditure purposes be

replaced that will ensure ongoing depth, security and efficiency of the Australian capital markets?

The decision to reduce government debt outstanding is not a new decision. Since the 1996-1997 federal budget, the focus of the federal government has been to reduce debt and increase federal asset sales. The $100 billion in CGS on issue at that time has been reduced to $50 billion. Over the same period, funds under management in superannuation schemes have risen from approximately $300 billion to approximately $600 billion (Skeffington 2002). The decreasing budget deficits and the increase in the push to make individuals more responsible for the retirement savings has created an environment of decreasing supply, with an increasing demand for high credit quality, low risk debt securities from superannuation fund managers (Brown 2001). The supply and demand issues seem to have kept yields down and have also balanced an expected increase in liquidity premium due to the decreasing liquidity.

Whilst the market liquidity in the CGS market is declining, the overall turnover in debt market securities in Australia has risen – futures, swaps and forward rate agreements (FRA's) turnover has increased. The total debt market turnover in 1997-1998 was $65 billion per day and by 2000-2001 the turnover had increased to approximately $90 billion per day (Baker 2002b).

This turnover in debt has been supported by an increase in domestic corporate bond market issuers. The corporate bond market has already developed issued amounts greater than the semi-government bond markets, and in mid-2001 had outgrown the CGS market (Brown 2001). This corporate bond market has been dominated by off-shore investors and off-shore issuers which could indicate a sophistication in the abilities of the participants in offshore capital markets to assess credit risk better than their domestic counterparts. In addition, the Kangaroo bond market continues to grow in the Asia Pacific region (Asiamoney 2000). Maturities are getting longer as investors become more comfortable with Australian names being offered.

The federal government sees that it is faced with three decisions – to wind down the CGS market; to consolidate the state and federal bond markets; or to maintain the CGS market and fund the Commonwealth's unfunded superannuation liabilities. This unfunded superannuation liability is not an insignificant amount at $84 billion (Skeffington 2002). The idea to issue bonds to invest in other assets to generate a return to fund this liability into the future has merit when considering the low cost of capital the government would face. But would this low cost of capital remain so in the face of tightening liquidity?

Liquidity Premium

A key area for future research and quantification is the cost of the liquidity premium given a market where demand is outstripping supply. Before the government can move forward on its idea to reduce the CGS market to zero, there needs to be an estimate of what the liquidity premium is and a comparison of that cost to the cost of maintaining a CGS market for the government. There is a view that the liquidity in the CGS market is already so low that there are better ways for

the government to manage its funds (Skeffington 2002). This is a very appealing opportunity for the government to reduce the long term coupon commitments in exchange for short term discount commitments.

The political advantage of not saddling future generations of Australians with the present generation's debt is significant, given the failure of Ricardian equivalence arguments to operate in empirical settings. However, a known current liability that can only grow should be offset with a current asset that grows at a faster rate. High growth, low or medium risk investment opportunities are diminishing in global capital markets. A commitment to issuing bonds for investing means a commitment to seeking offshore investment opportunities. It also means a commitment to increasing the amount on issue rather than decreasing the total CGS outstanding.

Credit Risk

Credit risk is a real risk in modern global financial markets. Default of either the interest payments or the capital repayments can occur at any level of credit rating. Whilst the government guarantee has always been supported in financial markets as the risk free rate for that economy, there have been spectacular instances in the past where governments have been unable to repay sovereign debt (e.g Mexico, Russia). Aside from these "one-off" instances, the other real risk in international markets is the change in the federal government credit rating that may occur when economic fundamentals deteriorate. Any time that a government has to pay a higher fee for its debt, the underlying economy pays a higher fee for its debt. In addition, Brooks, Faff, Hillier and Hillier (2002) have found that sovereign rating downgrades also impact on national stock markets suggesting a widespread impact of ratings changes.

Issuers and investors cling to the concept of federal government debt being the risk free rate of an economy. There are signs that this view can be re-educated to accept other securities as the lowest risk security in the Australian market. The ultimate risk free rate, the cash rate, has already switched from its historical physical status to a derivative. The Reserve Bank of Australia (the RBA) has switched to the indexed swap rate as its yard stick for short term interest rates (RBA 2002). The maturity of indexed swaps are one week to one year, although most are short term with three moths maturities accounting for 50% of the turnover. The market has grown since its inception in 1999 to a turnover of approximately $2 billion per day, compared with $34 billion in bank bill futures daily and $6 billion in bank bills daily (Baker 2002a).

The US Experience

This decreasing federal government debt is not limited to the Australian economy. In the US, between 1996 and 2000 the US government decreased the amount of coupon bonds issued by 50% and the amount of T-Bills issued by 30% (Chakravarty 2002). The role of US Treasuries in the capital markets is the same as the role in Australian CGS markets – benchmarking domestically and globally, hedging and safe haven for domestic and international investors, although global

safe haven markets are clearly more significant for the US. Similarly the US are experiencing the same impact of falling liquidity on hedging and the safe haven status for investors.

During 2000, the US government started an aggressive buy-back program of the 30 year bonds. The liquidity impact was so great as to cause the yield curve to invert. There was no corresponding inversion in corporate or Agency debt and subsequently the 30-year bond was abandoned as a benchmarking and pricing tool by market participants. However, the Treasury bond yield curve was not abandoned – the bellwether focus shifted back to the 10 year Treasury (Lamm 2000). The change in the dominance of the 30-year Treasury impacted on pricing for "off the run" (non-hot stocks) bonds and on the pricing of options and other derivatives. This was in part due to the substantial levels of liquidity and daily turnover of the 30-years making it the most easily priced longer dated government security.

When estimating what was to replace the Treasuries as benchmark securities, significant numbers of market participants believed the Agency debt market would supplement Treasuries over the next year (2002). The Agency market in the US is dominated by the Federal National Mortgage Association (Fannie Macs), the Federal Home Loan Mortgage Corporation (Freddie Macs) and the Federal Home Loan Bank System. There are a number of reasons why the basis of this thinking is well-supported. There are a large number of issues, over a large number of maturities. The secondary market is very liquid and the cumulative outstanding debt from Agencies already exceeds government debt with planned future growth (Lamm 2000). This Agency debt is not government guaranteed, however investors believe there is an implied guarantee as all three Agencies were created by the US Government. Hence these Agencies are classified as 'Government Sponsored Enterprises" (GSEs).

Investors support this quasi government status of the GSEs as they have regulatory and legal benefits not available to other corporate debt issuers in the US. There has been some discussion as to altering the status of GSEs but that has lead to concerns about the volatility of the underlying assets and real estate market, which could increase volatility and force yields up. A recent US study has found that there has been an increase in the level of Agency debt that corresponds with the reduction in federal debt (Ambrose and King 2002). This study also identified an overall reduction in yield spreads for the three main Agency issuers that lead to the conclusion that there had been an associated increase in liquidity for these issuers.

This switch to investing in mortgage backed securities has some anecdotal evidence of support in Australia. As investors leave the falling equity market and move to fixed interest, mortgage backed managed funds have attracted the most interest from retail investors (James 2002). The long term link in Australia between property values, business cycles and economic performance is a risky nexus that distracts from the credit quality of a securities mortgage-backed issue.

What then is the appropriate lesson to learn from the US experience? Liquidity matters. Credit risk matters. Hedging, benchmarking and pricing matters. All of these roles could be played by a credit based yield curve rather than an issuer based yield curve.

Commercial debt could become the basis of pricing all debt in Australia, with rating agencies determining the likelihood of default (Skeffington 2002). Currently, issuers with a credit rating below BBB have great difficulty issuing in any volume (Asiamoney 2000). Most of the demand and supply for corporate debt has come from AAA paper issued by supranational and supported by credit underwriters (Brown 2001).

The RBA is already supporting the liquidity in corporate bonds by accepting AAA rated supranational's bonds as security for use in bond repurchase agreements. This change from only accepting CGS and semi-governments has been in place since 2000 (Brown 2001). Government assistance in supporting the corporate debt market could help overcome the shortfalls unique to Australia i.e.

- No geographical spread
- Insufficient issuers
- Insufficient industries
- Insufficient opportunities for diversity
- Insufficient variety of maturity dates
- Poor credit rating
- No benchmark corporate issuers
- No high-yield secondary market (Skeffington 2002, Asiamoney 2002)

The need for locally and regionally focussed specialist debt rating arrangements from the rating agencies is clearly required. However, in the current market, this will only assist the A+ issuers. To add liquidity and create investor confidence, banks should be encouraged to undertake credit enhancement activities. Bank Accepted Bills and Bank Endorsed Bills are a common discount security well understood by market participants that has supported such markets as the promissory note, FRA and futures markets. Underwriting and credit enhancement could be extended to the bonds markets to create Bank Endorsed Bonds. A greater acceptance of these securities would come from the development of a 3- and 10-year corporate debt index futures contract.

The outcome of this bank endorsement would see many issuers in the A+ bracket and would therefore result in a AAA yield curve, a AA yield curve, an A yield curve and a BBB and below yield curve. This would create plenty of opportunities for pricing and risk management, as well as arbitrage amounts issuers. The financial trade off could be measured by each issuer at the time of issuer by comparing the cost of the underwriting fees and charges to the additional interest rate charged for their lower, unsupported credit level.

Encouraging the use of the swap yield curve as the benchmark yield curve for $A debt limits the role of the yield curve to pricing. In a balanced capital market, yield curves should reflect the cost of safe haven, the cost of liquidity, the cost of raising debt within that country, the outlook for the underlying economy (and therefore needs to be linked to the activities of the underlying economy) and the market sentiment about the future of that economy. An artificial yield curve created from

synthetic pricing tools dominated by four major banks is not consistent with these overall requirements.

Areas for Future Research

Whilst the Commonwealth Government's Review of the Commonwealth Government Securities Market Discussion Paper does identify some of the current issues surrounding the cessation of the CGS market in Australia, there are areas that additional research would enable a higher level of confidence in the final decision making.

- The financial services sector already enjoys some form of government support, either through the operations of the RBA and the regulatory environment and supervision from the Australian Prudential Regulatory Authority (APRA), or through the greater access to Australian financial markets for international organisations which provides greater diversity for investors and borrowers. The RBA interaction with banks in effect creates a quasi government support for their debt securities. It is this quasi government support that has benefited the growth of GSEs in the US as substitutes for federal debt. A closer review of this relationship with the view to enhancing it could see a rapid rise in the corporate debt issuance in Australia. By creating more opportunities with a variety of issuers, large fund managers can invest in a greater set of opportunities.

- This idea is not as risk free concept and will no doubt attract criticism from the low risk tolerant investor and from the share market investor burnt by poor corporate governance practices that have emerged in recent times (HIH, Ansett, One-tel etc). The currency crisis in Asia in the late 1990s highlighted the systemic problems that are introduced when there is a heavy reliance on bank sourced debt and stock markets, and not a balance of investor based debt (i.e. bonds and derivatives). This has led to many Asian economies seeking to develop more liquid and mature bond markets, in part by greater issuing of benchmark government securities.

- The International Monetary Fund is already discussing the use of "standstill clauses" in infrastructure debt programs which, should a crisis occur, allow for a period of time where restructuring talks could begin, with the majority of bond holders involved in these discussions. The purpose of these discussions would be to develop "collective action clauses" that would allow all debtors and creditors to work out a solution (Richards, Flood and Gugiatti 2002). Introducing such legislation into Australia would assist the federal government to become more willing to rely on corporate and bank backed funding measures within an economy.

- However, with only $50 billion outstanding, the Australian government may already be paying a premium for the lack of liquidity. More detailed research should be undertaken to support the need for replacing this liquidity with an equally well rated credit based scheme. The bond market crisis of the early 1990s need to be researched with the view to developing scenarios and

estimating the impact of those scenarios in Australia should there be no government debt as a safe haven.

- Ultimately the strength of Australia's capital markets will be measured by the cost of raising capital in both the equity and the debt markets. These costs are impacted on by legal fees, trading costs, stamp duty etc etc. Whilst these costs are in the main absorbed by the issuer, the liquidity cost are borne by the investor. Adding credit enhancement and last resort facilities to corporate debt will go some way towards adding liquidity and reducing credit risk for the investor, which would add to the uptake of the debt and the acceptance of it as a viable alternative to government debt.

- The unfunded superannuation liability needs to be addressed now with current dollars in current investments that will grow at a greater rate than inflation. This submission advocates that issuing more bonds now will only delay the inevitable lack of liquidity that the CGS market will face. A better option is to provide more investment opportunities for the whole of Australia by supporting all avenues of capital raising by corporate Australia.

Conclusions

The recommendation of this submission could be seen as the ultimate privatisation scheme. It does however build on existing knowledge and expertise, builds on existing support for the corporate debt market and links the Australian markets to best practice globally. A move away from issuer focused yield curves to credit rated yield curves will allow for more transparent benchmarking of all issuers, which can only add to the efficiency of Australia's capital markets.

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