QUEENSLAND TREASURY CORPORATION

Submission by Queensland Treasury Corporation (QTC)

to the Review of the Commonwealth Government Securities Market

December 2002

EXECUTIVE SUMMARY

Queensland Treasury Corporation

- QTC is a significant Australian borrower with total debt outstanding exceeding A$23 billion, of which approximately 40% is raised offshore. It raises between $2 and $8 billion of debt annually and, since 1991 has contributed in excess of $2 billion worth of benefits to Queensland. (For more information on QTC refer page 8).

- As the Commonwealth Government Securities (CGS) market is a key part of the domestic capital markets, and features in global bond indices, a decision on its future has the potential to significantly impact QTC's market operations and its ability to deliver value to Queensland.

Market Pricing and Operations in the Absence of the Risk Free Rate

- QTC believes the withdrawal of the Commonwealth from the capital markets has the potential to adversely impact:

  - the cost of capital for Australian governments and the private sector
  - the cost of funding productive assets
  - the willingness of global investors to commit funds to the Australian market
  - the attractiveness of global investments to Australian-based funds, and
  - the capacity of Australian businesses and governments to manage financial risks.

Funding Superannuation Liabilities

- Based on Queensland's experience, fully funding superannuation is well grounded in terms of intergenerational equity and can be implemented as part of a prudent fiscal strategy. It is recognised as such by ratings agencies, and can serve to reduce the potential uncertainty from the State's financial position, reduce the whole-of-life cost of superannuation, and enhance the strength of the State's AAA credit rating.

Optimal Use of Debt and Fiscal Management

- Debt can provide a commercial framework for the management of assets and infrastructure. It is also more cost efficient than many other sources of financing, such as long term leases and securitisation.

- The utilisation of debt to fund infrastructure supports intergenerational equity.

- The capacity to issue debt to respond quickly to emergent economic and budgetary pressures should remain an important element of fiscal and economic management.

Need for Further Analysis

- The proposed changes to the CGS market are significant, with change management impacts akin to those associated with the introduction of the GST. QTC believes that the policy analysis associated with the CGS market policy decision should be subjected to a higher degree of in-depth rigorous economic analysis than appears to have been the case to date.

Queensland Treasury Corporation (QTC) is the State's corporate treasury services provider and has developed this submission based on its own experience.

For more than 20 years, QTC and its predecessors have been accessing global funds and have maintained a regular program of discussion, interaction and feedback with global investors and financial market intermediaries in the world's major financial centres.

As a significant Australian borrower, QTC has total debt outstanding currently exceeding A$23 billion, of which approximately 40% is raised offshore (having fallen from around 60% two years ago, as many international investors withdrew from the Australian fixed interest market). It raises between $2 and $8 billion of debt annually and, since 1991 has contributed in excess of $2 billion worth of benefits to Queensland. *(More detail on QTC's operations is provided on page 8)*.

As the Commonwealth Government Securities (CGS) market is a key part of the domestic capital markets, and features in global bond indices, a decision on its future has the potential to significantly impact QTC's operations. In particular, changes may impact QTC's operations, ability to deliver value to Queensland taxpayers, and the operations of our financial intermediaries.

In this context, and in response to the CGS market review, QTC's submission focuses on:

- market pricing and operations in the absence of the risk free rate
- funding superannuation liabilities[1], and
- optimal capital structure.

While QTC has demonstrated expertise in capital markets operations, it does not purport to be an independent expert in the macroeconomic analysis required to fully address the potential economic implications of changing the current structure of the CGS market. However, it strongly believes that further analysis is required as due process for such an important policy decision.

MARKET PRICING AND OPERATIONS IN THE ABSENCE OF A RISK FREE RATE

Based on its capital markets experience, QTC believes the withdrawal of the Commonwealth from those markets will adversely impact:

- the cost of capital for both governments and the private sector in Australia
- the cost of funding productive assets in many levels of the economy, resulting in a new funding/growth equilibrium and related impacts
- the already reducing willingness of global investors to commit funds, both directly and indirectly, to the Australian market
- the attractiveness of global investments to Australian-based funds, leading to an acceleration in the transfer of fund management mandates to managers outside Australia, and
- the capacity of Australian businesses and governments to manage financial risks, not only in respect of funding and interest rate risk, but also in relation to any commodity, investment or other activities that forward markets would support.

[1] QTC believes that the future of the Commonwealth Government Securities market and funding the Commonwealth's unfunded superannuation liabilities are separate and unrelated issues and has therefore treated them separately in this document.

While the capital markets will continue to operate in the absence of a risk-free traded Commonwealth yield curve, further analysis is required to determine:

- how efficiently they would operate
- the implications this has for the operation of the economy, and
- the implications this has for the provision of services by government.

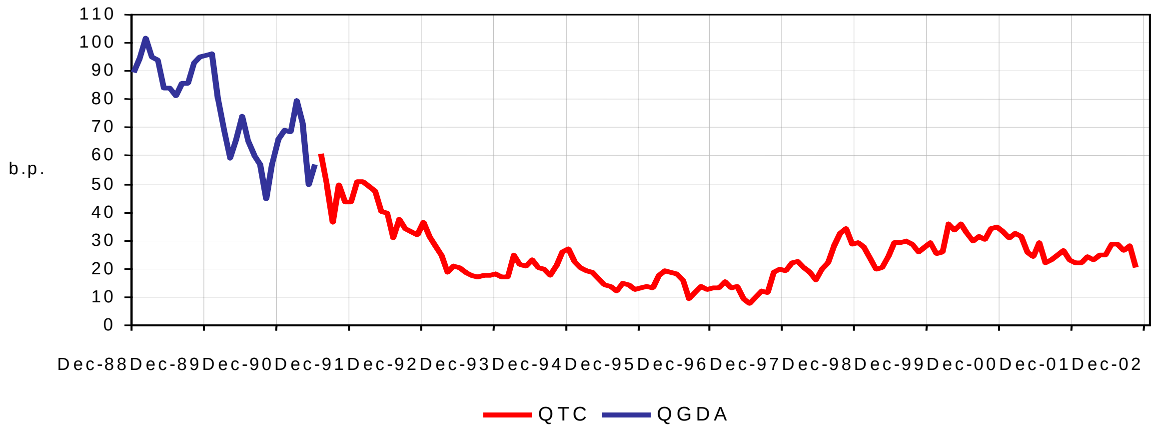
QTC has addressed these issues based on its experience and relationships with other borrowers, financial intermediaries and investors.

QTC's Experience

QTC has developed informed views on the operations of markets that it considers relevant to the issues currently being raised by the Commonwealth. In particular:

- since 1984 Queensland has moved from borrowing via brokered markets to borrowing in a relatively liquid traded market. The impact of the move from a brokered market to a traded market has been significant and is illustrated by the reduction in margins (shown in Chart 1 below), notwithstanding that Queensland has maintained its AAA rating throughout this period, and
- over the past decade, credit deterioration by some states has impacted on the interest margins of others. This is seen as evidence that structural changes in one sector of the financial markets should be considered in the light of the impacts resulting elsewhere in the financial system.

Chart 1: Queensland/QGDA/QTC Bonds: Average Margins to Commonwealth Bond Curve



Borrowers

- The removal of liquidity from the market leading to the development of a brokered, rather than traded, market would impact Australia's cost of capital. A potential increase in the cost of capital would place upward pressure on the required return on potential projects, resulting in marginal projects being rejected, or increased costs, taxes or charges. This is expected to lead to lower levels of economic activity than would otherwise be the case.

- Increased uncertainty may also arise when corporations determine their weighted average cost of capital (WACC). This is expected to have an adverse impact on the project evaluation process and on the economy more broadly.

- The Commonwealth yield curve is used by the market as the risk-free basis when determining the price of credit. Without this reference point, a greater level of uncertainty will exist when the market attempts to price corporate debt. QTC's experience has been that the use of proxies is not efficient in removing these uncertainties. For example, the swap curve would be a less efficient pricing basis for credit risk because it does not represent risk-free interest rates.

- New debt is generally only issued by corporates when they have a specific requirement. It is therefore unlikely they would increase their appetite for debt funding to replace Commonwealth debt. If corporates did seek additional funding, they would most likely have to use foreign credit markets to satisfy their demand. The ability of corporates to issue debt in the Australian market, as the capacity of brokers to hedge issues changes, is also expected to be reduced. This is expected to result in a continuation in the already occurring flow of money out of Australia, a negative influence on the A$, and a further reduction in market liquidity.

Financial Intermediaries

- Commonwealth bonds play an important role in the market-making function performed by financial intermediaries. Removal of this instrument is expected to reduce the ability of these intermediaries to hedge their interest rate risks and, therefore, further reduce their willingness to commit capital. This would lead to wider bid/offer spreads that would ultimately reduce market liquidity and lead to less competition between financial institutions, as smaller players exit the market.

- Based on QTC's experience and liaison with market participants, this is expected to:
  - force QTC to revert to borrowing funds on a brokered rather than a traded basis with a potential increase in costs of around 30 bp. In a full year, based on QTC's current onlendings portfolio of $18b, this would increase QTC's costs by $54m pa
  - impact the capacity to manage financial risks in all markets that have forward prices as a component of their operation. This would impact not only forward interest rates, but also all commodities in contracts that involve delivery over time. While the financial impact of reduced risk management capability is difficult to estimate, QTC's experience has been that issuance and risk management savings have been broadly comparable, so an estimate of a further 30 bp ($54m) is considered reasonable, and
  - impact on the Australian economy, as financial intermediaries continue the existing trend of downsizing the resources they maintain in the Australian market, and further reduce the amount of equity they are prepared to place at risk in Australia.

Investors

- Corporate and Commonwealth debt instruments are not substitute investments and have very different credit risk characteristics. While investors holding a diversified portfolio of fixed interest assets will typically have exposures to both forms of debt, it does not follow that there is a causal relationship, especially given the differences in credit risk and liquidity.[2]

[2] For example: there is not necessarily a causal relationship between the decline in CGS on issue and the growth in the corporate bond market. The downward trend in interest rates over the 1990s, the associated fall in the relative cost of debt funding and/or the growth in financial intermediation made possible by the deregulation of financial markets could just as easily explain this relationship.

- Superannuation funds, insurance companies and other investors typically have an ongoing requirement for longer-term fixed interest assets. There are few non-Commonwealth borrowers able to issue such instruments.

- The repayment of Commonwealth debt may change the way investors view the Australian fixed interest market. Discussions with QTC's investors indicate this is already an issue, particularly for those operating solely on bond indices. Some investors have already withdrawn from the market as Australia's position in these indices and the liquidity in the domestic market declines.

- With the closure of the CGS market QTC expects that Australia will lose access to additional groups of international investors as they accelerate the movement of their funds to other markets offering more desirable trading characteristics.

- Similarly, domestic investors will accelerate the movement of their funds to offshore markets to obtain their required level of high credit quality debt exposure, causing a further flow of capital out of Australia. This would negatively influence the Australian dollar, and impact the performance of the economy.

FUNDING SUPERANNUATION LIABILITIES

QTC accepts that alternative uses of cash surpluses and asset sale proceeds, including the funding of superannuation, are policy matters for the Commonwealth. However, the stated reasons for the rejection of funding superannuation in the discussion paper do not match with Queensland's practical experience in this area.

Since the late 1960s, Queensland has moved to its now long-standing policy position of fully-funding all public sector superannuation obligations. This unique feature of Queensland's public finance, together with prudent debt management strategies, has played a critical part in maintaining investor confidence in the State's issued securities.

Based on Queensland's experience, fully funded superannuation can be managed and implemented as part of a sound financial asset and liability management strategy. Indeed, many State Governments are now seeking to move towards fully funded positions.

QTC's interactions with investors, financial intermediaries and the rating agencies has demonstrated that all groups will provide a market pricing benefit to those bodies who fund their superannuation obligations. In Queensland's case:

- the market accepts and supports the view that the State's long-term diversified investment portfolio has outperformed the risk free rate. Accordingly, fully funding superannuation is seen as reducing the whole-of-life cost of superannuation and is therefore considered a better alternative than "pay as you go". That is, the cost (or tax equivalent) of unfunded superannuation is the opportunity cost (or tax equivalent) of the diversified earnings rate, not the risk free rate.

- fully funding superannuation entitlements is seen as having a strong grounding in terms of intergenerational equity. Setting aside funds to cover employee entitlements as they accrue reduces the likelihood of needing to alter fiscal policy settings applying to future generations, in order to fund payments accruing to today's public servants.

The Queensland experience therefore demonstrates that governments can successfully operate as both asset and liability managers to deliver maximum value to taxpayers. For example, in Queensland, Queensland Investment Corporation has been providing wholesale funds management for its public sector clients for more than 10 years.

OPTIMAL USE OF DEBT AND FISCAL MANAGEMENT

An assumption has been made in the discussion paper that the optimal level of debt in the national capital structure is zero.

However, Queensland's experience has demonstrated substantial benefits from having an access to, and utilising debt for the following reasons:

- it provides a commercial framework for the financing and management of commercial assets and infrastructure. It has also provided a cost efficient alternative to many other forms of financing, such as long-term office accommodation leases and securitisation, and
- it provides an avenue to achieve intergenerational equity between generations of taxpayers who will be benefiting from the use of long-term infrastructure.

Fiscal Policy Flexibility

In the context of managing the national Budget and its role of the manager of the national economy, the capacity to raise debt remains an important fiscal policy tool at the Commonwealth's disposal. It provides the Commonwealth with the capacity to quickly react to unexpected events and emerging issues.

The recent US experience is a case in point. In January 2001, the United States' Congressional Budget Office (CBO) forecast a budget surplus in the 2003-12 period in excess of $US 5 trillion. Accordingly, based on these forecasts, the US Government adopted a policy of retiring outstanding Treasury bonds.

However, following the events of September 11, with slower economic growth and increased defence spending, the CBO has recently reduced the projected 10-year budget surplus for the fiscal 2003-12 period to just $US1.015 trillion, down from estimates $US2.3 trillion in March 2002 and $US5.6 trillion in January 2001. Accordingly, the US Treasury is now reissuing government bonds. This is one prominent example of how a liquid bond market provides policy makers with the flexibility to respond to unexpected events.

Intergenerational Equity

Government infrastructure, which is funded out of current revenues, will not provide intergenerational equity if future generations make use of the infrastructure.

The majority of Government-funded infrastructure projects are long-term in nature, typically spanning more than one generation. By funding these projects using debt, the cost of the service can be spread over a similar timeframe as the depreciation, or usage, of the service.

If projects are funded out of current revenues, then the current generation pays in full for a service that will be used by future generations. Further, the process of paying down debt now means that the current generation is forced to pay the balance for all existing projects that future generations will utilise.

NEED FOR FURTHER ANALYSIS

The recent introduction of tax reforms in Australia, particularly the Goods and Services Tax (GST), was a significant policy change, with major ramifications for the Australian economy. Accordingly, the introduction of the taxation policy was supported by rigorous expert macro economic analysis.

The proposed changes to the CGS market are significant, with change management impacts akin to those associated with the introduction of the GST. QTC therefore believes that policy analysis associated with the CGS market decision should also be subjected to the same degree of in-depth rigorous expert economic analysis.

In particular, this analysis should seek to address the impact of zero or reduced liquidity of the CGS market on:

- the economy and the well being of all Australians
- the operation of capital markets and the cost of capital
- international capital flows and the attractiveness of the Australian market as a destination for international investment, and
- financial decision making and risk management.

QUEENSLAND TREASURY CORPORATION

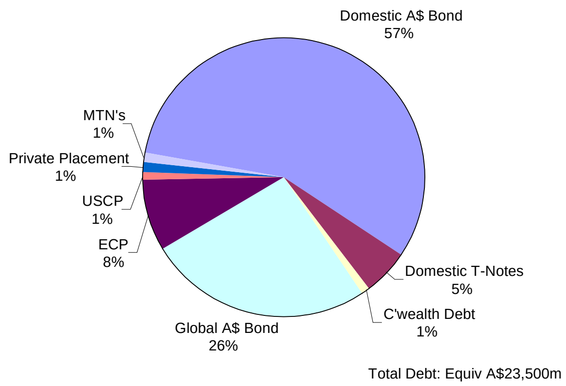
Established in 1984, Queensland Treasury Corporation (QTC) is Queensland's corporate treasury services provider, with responsibility for providing financial risk management advice, debt funding and cash and short-term funds management. QTC works within the framework developed by Queensland Treasury and the Queensland Government to deliver corporate treasury services. It does not formulate government policy.

QTC's whole-of-State focus enables it to capture significant economies of scale in the issuance, management and administration of debt, resulting in a lower cost of funds for Queensland's public sector and substantially improved financial risk management flexibility.

In its funding role, QTC borrows funds in both the domestic and international markets by issuing a variety of debt instruments. These funds are then on lent to its public sector customers. QTC currently funds more than 99% of the Queensland public sector's total borrowings.

QTC takes a global approach to funding and utilises a diverse range of funding facilities to maintain the flexibility to source the most cost-effective funds. In terms of size, QTC is a significant Australian borrower, with total debt outstandings currently exceeding A$23 billion, of which approximately 40% is raised offshore (*see Chart 2 below*). QTC raises between $2 and $8 billion of new debt annually.

CHART 2: Funding Facilities as at 30 September 2002



For more information on Queensland Treasury Corporation, visit: www.qtc.qld.gov.au