

Queensland Investment Corporation (QIC)

Submission to Commonwealth Treasury on the Future of the Commonwealth Government Securities Market



December 2002

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1. Executive Summary

Since the 1996-97 Budget, the Commonwealth Government's medium term fiscal strategy of balanced budgets along with significant asset sales has resulted in the size of the Commonwealth Government debt market falling significantly. With continued fiscal discipline along with the prospects of additional receipts from the further privatisation of Telstra, the Government has the ability to eliminate the Commonwealth Government securities (CGS) market over the next few years.

The Commonwealth Treasury prepared a discussion paper on the "Review of the Commonwealth Government Securities Market". The discussion paper highlights a number of roles of the CGS market and asks for submissions on the relative importance of and alternatives to these roles. The Government's discussion paper provides three options going forward:

- 1) Eliminate the CGS market;
- 2) Consolidate Commonwealth and State government debt markets;
- 3) Maintain the CGS market and fund the Commonwealth's unfunded superannuation liabilities.

QIC's submission comprises two parts:

- 1) A description and analysis of results from a QIC sponsored client survey on the relevant issues in this debate including the importance of CGS to our clients;
- 2) QIC detailed responses to the technical issues raised in the discussion paper relating to the role of the CGS market that are relevant to QIC Fixed Interest investment management and our clients.

This submission also provides our brief summary of the Commonwealth Treasury Discussion Paper and an overview of QIC and the Fixed Interest investment management process.

QIC Client Survey

The results of **our client survey show overwhelmingly strong support for retaining the CGS market** — evident in a 98% response rate amongst our clients to the survey.

QIC clients believe that the CGS market provides a valuable public good to the broader Australian community of a transparent risk-free rate. The resultant side-effects of this "good" are efficient risk management tools and practices and a lower cost of capital for all borrowers within Australia. If the CGS market were not available as part of the premium setting process for pricing insurance products, clients have suggested that the price of insurance products to the general public would rise.

Clients generally consider corporate bonds or hedged foreign bonds are not appropriate substitutes for CGS. In the case of corporate bonds, there may be an

aversion to accepting higher levels of credit risk. In the case of hedged foreign bonds there may be an aversion to the added complexity of foreign exchange hedging or the need for Australian purchasing power to be maintained.

A significant unknown surrounding this issue is the direction that the asset consulting industry will take in advising clients as to defensive asset class exposures in the lead up to and subsequent to any decision made concerning the future of the CGS market. There is a strong possibility that the elimination of CGS would trigger fixed interest funds to leave Australia, which would inevitably raise the cost of capital over time for all Australian borrowers including corporations and households.

QIC Response to Discussion Paper Technical Issues

QIC supports the existence of a CGS market of sufficient size to facilitate liquidity and efficiency in the broader Australian capital markets, including futures, interest rate swaps and corporate bond markets.

The elimination of the CGS market would in QIC's view result in:

- **An increased outflow to offshore sovereign markets** (eg US Treasuries) of client investment funds that would have previously been allocated to the domestic fixed interest market.
- **Reduced efficiency and increased volatility** in Australia's capital markets because of reduced transparency in markets through the elimination of CGS;
- **There are no feasible alternative instruments** (after consideration of swap, corporates, multinationals, mortgages) that could effectively replace the CGS and related futures market as viable benchmarks and ensure the same level of efficiency;
- **The cost of capital would rise** resulting in higher borrowing costs for the entire Australian community including corporate and mortgage borrowers; our estimate for increased borrowing costs reflecting reduced liquidity and increased volatility ranges from 20 to 50 basis points.

In the event that the Commonwealth Government decides to wind down the CGS market, QIC would support the consolidation of Commonwealth and State government debt markets to provide an alternative benchmark or referencing rate.

In Summary, QIC Strongly Favours Retaining the CGS Market

For the reasons outlined above, QIC strongly supports the Government maintaining the CGS market as a risk-free investment vehicle for our clients, especially those with short term investment horizons, as well as to continue to support the efficiency in Australian capital markets and lower cost of capital for all Australian borrowers than would otherwise be the case.

The decision facing the Government concerning the future of the CGS market is the most important macro-financial market structural decision made by a Government

since the decision to float the Australian Dollar in the early 1980's. The decision will have major ramifications for the funds management industry for many years to come and affect the way QIC and many of our clients invest.

2. Summary of Commonwealth Treasury Discussion Paper

The following is a summary of the major points of interest in the Commonwealth Government discussion paper on the “Review of the Commonwealth Government Securities Market”¹.

Since the 1996-97 Budget, the Commonwealth Government’s medium term fiscal strategy of balanced budgets along with significant asset sales has resulted in the size of the Commonwealth Government debt market falling significantly. With continued fiscal discipline along with the prospects of additional receipts from the further privatisation of Telstra, the Government has the ability to eliminate the CGS market over the next few years.

The discussion paper highlights a number of roles of the CGS market and asks for submissions on the relative importance of and alternatives to these roles. Broadly the roles of the market are:

- 1) *Pricing and referencing of financial products* – CGS provide a risk-free benchmark to improve the transparency of pricing for other securities of higher risk;
- 2) *Managing financial risk* – CGS allow for the efficient management of interest rate risk thereby lowering the cost of managing financial risk in other risky securities;
- 3) *Providing a long-term investment vehicle* – CGS play an important part in the investment process by providing investors with a low-risk, long-term investment vehicle;
- 4) *Implementing monetary policy* – the Reserve Bank of Australia uses CGS along with other instruments to effect monetary policy decisions;
- 5) *Providing a safe-haven during periods of financial instability* – CGS play an important role during times of instability such as the Asian crisis in 1998 and the September 11 terrorist attacks, by providing a liquid risk-free asset for investors to alter their investment mix.
- 6) *Attracting foreign capital and promoting Australia as a global financial centre.*

This QIC Submission will in the following sections respond to issues raised in the Government’s discussion paper in relation to 1), 2), 3), and 5).

The Government’s discussion paper provides three options going forward:

- 1) *Eliminate the CGS market* – this is the Government’s favoured option;

¹ Review of the Commonwealth Government Securities Market, Discussion Paper, Commonwealth of Australia, October 2002

- 2) *Consolidate Commonwealth and State government debt markets* – this proposal was recently rejected by interested parties and the discussion paper considers it unlikely to be reconsidered;
- 3) *Maintain the CGS market and fund the Commonwealth's unfunded superannuation liabilities* – this is the Government's least preferred option.

The decision facing the Government concerning the future of the CGS market is the most important macro-financial market structural decision made by a Government since the decision to float the Australian Dollar in the early 1980's. The decision will have significant ramifications for the funds management industry for many years to come and affect the way QIC and many of our clients invest.

3. Overview of QIC

Queensland Investment Corporation (QIC) was established in 1991 by the QIC Act 1991 and has grown to become one of the largest wholesale fund managers in Australia. At the end of June 2002², QIC was the fifth largest wholesale investment manager, managing in excess of \$25 billion on behalf of its clients. The Corporation manages investments for State public sector superannuation and insurance schemes, the Queensland Government, and a range of other clients including insurance, charitable, research and university funds.

QIC's Corporatisation Charter states:

“The objective of the Corporation is to conduct a successful commercial enterprise through the efficient provision of professional investment and fund management services and other financial services to the State, statutory bodies and any other persons whatever so as to generate a satisfactory commercial return on the State's investment in the Corporation.”

QIC, as a statutory Government Owned Corporation, was established as a body corporate under an Act and is not registered under the Corporations Act. QIC complies with the corporate governance regime laid down by the Queensland Government, which is similar to the regime contained in the Corporations Act. Even though QIC is exempt from the Corporations Act, QIC complies with the spirit of the Act where it is commercial and prudent to do so.

While QIC does not have a parent company, a Corporate Plan is presented to the shareholding Ministers each year. This Plan is included within an annual Statement of Corporate Intent. The Plan presents the current and future strategies of QIC. It is structured to provide a summary of the organisation's corporate direction, its process of strategic planning, core competencies, significant environmental issues facing or potentially impacting the Corporation, outcomes of previous year's key result areas (KRAs) and those proposed for the coming year.

While QIC is a Government Owned Corporation (GOC), the QIC Act specifically states that the Government must not give directions to the QIC Board in relation to dealing with investments, voting rights of securities, assets and liabilities. (Sections 34 & 35).

QIC operates on a wholly commercial basis, providing competitive service and achieving returns that consistently rank it amongst the most successful funds managers in the country. QIC, as trustee and fund manager, is a major investor in Australia and overseas. QIC actively manages funds in house, but also uses the expertise of closely monitored external managers giving our clients access to both local and international markets and investment expertise.

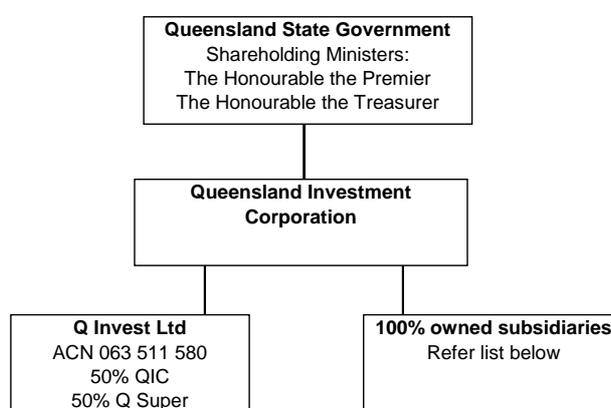
QIC offers a full service investment solution customised to each client's particular investment objectives. QIC advises on portfolio construction and strategy to maximise investors' returns consistent with expectations and risk tolerances. The

² As according to the Rainmaker Information June 2002.

QIC product range provides clients with the choice of either investing collectively with other clients (which provide economies of scale and diversification) or investing in discrete portfolios (in which there is a sole investor).

Since early 2000, QIC has developed many new and innovative products to meet the changing needs of current and potential clients. These new products include: Implemented Equity Fund, Premium Equity Fund, Venture Capital Fund, BioCapital Fund, Australian Credit Fund, Balanced Property Fund, Shopping Centre (Retail Property) Fund, Stable Fund, Growth Fund and High Growth Fund. These products have supplemented the funds which already existed pre-2000 including the QIC Balanced Fund (QICIT) and pooled sector funds across the major asset classes.

Figure 1: QIC

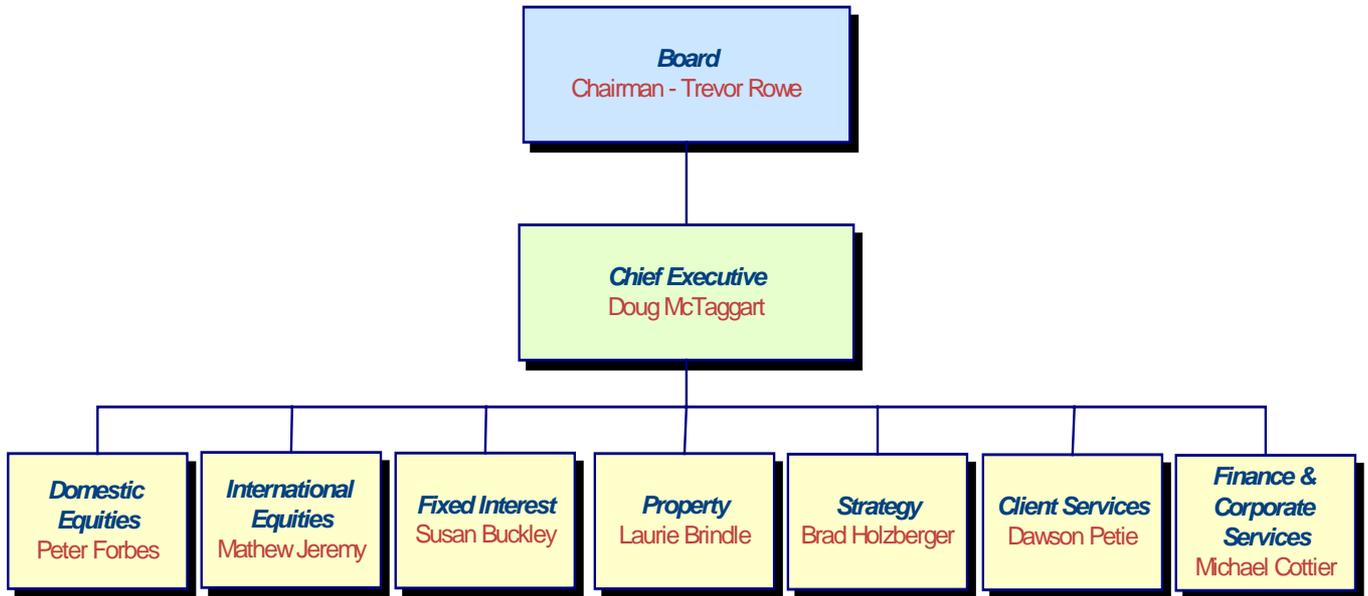


100% owned subsidiaries:

1. QIC Properties Pty Ltd (ACN 075 744 151)
2. Balfour Pty Ltd (ACN 051 675 033)
3. Bowmint Pty Ltd (ACN 052 971 776)
4. Canberra Centre Investments Pty Ltd (ACN 067 682 893)
5. Eastland Property Holdings Limited (ACN 055 780 295)
6. Grand Central Toowoomba Ltd (ACN 064 547 011)
7. Invermill Pty Ltd
8. Pacific Echo Pty Limited (ACN 074 053 446)
9. QIC 25 Bligh Street Pty Ltd (ACN 080 215 238)
10. QIC Colonial Centre Pty Ltd (ACN 080 253 425)
11. QIC Eastland Pty Ltd (ACN 080 215 354)
12. QIC Epping Road Pty Ltd (ACN 080 215 309)
13. QIC Helensvale Pty Ltd (ACN 080 215 247)
14. QIC Hi Yield Pty Ltd (ACN 077 572 199)
15. QIC Logan Hyperdome Pty Ltd (ACN 076 279 699)
16. QIC MLC Centre Pty Ltd (ACN 076 279 626)
17. QIC Office Pty Ltd (ACN 076 279 582)
18. QIC Property Funds Pty Ltd (ACN 076 279 528)
19. QIC Property Management Pty Ltd (ACN 076 279 359)
20. QIC Retail Pty Ltd (ACN 076 279 546)
21. QIC Retail (No.2) Pty Ltd (ACN 080 215 167)
22. QIC Ringwood Pty Ltd (ACN 080 216 185)
23. QIC Toowoomba Pty Ltd (ACN 076 279 484)
24. QIC Westpoint Pty Ltd (ACN 080 215 194)
25. Watergardens Pty Ltd (ACN 066 225 205)
26. Watergardens Brimbank (ACN 074 123 130)

A seven-person senior management team (shown in Figure 2) report to the Chief Executive Officer, Dr Doug McTaggart, in turn being responsible to the QIC Board.

Figure 2: QIC Management Structure



4. QIC Client Survey

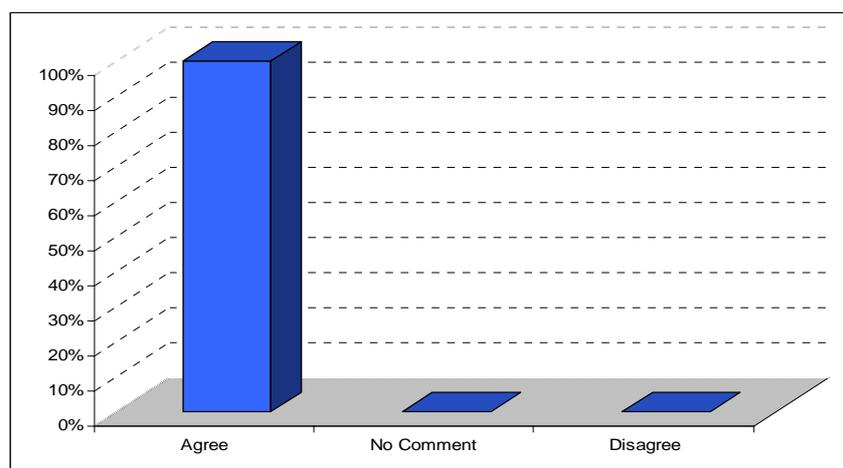
QIC's clients — representing approximately \$26 billion of invested funds — were asked to participate in a survey to determine their views in reaction to the major issues raised in the Commonwealth discussion paper.

Appendix 1 provides a copy of the actual survey provided to QIC's clients, along with a list of QIC's clients (Appendix 2). Given the short time period available for submissions, the survey method was chosen as the most timely way to gather feedback from QIC clients.

The 98% response rate of participating QIC clients shows the significant level of interest in, and importance of, these issues to many of our clients. The following results are provided on a percentage of client funds under management. These results are further discussed in the next section within the discussion of the importance of the role of CGS in providing a long-term investment vehicle.

The following charts provide a representation of the clients' responses to the four survey questions.

Figure 3 – Are CGS an important element of investment choice for investors?

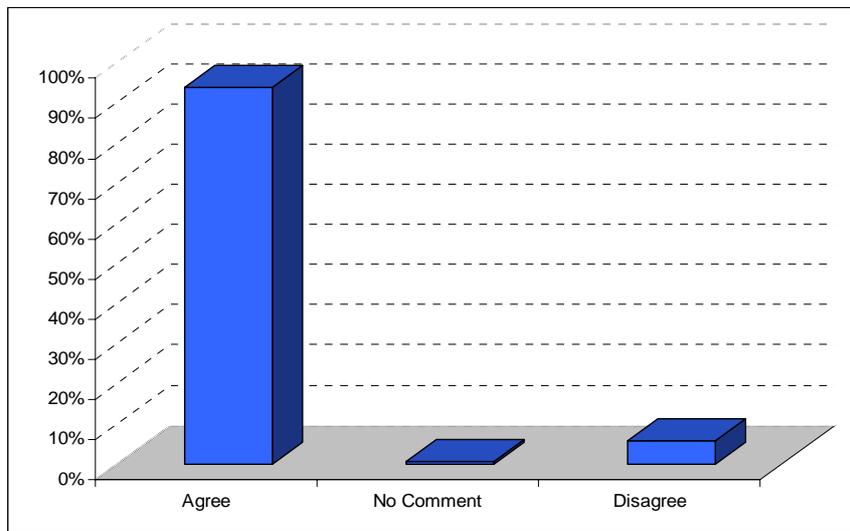


The above chart shows clients overwhelmingly consider CGS an important element of their investment choice.

Some of our clients have provided additional feedback including the following quote:

“CGS are the benchmark for determining the risk-free rate of return. The pricing of all other investments are at a margin over the risk-free rate. Without CGS the financial markets will need a substitute benchmark for the risk-free rate. This may lead to market instability and inefficiencies in the short to medium term”.

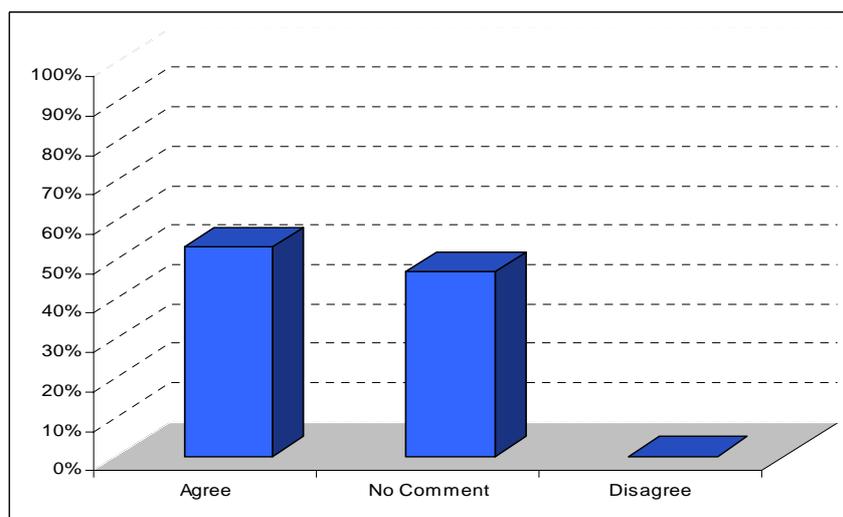
Figure 4 - Corporate bonds or hedged foreign bonds are not appropriate substitutes for CGS



The above chart shows clients generally consider corporate bonds or hedged foreign bonds are not appropriate substitutes for CGS. The analysis in the next section explores some reasons as to why this may be the case. In the case of corporate bonds, there may be an aversion to accepting higher levels of credit risk. In the case of hedged foreign bonds there may be an aversion to the added complexity of foreign exchange hedging or the need for Australian purchasing power to be maintained.

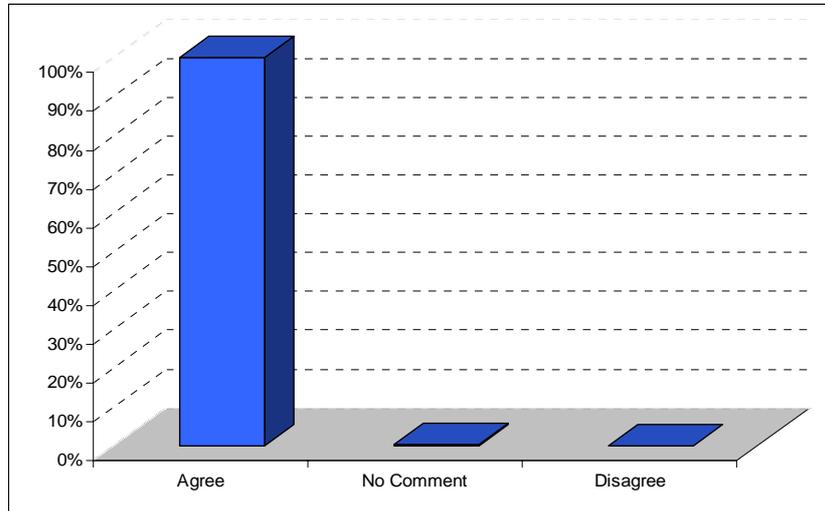
Some of our clients have provided additional feedback that they use the CGS market as part of the premium setting process for the pricing of insurance products they offer to the general public. In such cases if the CGS market were not available for this process and higher yielding swap yields were used, one result may be higher costs of insurance products to the general public.

Figure 5 - Given mandated superannuation contributions the Government has an obligation to provide a risk-free investment to facilitate member choice



The above chart shows some support from our client base for the notion that as the Federal government has made superannuation compulsory, it is obligated to provide a risk-free investment to facilitate member choice.

Figure 6 - CGS provide an important investment vehicle for investors with shorter investment horizons



Moreover, the above chart shows our clients support the notion that CGS provide an important investment vehicle for investors with shorter investment horizons. These types of investors include retirees, those nearing retirement, those investing for a shorter term goal such as education costs, those changing their investment plans. For such investors CGS comprise a much larger percentage of their overall investment portfolio and thus maintenance of the CGS market is important for these investors to deliver their investment objectives.

5. QIC Fixed Interest Management Responses to Discussion Paper Issues

QIC manages on behalf of its clients approximately \$6 billion in total assets across Cash, Australian Fixed Interest and International Fixed Interest. The function of the QIC Fixed Interest Division is to manage domestic and offshore cash and fixed interest portfolios with the objective of achieving target returns subject to prudent levels of risk.

The Fixed Interest Division comprises a team of nine people including five team members with Fixed Interest portfolio management expertise, as well as research specialists covering credit and quantitative analysis. The Division demonstrates core capabilities in the following areas:

- 1) *Interest Rate Risk Management*: including macro economic research and market analysis of the factors driving interest rates and yield curves across the major world economies, as well as Australia. This process involves combining research, judgements and market information into measured views that translate into discrete active positions and are tied to active return outcomes.
- 2) *Credit Risk Management*: including analysis and research of global and domestic swap and credit markets, as well as, industry, issuer and individual security research. This process involves combining research, judgements and market information into measured views that translate into discrete active positions and are tied to active return outcomes.
- 3) *Fixed Interest Implemented Management*: include qualitative and quantitative processes for analysing and selecting Global Fixed Income Managers to manage client Fixed Interest funds to achieve target active returns.
- 4) *Portfolio Construction and Performance Attribution*: use of risk management techniques to manage the risk profile of cash and fixed interest assets relative to the relevant client benchmarks as well as implement strategy decisions and monitor and manage the active positions across portfolios.

As an experienced and active Fixed Interest investment manager, QIC has provided in the following sections expert answers to the key questions raised in the discussion paper where applicable to the investment management activities of QIC.

Given that there are no previous examples of a developed country that has eliminated its well-functioning and efficient CGS market, discussing a scenario where this may unfold requires experienced and judgemental analysis. The main contributors to the following technical responses are Susan Buckley and Jeff Brunton with their respective biographies noted below:

- *Susan Buckley, Executive General Manager, Fixed Interest*
Susan joined QIC in November 2001 as Executive General Manager, Fixed Interest and brings seventeen years experience in the financial markets industry. Susan is responsible for the Fixed Interest Division including the expertise and

responsibilities of the team, the development and adherence to value adding and disciplined investment processes, oversight of daily risk management, the research process, portfolio management and risk systems, and Fixed Interest products. She is also a member of our executive management team, sharing responsibility for the strategic direction of QIC.

Prior to joining QIC, Susan held positions as the Head of Strategy for NRMA Asset Management, Senior Vice President at Bankers Trust Funds Management and Manager Fixed Interest at Suncorp Investment Management. She also worked as an economist for National Australia Bank and was Director, Foreign Exchange Services with Syntec Economic Services. Susan holds a Bachelor of Economics (Uni of Qld) and a Graduate Diploma in Economics (Uni of Melb). Susan is also a Registered Representative of the Sydney Futures Exchange.

➤ *Jeff Brunton, Head Portfolio Manager, Australian Fixed Interest and Cash*

Jeff joined QIC in December 1992 and has eleven years experience in the financial industry. Jeff has responsibility for the investment management and performance of QIC Australian Fixed Interest and Cash funds and oversees portfolio construction and implementation issues. He has responsibility for the Australian Fixed Interest and Cash team on a day to day basis. Jeff also directs and contributes to domestic Fixed Interest macro and credit research.

Before joining the Fixed Interest Division, Jeff worked in QIC's Investment Strategy Division. Jeff has a Bachelor of Commerce (Hons) and Bachelor of Law (Uni of Qld) and is a Chartered Financial Analyst (CFA).

6. The Pricing and Referencing of Financial Products

CGS provide a risk-free benchmark that improves the transparency of pricing for other securities of higher risk, thereby underpinning the efficiency and liquidity of the Australian capital markets. CGS markets are used to price and manage the interest rate risk component of swaps, corporates, mortgage-backed transactions and other wholesale and retail products.

Every \$1 of CGS are traded at least 9 times each year in the physical market and at least 40 times in the futures market³ demonstrating the widespread use of CGS as an active trading instrument and important hedging tool for corporate and swap transactions. To a large extent, this reflects the fact that “Australia is one of the very few western countries, offering international investors (and the derivatives trading community) bond derivative liquidity on a scale comparable to much larger capital markets ...government bond futures contracts are the ‘norm’ for the international trading and investment community to manage underlying exposures or trade medium or long term interest rate obligations”⁴.

Access to virtually 24 hour trading in CGS physical and futures markets contributes to the depth and liquidity of the CGS market. The SFE currently offers “the largest pool of government bond derivative liquidity outside of the US and German bond markets”⁵. Thus, while only 5% of total superannuation assets are held in CGS, the significant turnover in the CGS instruments reflect the widespread participation in this market ranging from local institutions, investment banks, major trading banks and other financial institutions, overseas investors, CTAs, hedge funds, day traders and so on. The breadth of participation in CGS turnover facilitates the widespread distribution of interest rate risk, that without the presence of the CGS market (physical and derivatives) would lead to a concentration of financial risk in fewer hands.

The Commonwealth’s discussion paper requests feedback on this issue in the following respects:

6.1 *Whether CGS is used extensively as the primary benchmark for pricing the debt securities of other issuers?*

Yes

QIC actively manages both the interest rate risk and credit risk of its Australian Fixed Interest investments.

The analytical process used to actively manage credit risk of the non-sovereign component of our portfolios uses CGS as the reference point to determine the relative attractiveness of credit. Indeed, the primary decision made reflects the overall credit spread to the relevant Commonwealth Government bond. Figure

³ Submission to the Review of the Commonwealth Government Securities Market, SFE Corporation Limited, Sydney, December 2002.

⁴ Ibid, p. 16.

⁵ Ibid, p. 16.

7 provides an extract from the output of our credit process, displaying part of our analytical approach to assessing the pricing of corporate bonds.

Figure 7 – QIC Credit Process Extracts (Spread to CGS)

Spread to Interpolated Bond		Spread to Interpolated Bond	
Top Wideners from 09 Oct 2002 to 10 Oct 2002		Top Tighteners from 09 Oct 2002 to 10 Oct 2002	
LastOfRating	(All)	LastOfRating	(All)
LastOfSector	(All)	LastOfSector	(All)
Sum of BondChange		Sum of BondChange	
CodeNameRating	Total	CodeNameRating	Total
FORDCRED16/03/045.75 BBB+	82	GOV-QUEBEC 15/02/065.75 A+	-3
SYDAIRPORT11/10/076.02 A+	81	DEUTSCHEOT15/04/046 BBB+	-2
HOUSEHOLD15/02/056 A	62	ETSA15/07/057.5 A-	-1
HOUSEHOLD01/12/066.5 A	60	EUROFIMA30/04/035 AAA	-1
FORDCRED15/08/036.75 BBB+	40	FAC02/06/038.25 AAA	-1
DUKEENERGY15/09/047.25 A-	30	BRD14/05/035.5 AAA	-1
HOUSEHOLD15/08/036.75 A	20	RAMS08/05/037 AAA	-1
PRINCIPAL215/07/057 AA	15	WBC SUB26/05/036 A+	-1
PRINCIPAL15/07/057 AA	15	AIRSERVICE15/11/068.5 AAA	0
PRINCIPAL31/01/086.25 AA	13	AMPDPT15/07/056.35 A	0
GECAPITAL15/09/097 AAA	12	AMPDPT15/08/037.5 A	0
CITIBANK15/07/055.75 AA	11	AMPDPT15/02/055 A	0
MERRILL-CO15/09/047 AA-	9	AMPDPT15/09/047.5 A	0
BAT15/11/068.5 A	9	ANZ15/07/056 AA-	0
NATWIDE23/02/045.5 AA	8	ANZ15/09/035.5 AA-	0
MERRILL-CO07/08/035.75 AA-	8	ANZ15/09/047 AA-	0
GECAPITAL15/04/056.25 AAA	8	ANZ15/10/025.75 AA-	0
		ANZ22/03/076.75 N/A	0
		ARMS10/03/056.105 AAA	0

If there were no CGS market, the active management process of adding value in a Domestic Fixed Interest portfolio for clients becomes comprised and questionable. There is a risk that clients change mandates to seek active returns in global sovereign credit markets.

6.2 *Is the interest rate swaps curve used widely for pricing debt securities? If not, are there obstacles to using the swap curve in the future?*

Yes and Yes

QIC uses the swap curve as a *secondary* reference point along with the CGS curve as pricing tools. Figure 8 provides an extract from the output of our credit process, displaying another part of our analytical approach to assessing the pricing of corporate bonds. In this instance, the corporate bond yield to swap yield spread is monitored.

However, the credit spread to swap is a less reliable indicator of the reward for risk of a credit security because the swap market is largely a "flow" driven market rather than a reference or benchmark.

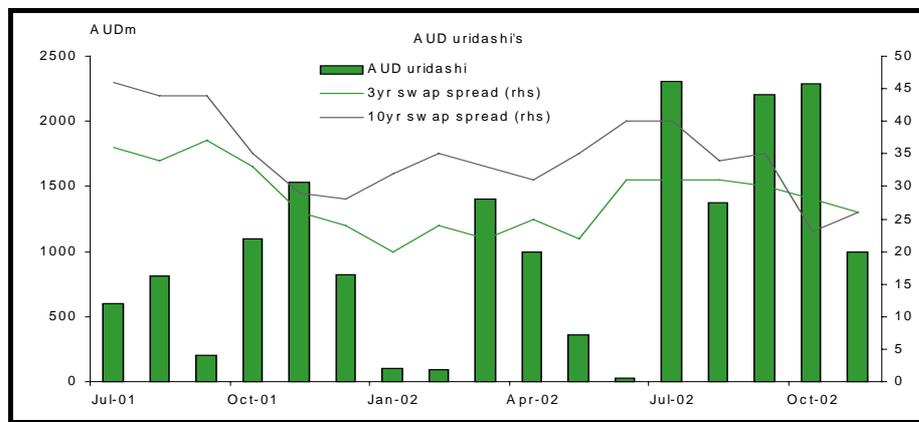
Theoretically the spread between a country's sovereign curve and its swap curve should reflect the overall credit quality of the country's banking system as traditionally swap markets have operated as over-the-counter inter-bank derivative markets. In practice, the swap spread to CGS is less an indicator of banking system credit quality, but more an indicator of investment flows.

Figure 8 – QIC Credit Process Extract (Spread to Swap)

15 top borrowers from 09 Oct 2002 to 10 Oct 2002		15 top lenders from 09 Oct 2002 to 10 Oct 2002	
Spread to Swap			
CodeNameRating	Total	CodeNameRating	Total
FORCHOLD1509045 75 BBB+	75	UTLCCORP1510027 25 BBB	-60
SYDARPORT1110078 02 A+	54	BCCOAS1510026 25 A+	-15
HOUSEHOLD1502056 A	54	SANTOS1510026 4 BBB+	-12
HOUSEHOLD1120066 S A	50	TELSTRA1510021 5 AA-	-12
FORDCRED1508036 75 BBB+	39	PRINCIPAL1510026 75 AA	-10
OURENERGY1509047 25 A-	20	PRIORITY1510026 AAA	-10
HOUSEHOLD1509036 75 A	10	PROGRESSA21510026 AAA	-10
PRINCIPAL1507057 AA	-13	WESTFIELD1510026 35 A	-10
PRINCIPAL1507057 AA	-13	CRUSADE1510027 265 AAA	-8
PRINCIPAL1507057 AA	11	COLONPN1510026 A+	-5
CITIBANK1507055 75 AA	10	BACL3006107 3 AAA	-4
MERPELL-CO0705035 75 AA	8	MELBAPCORP1509036 75 AAA	-4
SECAPITAL1508037 AAA	8	SOUTHCCORP2003108 25 BBB+	-4
NATWEBE2302045 5 AA	7	ARMS1503056 105 AAA	-3
MERPELL-CO1509047 AA-	7	AUSTPOST2503056 AAA	-2
BAT1511056 S A	7	BHP1509096 25 A	-2
		DELTAECHECT1504046 BBB+	-3
		ENPEC-MAE1509076 375 AAA	-3
		CASHNET2003097 AAA	-3
		GOV-GLBEC1502065 75 A+	-3
		AOL1509096 75 A	-3
		RENTENBANK1509096 AAA	-3
		STORCORP1510026 75 A	-3
		TELSTRA3003107 25 AA	-3
		TELSTRA3107087 AA	-3
		TOPRENS1103056 415 AAA	-3
		VIRTUE1503157 1 AAA	-3
		VIRTUE1503107 3 AAA	-3

Borrowers and lenders use the swap market to alter cash flow streams. Figures 9 and 10 provide a history of swap spreads and show how significant flows have caused spreads to narrow or widen, irrespective of the credit quality of the Australian banking system.

Figure 9 - Shorter Term History of Swap Spreads

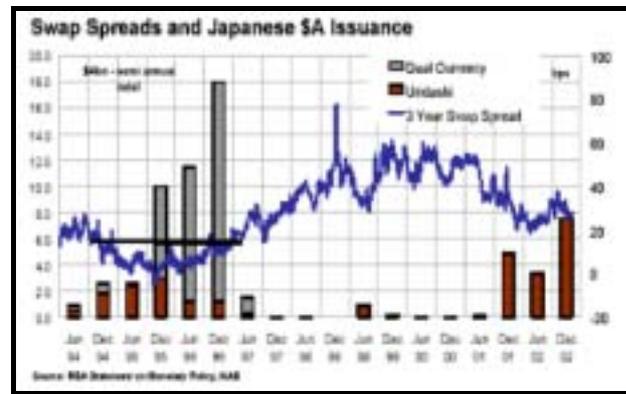


Source: ABN Amro

Figure 9 shows the influence of Uridashi or Japanese retail investor demand for AUD denominated cash flow streams and the resultant narrowing in Australian swap spreads, particularly at the longer maturity end of the swap curve since the start of this financial year. This narrowing in the swap spread has occurred against a generally deteriorating credit backdrop consisting of equity market weakness, corporate scandals and historically wide credit yield spreads to bond. In previous instances of rising risk aversion the swap spread has typically widened.

Figure 10 provides a longer term history which shows flows from “kangaroo bond”⁶ issuance, along with Uridashi, have major impacts on swap spreads.

Figure 10 - Longer Term History of Swap Spreads

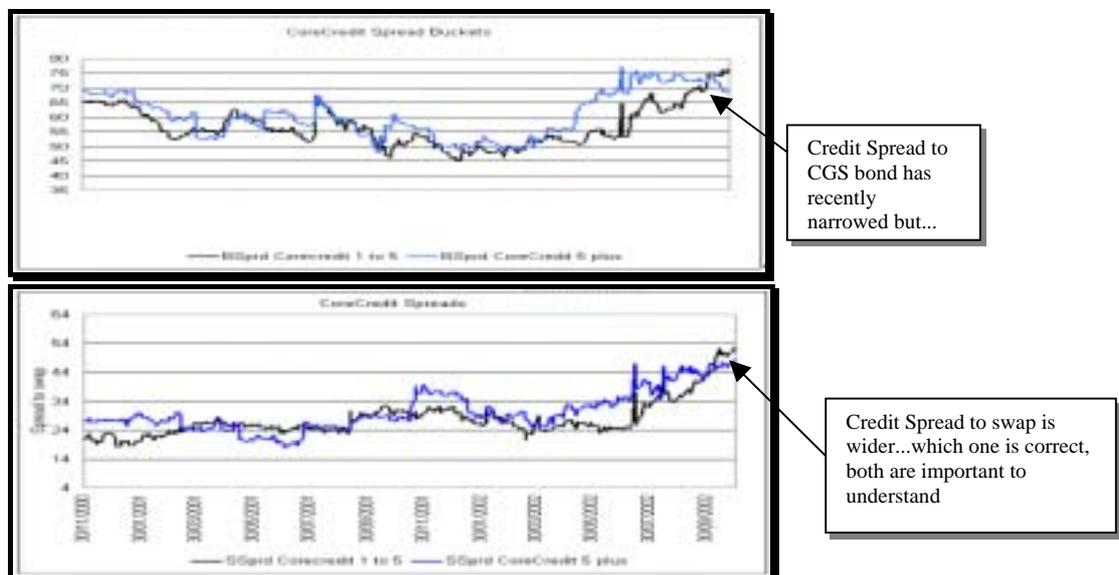


Source: NAB

The recent experience is similar to the 1995-96 experience of large Uridashi interest maintaining swap spreads at historically narrow levels.

Figure 11 shows the effect of this narrowing of swap spreads on the analysis of credit spreads to bond and swaps.

Figure 11 – Extract from Credit Analytical Process



Clearly, conflicting pricing signals are provided depending on the pricing benchmark used, such that it is important to have both references to determine the appropriate pricing of debt securities.

While there has been a growing use of swaps for reference pricing and managing spread risk, the turnover in the swaps market is still only \$2.6

⁶ Kangaroo bonds are issued by foreign obligors into the Australian debt markets.

trillion in a financial market where exchange and OTC turnover runs at around \$50 trillion⁷.

6.3 *What other options are available for pricing debt securities? How effective are they?*

Uncertain

When choosing any pricing benchmark it is important that such a benchmark is:

- risk-free;
- not flow driven;
- of uniform credit; and
- highly liquid under all market conditions.

These traits allow for an objective determination of the pricing of credit risk. *The swap curve is impacted by flows and thus fails one of the above requirements. Corporate bonds lack uniformity of credit risk and are not highly liquid during periods of financial market dislocation.*

The most likely candidate would be a merged semi-government debt market, although uniformity of credit risk may be an issue. It is unclear how the various State Government Central Borrowing Authorities would implement such a scheme, especially issues of cross-guarantees. Such an amalgamation was rejected in 2001 by the States but has recently been re-examined by the eastern States. Little detail of the proposal is known at this stage such that informed comment is difficult. In any event, the effectiveness of such a plan will take some time to evaluate once it is operational.

⁷ “Australian Financial Markets Report”, AFMA, 2002, p.3.

7. Managing Financial Risk

CGS provide a role in the functioning of the Treasury Bond futures market, this market uses similar maturity CGS to determine the expiration price of the Treasury bond future. Treasury bond futures provide a vital interest rate risk management tool to borrowers and lenders alike.

The discussion paper requests feedback on this issue in the following respects:

- 7.1 *Whether there is scope for the Treasury bond futures market to be replaced by a futures market based on alternative instruments. What could hamper an alternative futures market from developing?*

Unknown

Apart from the US derivatives market, which has a relatively illiquid swap derivatives contract, there is little international experience with interest rate risk management derivatives that are not based on risk-free government securities. Indeed, the US swap contract daily turnover averages approximately 1% of the daily turnover of the US Treasury note futures contract, and is mainly used in connection with trading and hedging mortgage backed securities.

- 7.2 *Whether the interest rate swap market is sufficiently liquid at maturities longer than five years to facilitate interest rate risk management?*

No

QIC actively uses the current swap market extensively to implement primarily active credit risk management strategies. Documentation and settlement requirements are far greater compared with dealing in the CGS market. QIC counterparties include the country's largest swap houses and we have ISDA Agreements in place with several counterparties and are in negotiations with other counterparties to implement an ISDA Agreement.

Our experience, negotiations and actual dealings in the swap market have shown a lack of liquidity in this market stemming from the introduction of counterparty credit risk on both sides of the swap transaction. The generally accepted market practice when entering swap transactions with maturities later than 5 years is to provide a mutual right to break clause at year 5 in the documentation. The addition of such a clause renders longer-term asset portfolio management difficult, as the life of the swap contract is ultimately uncertain.

QIC has also found from time to time that as a large multi-asset class fund manager that some of our swap counterparties have experienced limit problems due to counterparty exposures to QIC arising in asset classes other than fixed interest. *Thus there is a clear capacity constraint in the Australian market place for counterparty risk and this will surely impact the liquidity of swaps for credit risk and interest rate risk management.*

- 7.3 *Whether the viability of the interest rate swap market would be affected significantly by winding down the CGS market?*

Yes

The swap market and CGS market are closely related. The swap market is dependent on the CGS market to provide a measure of the risk-free rate at a particular maturity. The shape of this risk-free rate for various maturities is referred to as the risk-free yield curve. The shape of the yield curve is driven by monetary policy expectations, inflation, and inflation risk premia. If this risk-free yield curve was unavailable, the level of transparency currently available in risk management tools would fall significantly thereby reducing the liquidity and viability of the swap market.

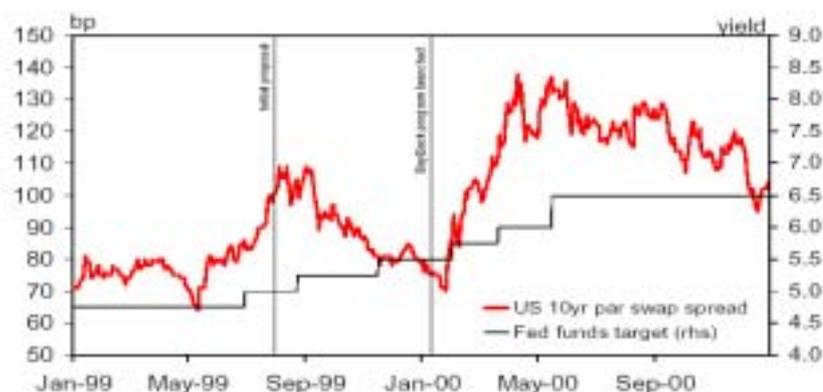
Further, the liquidity of the CGS market improves the liquidity of other associated markets including the futures markets, swap markets and corporate bond markets. To a large extent these markets are interdependent on each other and the removal of the CGS market will reduce the liquidity and transparency of other markets.

- 7.4 *If alternative risk management tools were not available, what would be the likely impact of this on the cost of capital for corporate bond issuers?*

Increase

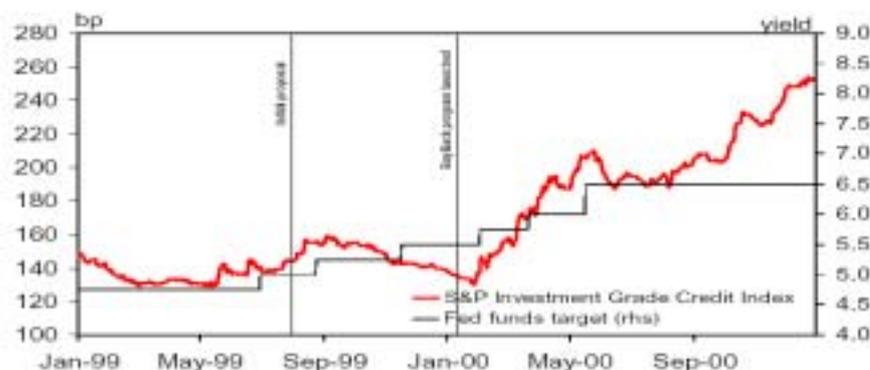
It is likely that lenders would require an illiquidity premium if alternative risk management tools were unavailable. This would increase the cost of capital for corporate borrowers. Our examination of market pricing for liquid and illiquid securities suggests that 20 to 50 basis points is a reasonable premium for a lender to give up liquidity in an exposure of comparable credit quality.

This estimation draws on US experience surrounding their Treasury's decision in late 1999 and early 2000 to begin to apply budget surpluses to reducing the supply of US Treasuries outstanding, particularly in the longer end of the US yield curve. Figure 12 shows US 10 year swap spreads widened by 40 to 50 basis points in the weeks following the launch of their buy-back programs in early 2000. US 10 year swap spreads widened from 80 to 90 basis points over US Treasuries prior to the launching of the buy-back program to 120 to 140 basis points over following the launch of the program.

Figure 12 – US 10 Year Swap Spreads

Source: WBC

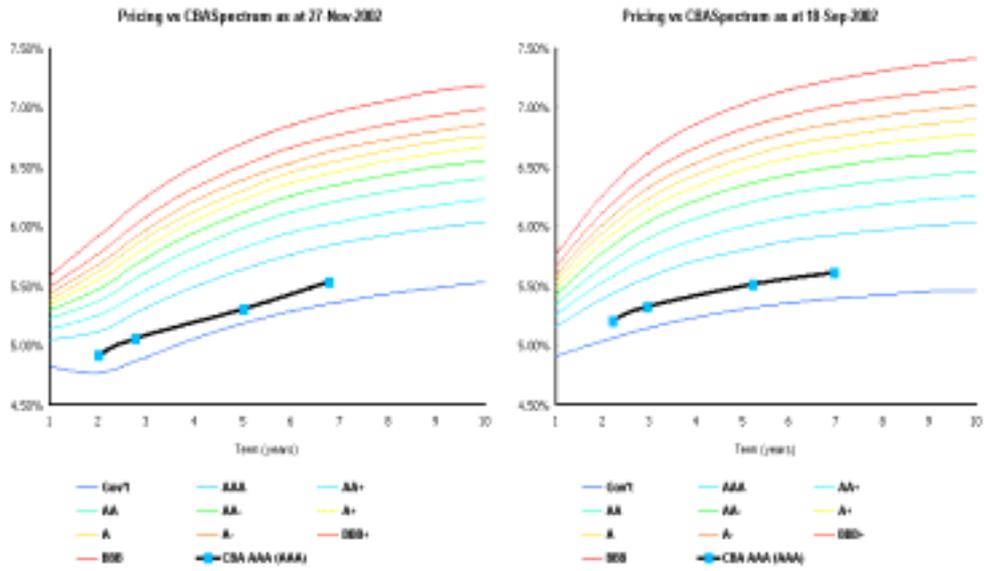
During the same period, US corporate borrowers experienced higher borrowing costs of between 40 to 50 basis points. This widening of spreads as shown in Figure 13 is due to a rising illiquidity premium associated with the removal of the US Treasury market.

Figure 13 – US Investment Grade Credit Spreads

Source: WBC

In the Australian context, lending data shows in excess of \$737 billion of debt outstanding, evenly split between households and corporations. With borrowing costs rising 50 basis points due to an illiquidity premium, the overall economy would suffer a \$3.5 to \$4 billion cost, evenly shared between households and corporations. These higher borrowing costs are shown in Figure 14 which portrays yield curves for various credit rating bands during normal market conditions (27 Nov 2002) and during illiquid market conditions (18 Sep 2001 – the week after the US terrorist attacks).

Figure 14 – Australian Credit Spreads



This risk aversion in the second panel shows higher concavity of yield curves with shorter term borrowing costs rising more. For instance an A-rated borrower paid about 6.60% on 18 September 2001, which equated to approximately 130 basis points over a comparable maturity CGS. However during more liquid market conditions experienced on 27 November 2002, the A-rated borrower paid 6.30%, which equated to 100 basis points over a comparable maturity CGS.

8. Providing a Long-Term Investment Vehicle

CGS play an important part in the investment process by providing investors with a low-risk, long-term investment vehicle, typically as part of a balanced portfolio or as the main asset class of choice for investors with shorter term investment horizons.

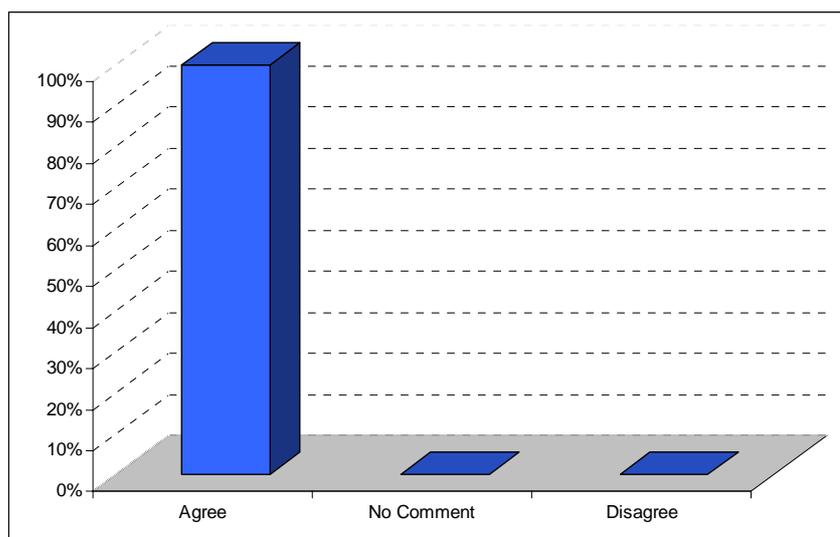
The discussion paper requests feedback on this issue in the following respects:

- 8.1 *The significance of CGS as a long-term investment vehicle, particularly for institutional investors such as superannuation funds and life offices.*

High Level of Significance

Given the results of the QIC client survey, presented earlier, it is clear that CGS are an important long term investment vehicle.

Figure 15 – Are CGS an important element of investment choice for investors?



Furthermore, CGS play an important role for investors with shorter investment horizons such as retirees, those approaching retirement and when moving between funds. These investors seek lower risk investments and stable returns and tend to favour the defensive (fixed interest, cash) versus growth (equities, property) asset classes.

- 8.2 *Whether there is currently an unmet demand for CGS within the superannuation sector*

No

QIC through its activities in Australian Fixed Interest markets finds sufficient liquidity and supply of CGS at current levels of outstandings. Most CGS have

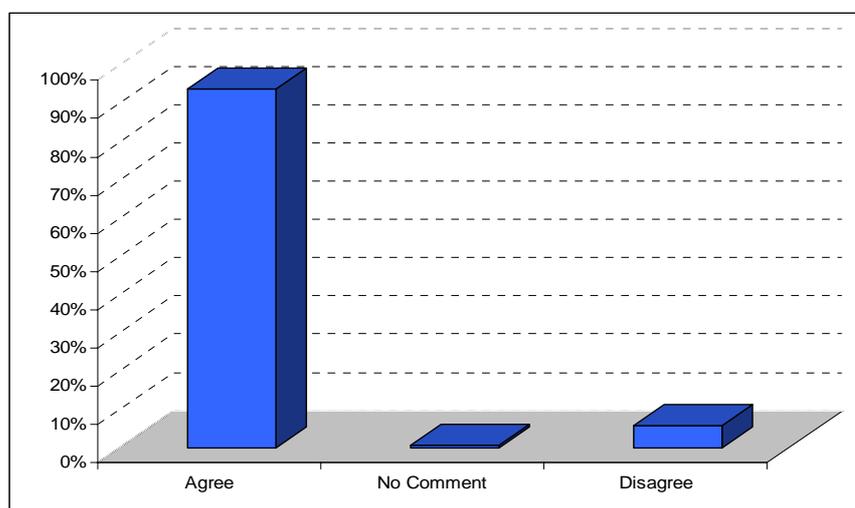
around \$5 billion outstanding at any particular maturity. This amount of outstandings provides sufficient liquidity, witnessed by tight bid/offer spreads and many market makers providing two-way markets under any market conditions virtually twenty-four hours a day.

8.3 *The potential to develop alternative long-term investment instruments?*

Mostly No

The results of the QIC client survey suggest that clients do not perceive corporate bonds or currency hedged foreign bonds as appropriate substitutes for CGS. Corporate bonds involve higher risk by virtue of increased credit risk, while hedged foreign bonds introduce added complexity and costs involved with foreign exchange hedging.

Figure 16 - Corporate bonds or hedged foreign bonds are not appropriate substitutes for CGS



Furthermore, QIC's clients typically invest either in pooled investment vehicles or via discrete portfolios. For both types of investing, QIC has established Investment Policies and Guidelines which are Board approved guidelines established in consideration of the clients risk/return tolerances and investment constraints.

These investment constraints typically have higher weightings to CGS compared to alternative investments such as corporate bonds, reflecting the defensive nature of this asset class in clients' investment plans. This is demonstrated in Figure 17 showing an extract from the Investment Policies and Guidelines representative of our fixed interest vehicles. Typically, the client mandate limit to swaps in such portfolios is 30% exposure versus 100% for CGS.

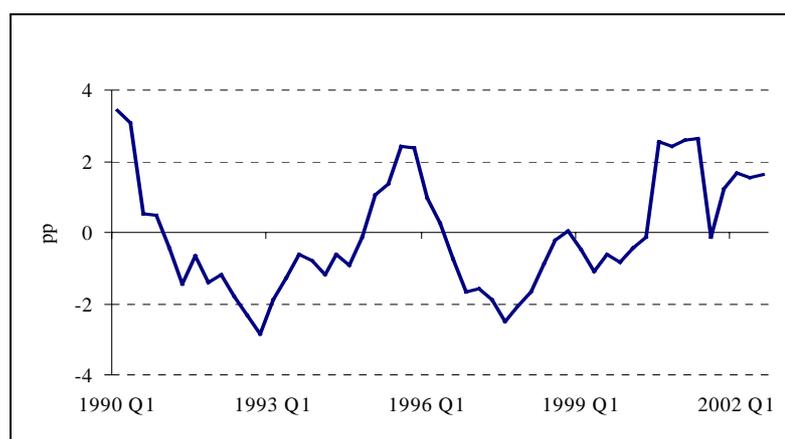
Figure 17 – Extract from Investment Policies and Guidelines

Sector Limits

The weighting of each sector within the Fund will be maintained in the following bands:

SECTOR RANGES AND LIMITS FOR AFI		
(Market Value % of Fund)	Minimum	Maximum
Commonwealth Government Securities	20	100
- Government Guaranteed (ex CBL)	0	40
Semi-Government Securities	20	80
Corporate Securities	0	65
- Sub-Investment Grade	0	10

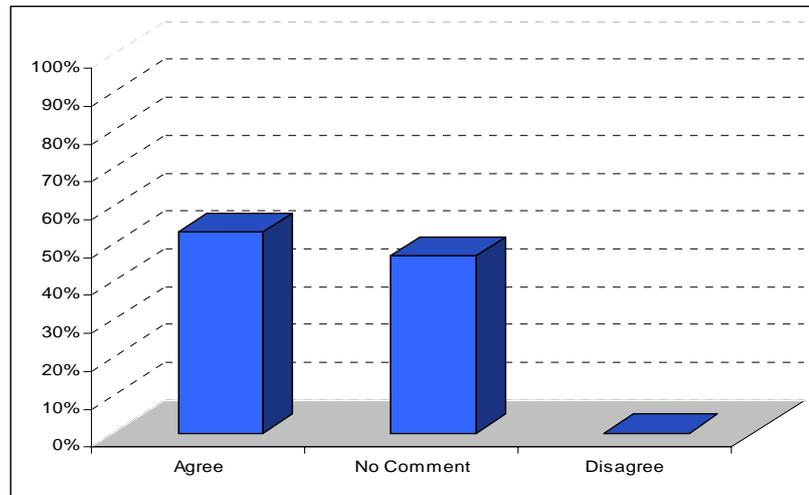
Using hedged foreign bonds as a substitute for Australian bonds assumes the relative inflation performance of the two currencies will be the same over the investment horizon. Clearly, shorter or medium term investors may run greater risks as the relative inflation performance of Australia and foreign nations may diverge. Figure 18 shows the relative inflation gap between Australia and the US on a rolling annual basis.

Figure 18 – Inflation Differential: Australia versus US

This difference in inflation performance impacts the returns investors will earn from Australian bonds to hedged foreign bonds with the latter underperforming the former when the inflation differential is narrowing and vice versa.

Further, for investors with shorter-term investment horizons such as retirees, those nearing retirement, or when shifting between funds it is important to have a \$A risk-free investment vehicle. In such circumstances, weightings to defensive asset classes such as CGS are much higher than in cases involving longer term investing.

Figure 19 - CGS provide an important investment vehicle for investors with shorter investment horizons



A significant unknown surrounding this issue is the direction that the asset consulting industry will take in advising clients as to these defensive asset class exposures in the lead up to and subsequent to any decision made concerning the future of the CGS market. A possible outcome may involve further funds leaving Australia, which will inevitably raise the cost of capital over time for all Australian borrowers including corporations and households.

9. Providing a Safe-Haven During Periods of Financial Instability

As the Honourable Treasurer, Peter Costello recently stated, “the size and stability of Australia’s financial markets play a vital role in the performance of the economy as a whole”⁸, and in particular through periods of global instability.

Just as the floating Australian dollar has played an important stabilising role for the economy in recent years, the CGS market⁹ has also played a vital role during times of instability such as the Asian crisis in 1998 and the September 11 terrorist attacks, by providing a liquid risk-free asset for investors to alter their investment mix.

The discussion paper requests feedback on this issue in the following respects:

9.1 *The importance of the CGS market in providing a safe haven during periods of financial instability?*

Periods of financial instability are characterised by dysfunctional markets where price discovery is impaired. The main cause of this impairment is a lack of liquidity whereby most market participants disengage from risk seeking activities such that the price for risk rises dramatically.

In such environments the CGS market provides continuity of functionality allowing market participants to continue to manage interest rate risk during such periods. This function acts to maintain and restore confidence in the financial markets once the shock or instability recedes in importance.

During financial instability the price for risk, or the risk premium, rises. This leads to higher required returns for bearing risk, which is facilitated by falling prices. As the price of risky bonds falls their yield rises and consequently their spread to the risk-free benchmark, namely CGS, widens.

QIC’s Investment Policies and Guidelines shown previously in Figure 17 have higher weightings to CGS compared to benchmark characteristics to allow flexibility in QIC’s investment activities for situations involving extreme financial market instability.

9.2 *What evidence is there of the role of CGS as a safe haven?*

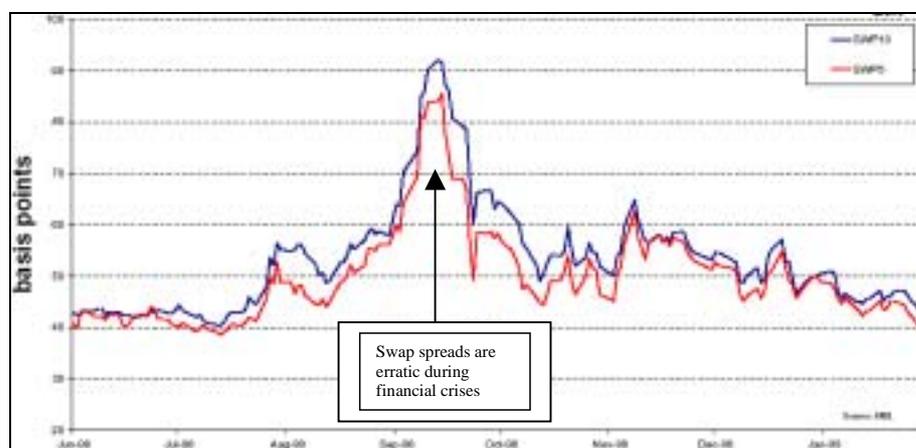
The Asian crisis of 1998 provides the strongest evidence of the role of CGS as a safe haven during financial instability. During the second half of 1998 concern over the credit standing of many emerging and developed Asian based capital markets saw capital flight from the region and an extreme rise in risk aversion. Despite Australia maintaining prudent financial policies at the time

⁸ Hon Peter Costello MP, Treasurer of Australia, “Foreword”, *AFMA Report*, 2002.

⁹ The futures market, dominated by 3 year and 10 year futures turnover, is the second largest market in Australia behind the foreign exchange market as according to the *AFMA Report*, 2002.

our markets were not immune to this extreme risk aversion. Figure 20 shows swap spreads during the Asian crisis.

Figure 20 – Swap Spreads during Asian Crisis 1998



Source: Macquarie Bank

For a number of weeks swap spreads experienced a large widening as borrowers were forced to pay up to 50 basis points more for funds during this period. In contrast to other affected markets in the region, Australia possessed a liquid and well-functioning CGS and futures market which acted to restore stability to other markets including swaps and corporate bonds.

Other Asian markets without well-developed government securities markets were forced to implement draconian measures including massive increases in overnight cash rates to attract foreign capital and placing controls and restrictions on the removal of foreign currency unrelated to trade activities.

The effects of these measures on these countries included economic recessions, rising unemployment, and political instability which persisted for years. Australia's well-developed and sophisticated financial markets, particularly its CGS and foreign exchange markets, contributed to our country avoiding the fate of many of our regional neighbours.

9.3 *What possible alternative safe havens exist and how appropriate are they?*

Unknown

The financial market cannot create a product that has all the features of the CGS market.

Semi-Government bonds possess some of the qualities of the CGS market but suffer from liquidity constraints. Swap markets lack homogeneity with each party to a swap transaction taking on counterparty risk and hence, this market could never be as liquid as CGS markets. Corporate debt is more volatile with inherent credit risks being tied to the economy, industry and individual issuer specific factors. Domestic mortgage issuance is not backed by the

Commonwealth or State Governments as they are in the US and thus, are not seen as viable benchmark alternatives.

Probably the most likely safe haven asset would be US government securities, although comments raised earlier in connection with foreign bonds are also relevant in this instance.

10. The Appropriate Size of the CGS market

The discussion paper requests feedback on the appropriate size of the CGS market in the event that the market is to be maintained.

QIC believes the appropriate minimum size of the CGS market is largely determined by the need to maintain a liquid futures market.

Many foreign bond markets have only one liquid ten year futures contract. This model could be adopted for Australia using three to four liquid CGS in the ten year maturity range. Each CGS would need in excess of \$4 billion in outstandings to ensure liquidity. Thus in total the CGS outstandings would range between \$12 – 16 billion. There is an issue with respect to how the government would manage such a program as there arises a need to redeem the shortest maturity bond every year or two and re-issue a longer-dated bond to ensure all CGS on issue fall into the maturity bucket for the ten year futures contract.

A more expanded and our preferred model would include maintaining sufficient CGS outstanding to support a liquid three year and ten year futures contracts. Using similar analysis the amount of CGS outstanding would range between \$25 – 35 billion. This approach may reduce the need for government management of the bond borrowing program as bonds could be issued approximately every two years out to twelve of fourteen years.

11. QIC Views on the Options

11.1 *Option 1: Wind down the CGS market*

The discussion paper requests feedback on the potential implications of winding down the CGS market, including: 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.

Generally, QIC's view on this option is negative and is provided within the responses contained within this submission. The resultant lack of liquidity and transparency will cause the cost of capital for all borrowers within Australia to rise, estimated at between 20 to 50 basis points.

Despite this view, should the government decide to adopt this option, QIC believes that a two to three year implementation timetable would be required to allow all stakeholders adequate time to analyse, prepare for and implement changes to their business and investment models and activities.

Further, QIC believes the likely re-entry costs on the government, if in the future the need for borrowing arises, would be significant. The government would pay an illiquidity premium for such borrowings. Once consultants and Superannuation Trustees have made decisions to redirect investments from CGS to other asset classes, such decisions would not be easily reversed.

11.2 *Option 2: Consolidate Commonwealth and State government debt markets*

The discussion paper requests feedback as to 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.

This is QIC's alternatively favoured option, apart from maintaining a smaller CGS market to ensure a liquid futures market, as discussed in Section 10.

QIC supports the concept of consolidation of Commonwealth and State government debt markets, however, there are many unanswered issues surrounding the details of such a model. QIC has particular concerns surrounding the lack of uniformity of credit in the absence of cross-guarantees between the individual government borrowers. Clearly, there are many outstanding issues that are required to be addressed in implementing such a model.

11.3 *Option 3: Maintain the CGS market and fund the Commonwealth's unfunded superannuation liabilities*

The discussion paper requests feedback on issues associated with funding its unfunded superannuation liabilities.

QIC believes the funding of unfunded superannuation liabilities is a separate decision to that of maintaining the CGS market, thus the comments below are directed mainly to the separate issue of funding the unfunded superannuation liabilities.

This option or model has been used by the Queensland Government for many years and QIC as the fund manager for the Queensland Government plays an important role in this process. This model has worked successfully for the Queensland Government and QIC for many years.

For further detail on the specific arrangements associated with this model please refer to the earlier section on the overview of QIC. QIC is able to provide additional assistance or specific information on this model if required.

12. Conclusion

A recent survey of QIC clients shows 100% agreement that CGS is an important element of investment choice for Australian investors.

Furthermore, QIC strongly supports the Government maintaining the CGS market as a risk-free investment vehicle for our clients, especially those with short term investment horizons, as well as to continue to support the efficiency in Australian capital markets and lower cost of capital for all Australian borrowers than would otherwise be the case.

QIC's major conclusions in reaction to the Commonwealth Government's discussion paper reviewing the CGS market are succinctly summarised in a recent research paper from the IMF, as follows:

“Reliable private substitutes for government securities simply do not exist in many, if not most, financial systems. The public benefits of effective, if not efficient, government securities markets for pricing, quoting, and hedging private financial risks can be significant well developed markets for government securities, in adequate supplies in a range of maturities, may provide significant public benefits that would be difficult, if not impossible to replicate, even in the comparatively well-developed dollar fixed income market.

Ultimately, countries must decide what role government securities markets can play in providing public benefits in the form of a financial market structure that fosters efficient finance and that encourages, and helps manage, systemic financial stability”¹⁰.

QIC thanks the Commonwealth Government for the opportunity to participate in the public debate over the future of the CGS market and the opportunity to provide supporting evidence for retaining the CGS market.

The decision facing the Government concerning the future of the CGS market is the most important macro-financial market structural decision made by a Government since the decision to float the Australian Dollar in the early 1980's. Elimination of the financial infrastructure provided by the CGS market, will not only affect financial market participants such as QIC and our clients, but will impact every financial transaction in the Australian community.

¹⁰ Schinasi, G.J., Kramer, C.F., Todd Smith, R., “Financial Implications of the Shrinking Supply of U.S. Treasury Securities”, IMF Working Paper, WP/01/61, May 2001.

Appendix 1 – Client Survey

QIC Client Survey

THE FUTURE OF THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

November 2002



1. Introduction

Queensland Investment Corporation (QIC) is seeking information from our clients in response to the release of the Commonwealth Government discussion paper on the “Review of the Commonwealth Government Securities Market” to determine whether to make a submission to the Government by the 6th December deadline.

To assist in this determination, QIC seeks information via this short survey from a sample of our clients. This survey covers topics contained in the discussion paper on which further information has been requested. Should QIC make a formal submission, these survey responses will form an important part of the information provided.

Given the tight timetable, QIC would very much appreciate your early response to questions raised in response to the Commonwealth Government paper.

Your responses will remain confidential to QIC. If you have any questions or concerns about the confidentiality of your responses on any part of this process please contact Dawson Petie or Susan Buckley.

QIC will endeavour to canvass our clients widely before making a submission to the Commonwealth Government.

A summary of the Commonwealth Discussion paper has been included in Section 2 for your reference.

Thank you for your time.

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2. SUMMARY OF COMMONWEALTH TREASURY DISCUSSION PAPER

The following is a summary of the major points of interest in the Commonwealth Government discussion paper on the “Review of the Commonwealth Government Securities Market”.

Since the 1996-97 Budget, the Commonwealth Government’s medium term fiscal strategy of balanced budgets along with significant asset sales has resulted in the size of the Commonwealth Government debt market falling significantly. With continued fiscal discipline along with the prospects of additional receipts from the further privatisation of Telstra, the Government has the ability to eliminate the Commonwealth Government securities (CGS) market over the next few years.

The discussion paper highlights a number of roles of the CGS market and asks for submissions on the relative importance of and alternatives to these roles. Broadly the roles of the market are:

- Pricing of financial products – CGS provide a stable benchmark to improve the transparency of pricing for other securities of higher risk;
- Managing financial risk – CGS allow for the efficient management of interest rate risk thereby lowering the cost of managing financial risk in other risky securities;
- Providing a long-term investment vehicle – CGS play an important part in the investment process by providing investors with a low-risk, long-term investment vehicle;
- Implementing monetary policy – the Reserve Bank of Australia uses CGS along with other instruments to effect monetary policy decisions;
- Providing a safe-haven during periods of financial instability – CGS play an important role during times of instability such as the Asian crisis in 1998 and the September 11 terrorist attacks, by providing a liquid asset for investors, both long and short term, to alter their investment mix.
- Attracting foreign capital and promoting Australia as a global financial centre;

The survey focuses on the third point above as the most relevant for QIC and our clients, however, in the event QIC makes a submission all of the above points will be covered.

The Government's discussion paper provides three options going forward:

1. Eliminate the CGS market – this is the Government's preferred option;
2. Consolidate Commonwealth and State government debt markets – this proposal was recently rejected by interested parties and is unlikely to be reconsidered;
3. Maintain the CGS market and fund the Commonwealth's unfunded superannuation liabilities –this is the Government's least preferred option for reasons which will be analysed during the submission process;

The decision facing the Government concerning the future of the CGS market is the most important macro-financial market structural decision made by a Government since the decision to float the Australian Dollar in the early 1980s. The decision will have ramifications for the funds management industry for many years to come and affect the way QIC and many of our clients invest.

3. CLIENT SURVEY – please complete and return by Friday 22 November

Name

Fund/Department/Organisation

Please indicate your response to the following statements with an “X” next to the preferred answer:

1. Commonwealth Government Securities (CGS) provide an important element of investment choice for investors.

Agree

No Comment

Disagree

2. Other forms of investments including corporate bonds or hedged foreign bonds are not an appropriate substitute for CGS for our funds.

Agree

No Comment

Disagree

3. As the Government has legislated mandatory superannuation contributions, they have an obligation to provide a stable investment for those who wish to choose their investment strategy.

Agree

No Comment

Disagree

4. CGS provide an important form of investment for those investors with shorter investment horizons.

Agree

No Comment

Disagree

5. Will you be making your own submission to the Commonwealth Treasury?

Yes

No Comment

No

If so, can QIC provide any assistance?

Yes

No Comment

No

6. Please provide below any further comments.

Appendix 2

QIC Clients

