TD Securities

Submission to the Review of the Commonwealth Government Securities Market

From TD Securities

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This submission from TD Securities to the Commonwealth Debt Management Review addresses the key questions posed by the Review Team and outlines other issues associated with the transition of the Australian fixed income market from one that has been dominated by Commonwealth Government Securities (CGS) to one where alternative fixed income issuers and instruments will likely develop.

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We agree with the broad thrust of the Debt Management Review paper, given the commitment of the Government to maintain budget balance, on average, over the course of the economic cycle. We note the fundamental point in the Review paper that ''The Government will not consider options that weaken the fiscal strategy … the Government will not consider proposals to build budget deficits so as to create the need for new CGS issuance''.

There is no doubt most market participants would be comfortable in an environment where a large and liquid market for CGS remained. It would be a 'business as usual' position for all involved. Maintaining a market for CGS when the government is committed to balanced budgets and further assets sales is, however, inappropriate.

We contend that in an era where CGS is phased out, there would be ample opportunity for financial market participants and the economy more generally to not only cope and adjust to the change, but to expand and flourish. The competitive challenges posed, and opportunities presented, from the potential CGS phase out could deliver increased depth and sophistication for Australian financial markets and corporations looking to access the Australian debt market. This could raise the profile of Australia as a global financial centre.

In our view, many of the concerns of some stake holders will be overcome once there is a more detailed understanding of how the non-CGS market continues to develop. This would be enhanced if the Government provided a framework which would help in the transition process, especially if it facilitated non-government issuance of A$ denominated debt. This could include initiatives which help highly rated borrowers, especially supra-national entities, issue 'risk free' securities.

OVERVIEW

In the view of TD Securities, Australian financial markets will continue to flourish in an environment where CGS either remains or is phased out. CGS is already a declining, yet important, part of the structure of financial markets, but either with or without CGS, the sophistication, depth and underlying level of innovation in the Australian market will provide opportunities for issuers of debt and investors, both domestically and abroad.

One concern arising from the proposed phase out of CGS is that Australian fund managers will be forced to increasingly track global sovereign fixed income mandates. By definition, this occurs because there will be no CGS to invest in. There is a judgment that such a development will see an increasing pool of Australian superannuation money managed by foreign fund managers who are judged to have an advantage in managing global sovereign bond funds.

This development is seen as a negative due to the perception that it involves exporting of profits of such ventures and, at the margin, it adds to the 'brain-drain' of high quality Australian fixed income professionals who may move overseas to help manage these funds in offshore centres.

We agree that there is a high risk, if not certainty, that Australian global fixed income funds will have a higher allocation to non-Australian bonds as CGS is phased out. If so, this would merely be a continuation of the trend evident in recent years. Rather than this being a negative for Australian financial markets, this phenomenon could see Australian based fixed income managers improve their competence and efficiency (from an already high level) in the area of global fixed income management. If successful, this would help Australian fund managers maintain global fixed income mandates within the current structure. In other words, if Australian based fund managers can effectively compete with the foreign competitors, which is a move likely to be encouraged by the CGS phase out, the net effect could see an increase in global funds managed within Australia.

The fixed income funds management sector is currently confronting many of the issues faced by other industries when challenged by competitive pressures. In other industries that have been exposed to the challenges posed by global competition, productivity and efficiency have improved or the industries have closed down. The fixed income managers in Australia may have to develop their skill base and engage competent global fixed income managers to work in Australia, where the global fixed income funds can be managed. This could see the reverse of the 'brain drain' emerge – foreign fixed income professionals being employed by Australian fund managers in Australia to manage global bond portfolios.

If this occurred and Australian based fund managers enhanced their fixed income business by covering global bonds, the skill base of the financial makers would be advanced which in turn would raise the profile of Australia as a global financial centre.

If, however, the Australian funds management industry was not able to respond to the increased competition in this manner and funds in global fixed income was funnelled to foreign fund managers, there would be some cost to the Australian economy.

THE TRANSITION

Given the likely long run time horizon mentioned in the review for the phase out of CGS, there will be a significant opportunity for alternative AAA (risk free) issuers of A$ denominated securities to enter the Australian market.

It is highly likely that many supra-national issuers would find attractive funding levels in Australia. The attractiveness of raising funds within the Australian capital market could see supra-national issuers at least partly fill the position of CGS by providing a high quality (risk free) yield curve with a profile of maturities.

To facilitate this process, which we consider would be desirable, the Government may want to give consideration to a range of policies that may increase the attractiveness of Australia for supra-national issuers and to encourage investors to actively trade the supra-national bonds. To ensure the assessment of supra-national issuers is 'risk free', the Government may want to 'credit wrap' any supra-national bonds or give a guarantee for the A$ bonds issued by such borrowers. This would be a very low cost and low risk strategy that would be a useful fill in as CGS is phased out.

THE QUESTIONS FROM THE REVIEW TEAM

In this section, TD Securities only addresses the questions raised by the Review team where we can add value or have a strong view.

Providing a safe haven in times of financial volatility

The Government would appreciate views from stakeholders on:

- the importance of the CGS market in providing a safe haven during periods of financial instability;
- what evidence there is of the role of CGS as a safe haven? and
- what possible alternative safe havens exist and how appropriate they are?

The perception of the 'safe haven' status of CGS is not at all clear from the change in the price of CGS during what is termed 'periods of financial instability'. While the face value of the bond is undoubtedly preserved, the change in the price of CGS can see funds lose money as markets change according to news and developments.

The safe haven discussion does not necessarily fit with recent events of financial instability. For example, an investor buying a 10 year bond shortly after the terrorist actions in the US on 11 September 2001, would have actually lost around 4% of their capital in less than two months as the yield on CGS rose from below 5% to above 5.9%.

There are many similar examples of capital being lost by investors in CGS in the wake of financial instability. The knee-jerk rise in prices (fall in yields) in the wake of the Russian debt default and demise of US based Long Term Capital Management in 1998 were quickly reversed over subsequent months. The move caused holders of long dated CGS to have their capital eroded.

The safe haven issue also assumes that the 'financial instability' is outside the area of CGS. This may be a wrong assessment if there are circumstances of instability that are generated by sharp changes in the price of CGS. This possible misunderstanding may have been influenced by the decade long bull run for bonds, except for the temporary period of weakness in bond prices during 1994. Over the past decade, the perception of bonds being a safe haven has also been enhanced and cultivated by the success monetary policy has had in keeping inflation within the 2 to 3% target.

While we cannot readily envisage a period where monetary policy fails to keep inflation within the target range, there is some risk that in the future, inflation or deflation pressures persist for a protracted period. If, or indeed, when the circumstance of higher inflation or deflation occurs, market pricing of CGS could actually be a major contributor to financial instability as investors aggressively sold or bought CGS, altering its price.

In other words, financial instability could be triggered from within the CGS market.

In our view, the government has no direct role in providing an instrument for investors during periods of financial instability other than through the operations of the Reserve Bank of Australia. As the Review correctly highlights, the injection of liquidity into the banking system by the RBA is appropriate at these times. The RBA can also consider other forms of monetary policy action during times of financial crisis, including changing the level of official interest rates. Having a large amount of CGS on issue will not necessarily alleviate the root cause of any financial instability.

Attracting foreign capital inflow

The Government would appreciate views from stakeholders on:

- whether the absence of a CGS market would affect Australia's attractiveness to foreign investors; and
- how important global bond indices are for foreign investment in Australia.

It is not clear that the absence of CGS would have a material impact on Australia's attractiveness as an investment destination for foreign investors. With the absence of CGS, one key investment segment will disappear from the array of available investments. Importantly, other areas are likely to pick up some, or all, of the 'slack' left by the CGS phase out. In our view, which is based on the way the business flows have evolved at TD Securities in recent years, foreign interest in A$ bonds issued by supra-national and corporations will increase. To the extent that these markets will continue to grow as CGS is phased out, a reasonable volume of fixed income interest and involvement in Australia will remain.

The attractiveness of these bonds will, in part, be driven by the same sorts of risks that often emerge when global investors look to a particular market. In addition to the underlying credit quality of the issuer (which is relevant to CGS as well as other bonds), factors relating to the economic scorecard of the economy are important:

- macroeconomic conditions;
- monetary policy momentum;
- changes to tax and other fiscal settings;
- popular themes (recent ones include perceptions of an IT base, old economy, political risk) can influence investor behaviour;
- current account/terms of trade and other factors that may impact on the A$ exchange rate;

are all factors that will remain important variables in determining the desirability of bonds, be they issued by the Commonwealth Government or anyone else.

In addition to alternative fixed income vehicles for foreign investors to consider and invest in, the fact that a proportion of the third tranche of Telstra will be purchased by foreign based stock market investors will add to capital inflows. Capital inflows could be further enhanced if investors view a fully privatised Telstra more favourably.

The market capitalisation of the major Australian stock indexes will increase with the Telstra full privatisation. This will increase Australia's weight in global stock indices, leading to capital flows into Australia from global stock market fund managers. As a counter to Australia falling out of global sovereign bond indexes, Australia's weight in global stock indexes will increase.

For many investors, the various sovereign bond indexes are an important benchmark that guide investment flows. In our experience, however, very few investors have a portfolio that exactly matches the index weights. Strategic or opportunistic decisions see investors 'overweight' or 'underweight' certain markets or take a position in a certain part of the yield curve to enhance their returns. As discussed earlier, those decisions can be related to shifts in the relative macroeconomic/economic policy position of a country, rather than any inherent opportunity from price movements in the bond.

The fact that Australia is currently included in the bulk of these sovereign bond indexes means that some attention is focussed on the extent to which the investor should be participating in the Australian CGS market. Informal feedback from TD Securities major foreign fixed income clients is mixed.

Some are strongly of the view that their participation in the Australian bond market will cease with the phase out of CGS. Others suggest that they will continue to look at Australia as an opportunistic market, which means that they will enter and exit the Australian fixed income market when relative value presents.

The composition of the various global bond indexes continues to evolve as the nature of the fixed income market evolves and develops. It is clear that investors are placing less attention on the sovereign bond indexes as the market for non-government bonds increases. The evolution of the non-government fixed income market over the past decade means that investors are allocating significant and increasing proportions of funds for these markets. Investors are dedicating more effort and resources to trading corporate bonds and this trend should not be interrupted with the CGS phase out.

New Zealand government bonds are not included in the main indexes. This is not an impediment to many foreign investors participating in that market from time to time. When the broad fundamentals are perceived to be ‘right’, foreign investors buy into the market. It is a similar situation with other ‘small’ bond markets.

It would be reasonable to expect the Australian non-government bond market to follow this trend after CGS is phased out.

If the wind down of CGS allows or encourages the non-government issuers to continue to issue increasing volumes of A$ denominated bonds, the weighting of Australian non-government bonds in the non-sovereign indexes is likely to increase.

Promoting Australia as a global financial centre
The Government would appreciate views from stakeholders on:
- whether the CGS market plays a significant role in promoting Australia as a global financial centre; and
- whether the absence of a CGS market would affect transaction costs and Australia's attractions as a centre for global financial services.

See introductory comments regarding Australian fund managers building up global fixed income expertise.

Appropriate size of the Commonwealth Government Securities market
The Government would appreciate views from stakeholders on the appropriate size of the CGS market in the event that the market is to be maintained.

There is no ideal size for the CGS market, other than as it relates to Australia maintaining its weighting in the various indexes. If, as appears to be the experience with the CGS market over the past few years, the sovereign bond indexes assign weights according to the amount of bonds on issue, Australia is likely to fall out of the indexes even with the current level of bonds being maintained. To hold a position in the indexes, the Government would have to have substantial net issuance of bonds which is not possible with the government’s stated fiscal objectives.

Options available to the Commonwealth

Option 1: Wind down the Commonwealth Government Securities market
The Government would appreciate views from stakeholders on:
- potential implications of winding down the CGS market;
- the likely impact on the cost of capital;

- the most appropriate approach and timeframe to implement a decision to wind down the market, if this decision is made; and
- the likely re-entry costs (in the form of additional borrowing costs) if the Commonwealth withdraws from the market.

In discussion of the 'wind down' of the CGS market, the review paper noted that ''once CGS outstanding falls .. there may be a large downward step in the amount of CGS sought by investors due to the withdrawal of global bond index investors. Consequently, there may be a step down in the price of CGS'' (page 80). An implication of this could be that any program of buy-backs be frequent and relatively small, allowing the Commonwealth to minimise the risk of a jump in prices that may be associated with a more concentrated buy-back program.

In the event of an unforeseen need to re-enter the market after the wind down of CGS, it would appear that domestic and foreign investors would be willing to invest in any new bond issue. The options of how this could occur would be canvassed at the time, depending on the extent of the cash shortfall and the expected duration of the budget deficit position.

In the event of a budget deficit, several other options may need to be considered. If, over the time frame of the phase out of CGS, the government has larger than expected cash surpluses (which is as likely as a return to deficit), we would assume that the government would hold the surplus cash on deposit with the RBA to meet any future budget shortfalls. This scenario would allow the run down of those reserves at the time the budget slipped into deficit, avoiding any future need for the Commonwealth to issue bonds.

If the alternative unfolded and the budget slipped into deficit before the government had the opportunity to accumulate cash reserves, the government could consider issuing one or two year T-Notes to cover a temporary short fall. There would be little doubt that the market appetite for such instruments would remain strong with little pricing pressure discernible.

Option 2: Consolidate Commonwealth and State government debt markets

The Government would appreciate views from stakeholders on:

- whether there is merit in reconsidering the idea of consolidating Commonwealth, State and Territory government debt into one market; and
- whether this option would assist with the transition to reducing the supply of Government debt.

Consolidating Commonwealth, State and Territory government debt into one market could have longer run negative consequences for the ability of those authorities to raise debt. The semi government authorities could lose their profile, credibility and therefore appeal to investors if this consolidation was ever unwound. The different treatment of withholding tax between CGS and some State and Territory bonds is a further complicating factor working against this option. In addition, the Commonwealth would be taking on extra credit risk in this scenario.

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