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6 December 2002

Commonwealth Debt Management Review Team
c/- Department of the Treasury
Langton Crescent
PARKES ACT 2600

ABN AMRO Submission to the Bond Market Review

Dear Sir/Madam

We welcome the opportunity to make a submission to the Review of the Commonwealth Government Securities Market. ABN AMRO has contributed to the CGS Market Industry Working Group joint submission, but we would like to add the attached submission concerning Interest Withholding Tax (IWT) and the Semi-Government bond market. The submission proposes exempting Semi-Government bonds from IWT, which would enable the State central borrowing authorities to issue their debt domestically, improving the liquidity of the market. Increasing the supply of this close, but imperfect substitute for Commonwealth debt would help reduce the transition costs involved in the Commonwealth's preferred option of winding down the Commonwealth bond market.

If you require clarification of the points raised in the paper or wish to explore our thoughts on the removal of IWT further, please call either Kieran Davies (ph. (02) 8259 5171) or Andrew Kennedy (ph. (02) 8259 6305) as we would be most happy to discuss these issues in more detail.

Yours faithfully

Colin McKeith	Steve Crane
Head of Global Financial Markets	Chief Executive Officer

ABN AMRO SUBMISSION TO THE REVIEW OF THE COMMONWEALTH SECURITIES MARKET

6 December, 2002

Interest Withholding Tax and Semi-Government bonds - reducing the transition costs in winding down the Commonwealth bond market

Please refer to terms relating to the provision of this submission at the end of the document.

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Executive summary

- As detailed in the CGS Market Industry Working Group's submission on the future of the Commonwealth bond market, ABN AMRO believes that there is considerable benefit to retaining the bond market, with advantages to funding the Commonwealth's unfunded superanuation liabilities.

- If the Government rejects the market's advice and decides to wind down the Commonwealth bond market, we believe that this would lead to a less efficient functioning of the financial system and an increased vulnerability to shocks.

- To minimise these costs and ensure a smoother transition to a smaller Commonwealth bond market, we propose a full exemption of Semi-Government bonds from Interest Withholding Tax (IWT).

- Semi-Government bonds are imperfect substitutes for Commonwealth bonds (State Government credit ratings can vary from the Commonwealth Government's rating), but they share many of the same characteristics and are a superior alternative to private-sector instruments.

- An IWT exemption would allow the State Governments to issue more debt domestically (they currently have $19b in bonds issued offshore versus $53b in bonds issues domestically). This would significantly enhance the liquidity of the local debt market.

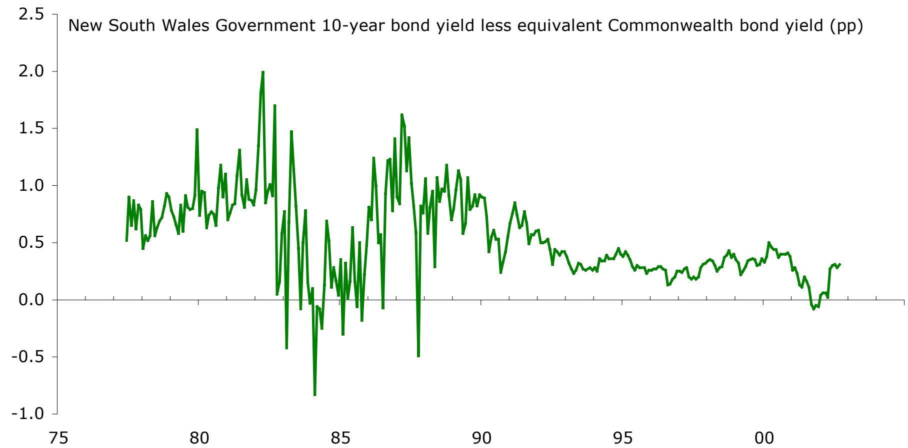
- The IWT was last modified in 1998 when corporate bonds were made exempt in order to "further encourage the development of the corporate debt market", "(enhance) Australia's attractiveness as a financial centre" and "increase competitive pressures in lending for home buyers and consumers".

- Total IWT revenue currently amounts to $689m and we estimate that most of it is earned on Commonwealth Government bonds, with Semi-Government bonds accounting for about $20-25m. This suggests that the cost of exempting Semi-Government bonds is small, particularly when judged against the public debt interest savings the Commonwealth would achieve if it paid down more debt.

Background

Semi-Government bonds are close, but not perfect substitutes for Commonwealth bonds, although the narrowing in the differential between Semi-Government bonds and their Commonwealth equivalents over the past decade or so indicates that they have become closer substitutes over time.

Semi-Government bonds are generally close, but not perfect, substitutes for Commonwealth Government securities



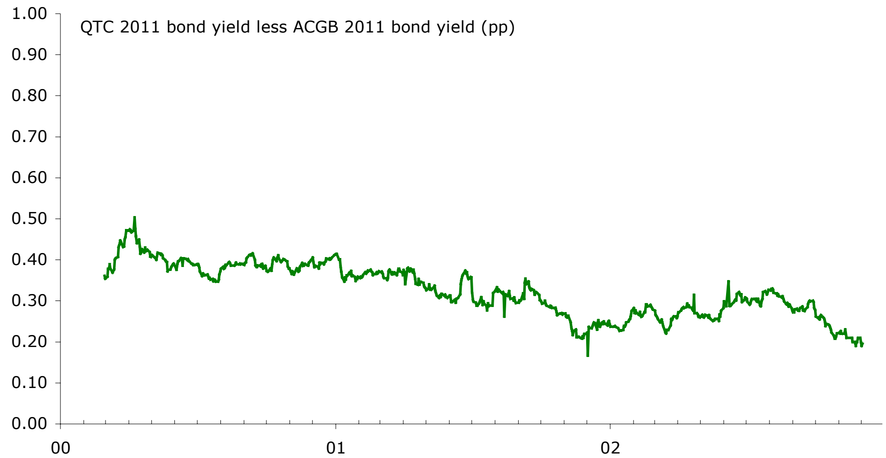
Source: ABN AMRO & RBA

This narrowing has reflected a variety of factors, including important changes to Commonwealth-State financial relations and structural improvements in State fiscal policy and finances.

More recently there have been further changes to enhance State Government finances including the introduction of the Goods and Services tax, which broadens the revenue base of the States and reduces their reliance on Commonwealth funding.

- As a result, there has generally been increased stability in the range of Semi-Government spreads despite significant volatility in global financial markets and the large swings in domestic growth in recent years.

The spread on Semi-Government bonds has been remarkably stable over the past couple of years despite significant volatility in the local economy and global financial markets



Source: ABN AMRO & Bloomberg

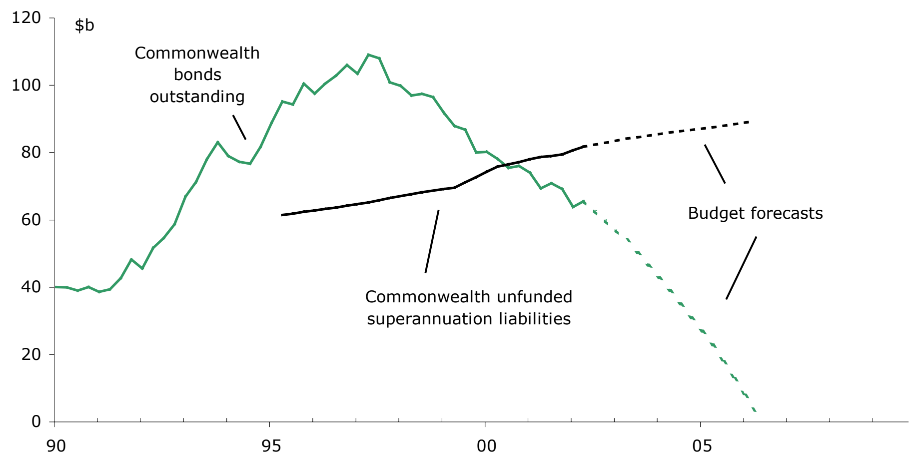
Detail

The Commonwealth Government has recently called for submissions to its Review of the Commonwealth Government Securities Market, intending to make its decision on the future of the market early next year.

ABN AMRO Bank's view is that there is considerable benefit to retaining the market, with advantages in the Commonwealth Government issuing debt to fund its large unfunded superannuation liabilities.

- These views reflect the detailed arguments put forward in the CGS Market Industry Working Group submission – which ABN AMRO Bank contributed to - lodged with the Debt Management Review team.

The Treasurer has a preference to pay down debt – we believe that a better option would be to issue debt to fund the Commonwealth Government's unfunded superannuation liabilities



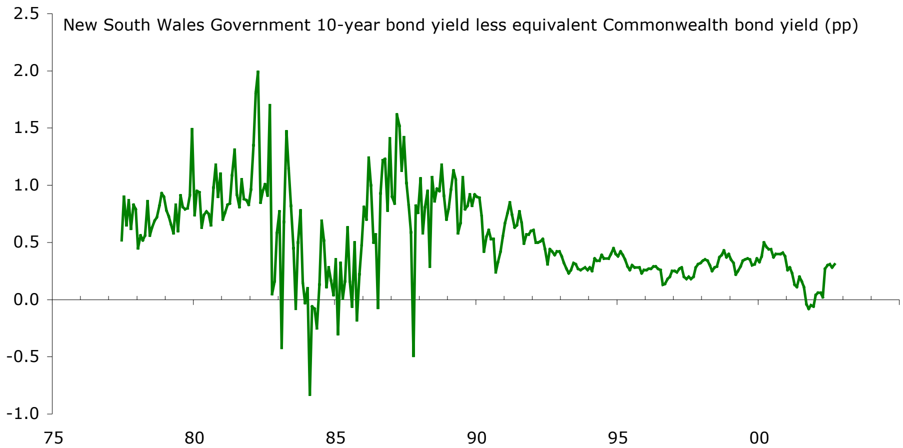
Source: ABN AMRO, ABS, Commonwealth Treasury & DoFA

If the Commonwealth Government ultimately decides to reject the market's advice and wind down the Commonwealth bond market, we believe that there will be costs in terms of a less efficient functioning of a broad range of financial markets and an increased vulnerability of the overall financial system to shocks.

In such circumstances, one way to minimise these costs and ensure a smoother transition to a smaller Commonwealth Government bond market would be to increase the supply and enhance the attractiveness of existing close substitutes for Commonwealth bonds.

In particular, we propose a full exemption of Semi-Government bonds from Interest Withholding Tax (IWT). This tax, which is currently levied at 10%, applies to interest earned on Australian bonds, including Commonwealth and Semi-Government bonds.

Semi-Government bonds are close, but not perfect, substitutes for Commonwealth Government securities



Source: ABN AMRO & RBA

The only major change to IWT in recent years was in 1998 when the Commonwealth Government widened the exemption for corporate bonds under section 128F of the Income Tax Assessment Act.

This change involved making two amendments.

1. The first amendment allowed bearer debentures or interests in bearer debentures to be issued to Australian residents and still attract the IWT exemption under section 128F. This further integrated the domestic and offshore corporate debt markets by allowing companies to offer bearer debentures simultaneously to investors in Australia and overseas.

2. The second amendment was that an Australian company acting in the capacity of trustee for an Australian trust is now treated as a company for the purposes of section 128F. This amendment allows financial institutions involved in securitisation transactions to more easily access the section 128F IWT exemption.

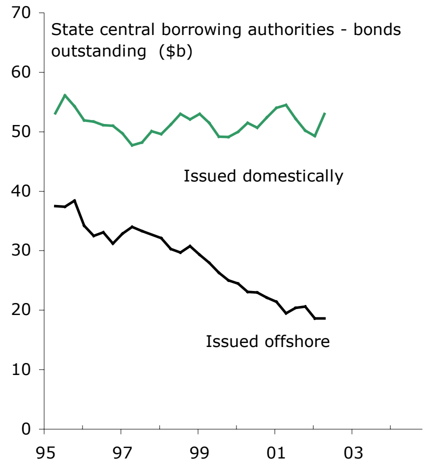
These two amendments were made with the aim of "further (encouraging) the development of the domestic corporate debt market and (were) in line with the Government's objectives of enhancing Australia's attractiveness as a financial center in our region".

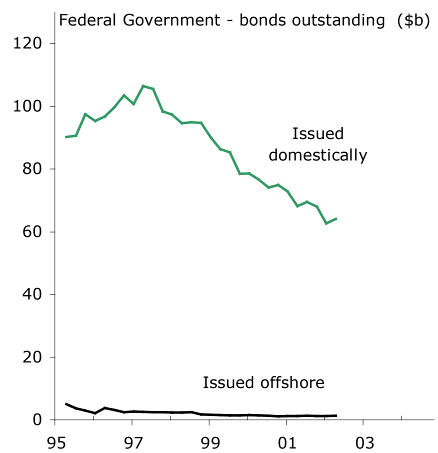
- In particular, the amendments were designed to "increase competitive pressures in lending for home buyers and consumers by allowing lenders to access the cheapest funds free of withholding tax".

In the case of the Semi-Governments, we believe that an IWT exemption would provide benefits in that States could raise more finance domestically rather than internationally, with increased domestic issuance acting to reduce the transition costs involved in shifting to a smaller Commonwealth Government bond market by enhancing the liquidity of the local debt market.

The amounts involved are considerable given that the State Government central borrowing authorities still issue a large volume of debt offshore. The amount of offshore issuance has declined over time, but at $19b the volume of debt outstanding compares with $53b in domestic Semi-Government offerings and $64b in Commonwealth Government securities on issue (the Commonwealth has almost no offshore bonds outstanding).

State Governments are still active in issuing debt offshore





Source: ABN AMRO & ABS

In addition to providing a close, but imperfect substitute for a declining supply of Commonwealth Government securities, increased domestic issuance would provide some benefit for the currency given that less debt would be issued offshore. It would also reduce costs for the State Governments as it is expensive for the central borrowing authorities to maintain global borrowing programmes (it would also maintain fiscal autonomy for the States, contrasting with one of the Commonwealth Government discussion paper's options of merging the Commonwealth and State Government debt markets).

For the Commonwealth Government, there is a cost involved in exempting Semi-Government bonds, which is the IWT revenue foregone. IWT revenue totalled $689m in 2000-01, or about 0.4% of total Commonwealth tax revenue.

- Based on recent discussions with the State central borrowing authorities we estimate that the IWT paid on Semi-Government bonds is only a small part of total IWT revenue, less than $25m.

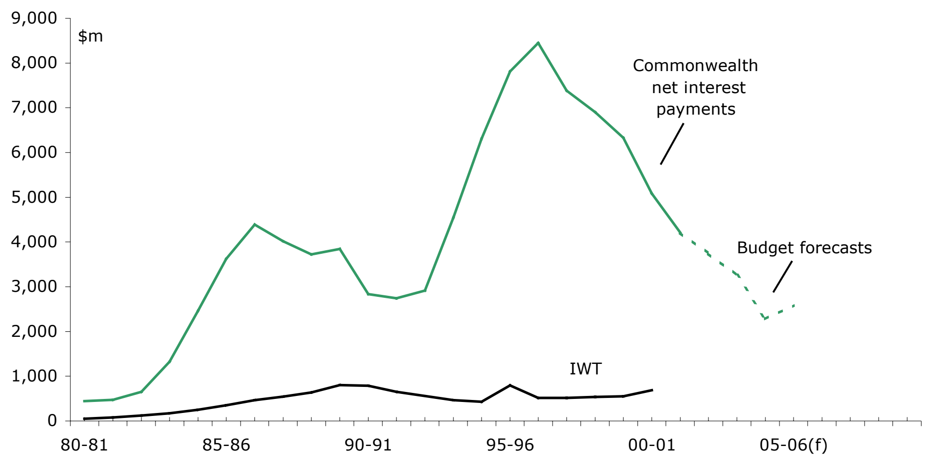
- Estimates based on ABS data on bond holdings support this view. The ABS calculates that about $21.2b in Semi-Government bonds are currently held by non-residents. Assuming that these investors hold all the Semi-Government debt issued offshore, this leaves about $2.6b in domestic debt held by non-residents. Assuming an arbitrary 7% coupon on these bonds, this suggests that roughly $20m is raised in IWT revenue.

Since these calculations suggest that holdings of Semi-Government bonds account for only a small part of IWT revenue, then presumably non-resident holdings of Commonwealth bonds account for the lion's share of the total revenue. This means that one of the consequences of winding down the Commonwealth bond market is a likely reduction in IWT revenue.

More significantly, in the event that the Commonwealth wound back its bond market, any decline in IWT revenue from exempting Semi-Government bonds would be easily overshadowed by savings in the form of lower public debt interest payments. The exact savings will depend on how quickly the market is wound back, but are likely to be large given that Commonwealth Government net interest payments currently amount to $4.2b, well in excess of the $689m raised in IWT.

- As such, public debt interest savings would provide a very large offset to the revenue foregone in exempting Semi-Government bonds from IWT.

Reduced IWT revenue from exempting Semi-Government bonds is dwarfed by lower interest payments arising from paying down Commonwealth debt



Source: ABN AMRO & ABS

From a broader perspective though, the likely increased supply of domestically issued Semi-Government bonds would help fill the gap left by a diminishing supply of Commonwealth bonds. Although Semi-Government bonds will never be perfect substitutes for Commonwealth bonds given that the State Governments can, at times, have a different credit rating to the Commonwealth, they are a close substitute and share most of the useful characteristics of Commonwealth bonds outlined in the Government's discussion paper.

In particular, depending on the credit rating of the State Government bond in question:

- Semi-Government bonds have some capacity to be used as a benchmark bond for pricing other financial products.

- They can also act as an investment vehicle for fund managers and have safe-haven characteristics in a time of financial crisis.

- The bonds could be used by the Reserve Bank to implement its monetary policy.

- Semi-Government bonds are already attractive to foreign borrowers and maintaining the size of the overall domestic bond market would help promote Australia as a financial centre.
  - The latter point was one reason why the Government exempted corporate bonds from IWT in 1998.

Importantly, however, apart from the possibility that the different Semi-Government bonds can have a different credit rating to Commonwealth bonds, a practical shortcoming of Semi-Government bonds is that there is no futures contract for them. This is unlike the highly traded futures contracts based on Commonwealth bonds, which enhance the desirable characteristics of Commonwealth bonds as a liquid risk-free asset and yield benefits in increasing their integration into the broader financial system.

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