

Submission to
Review of the Commonwealth Government
Securities Market

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Executive Summary

The National welcomes the opportunity to contribute to the review of the Commonwealth Government Securities (CGS) Market. The National recognises that prudent fiscal policy and assets sales have allowed the Government to substantially reduce the level of its debt, and for this the Government should be congratulated. However, it is now clearly decision time with CGS outstandings already low enough for the National and our clients to be concerned about the financial landscape ahead.

The recently released Discussion Paper has begun the decision process by raising a number of questions the Government is seeking guidance on. Our response does not attempt to answer all these questions, as on some topics we expect others will be better placed to assist the Government. Rather, this response is confined to the areas in which the National can offer an expert opinion as both a user and distributor of government bonds and the risk management products that derive from them.

This submission is in two parts. First under consideration is the crucial part the CGS market plays in enabling the private sector to manage financial risk and what the implications will be in the absence of a CGS market. Second, this paper addresses some of the other key issues the Government should consider as it approaches this important decision.

Overall, the National believes that there are sound public policy reasons for the retention of the Government Securities Debt Market. Australia's financial system has undergone far-reaching change over the last two decades and presently we are now in the fortunate position of having a vibrant and robust financial market. The CGS market is a critical part of this system and in many cases is the foundation that enables the delivery of innovative and cost effective investment and risk management solutions that benefit all Australians. In the National's view, the private sector would find it difficult, impossible in some cases, to perform some of these roles.

This response has looked specifically at how the private sector could manage financial risk in the absence of the CGS market. On balance, the National believes that the private sector would still be able to manage financial risk without a CGS market, but almost certainly the cost of managing financial risks would rise. In answer to one of the Governments specific questions, our analysis suggests it is improbable that a swap futures contract could replace the liquidity presently offered by bond futures. The small bit of history that can be referred to suggests that if swap futures have limited appeal and liquidity now, then even in the absence of a CGS market and bond futures, they will continue to have limited appeal and liquidity in the future.

A reduction in market liquidity would directly reduce the efficiency of Australia's financial system, leading to an overall welfare loss for Australia. What is uncertain is the actual dollar value of that loss. By implication, this makes it difficult to put an accurate dollar value on the "public good" aspect of the CGS market. Unfortunately, there is scant historical or international evidence to judge from and so to a large degree the Government will need to rely on a qualitative assessment.

However, what the National does submit is that loss of welfare to the private sector does not need to be large to justify the continuance of the CGS market from Australia's perspective. Private sector borrowings are currently 13 times the size of the CGS market and rising, while investment funds under management for Australian's are also 13 times the CGS market and rising. Accordingly, the potential loss of financial efficiency - i.e. an increase in borrowing costs or a reduction in risk adjusted investment returns - needs only be tiny to justify maintaining a CGS market that with sound governance structures can be run for zero cost and minimal risk.

We trust the Government will carefully weigh all the evidence as they approach this very important decision. We at the National are happy to provide further assistance.

Our paper is set out as follows:

1. Managing Financial Risk in the Absence of a CGS Market

- 1.1.** A new futures contract – can a futures contract based on swap, semi government or corporate bond markets develop?
 - 1.1.1.** Fundamental Impediments to new futures contracts, particularly swap.
 - 1.1.2.** The historical experience suggests caution.
- 1.2.** The outright swap market is not an alternative to the CGS market.
- 1.3.** Where will the financial costs be borne if a liquid alternative to bond futures does not develop?
 - 1.3.1.** The level of the swap curve may rise.
 - 1.3.2.** Reduced liquidity in swap will increase transaction costs.
 - 1.3.3.** The potential size and maturity of transactions will be reduced.
 - 1.3.4.** The yield curve may steepen.

2. Other Factors the Government Needs to Mindful of:

- 2.1.** Our submission presents some metrics, which suggest the benefit of maintaining the CGS market to Australians need be only very small to justify its continuance.
- 2.2.** Reduced liquidity and higher transaction costs in the swap market will impede the development of an alternative high quality benchmark bond curve.
- 2.3.** Reduced liquidity and higher transaction costs in the swap market will further encourage the recent development of Australian companies accessing funds in foreign bond markets.
- 2.4.** Growth in the domestic corporate bond market already appears to be stalling.
- 2.5.** The elimination of the Commonwealth Indexed Linked Market will take away the only material benchmark liquidity in this increasingly important asset and liability class.
- 2.6.** Concentrating bond market pricing in fewer hands may further increase transaction costs in debt capital markets as well as increasing systemic risk in the financial system.

1. Managing Financial Risk in the Absence of a CGS Market

The Government discussion paper correctly notes that one of the key roles the CGS market performs is that it allows companies, like the National Australia Bank, to manage financial risks in a cost effective way. The Discussion Paper gives a useful introduction into the mechanisms of financial risk management and the crucial role the CGS market presently plays in this system. This discussion will not be repeated here. Suffice to say that it is not the actual physical CGS market that is important for the management of private sector financial risks, but rather the wide array of derivative markets and products that currently rest on the CGS market. It is liquidity in the bond futures that allows efficient pricing in swap, cross currency, and swaptions markets. This in turn allows financial institutions to deliver cost effective and innovative risk management products to their clients. It is no stretch to say that the present CGS market and the deep liquidity in bond futures enables the National to deliver attractively priced fixed rate products to borrowers.

So,

- If a liquid interest rate swap market can be maintained in the absence of the CGS and bond futures markets, then the cost of borrowing/investing/hedging via swap will be unchanged. The obvious candidate to provide this liquidity is a swap futures market. If the swap futures market flourishes then from the perspective of managing financial risk at least¹, the status quo will be maintained.
- Alternatively, if liquidity in swap futures does not develop then liquidity in the swap market will deteriorate. If so, the cost of managing financial risk will rise. As a supplier of swap based interest rate products this increase in cost will impact directly on our retail and corporate lending products. As a user of the swaps market to manage the National's own interest rate risk, these additional costs could impact on our risk levels.

Mindful of these issues and the questions raised in the Discussion Paper the National has asked:

1. Can futures contracts based on other markets attain the same liquidity as bond futures?
2. Is the outright swap market an alternative to the CGS market.
3. If the futures contracts based on other markets don't flourish, what are the likely impacts on the cost of financial risk management?

1.1 A New Futures Contract

With necessity often the mother of invention, many assume that in the absence of a CGS market the deep liquidity in bond futures will simply migrate to a new futures contract based either on semi government bonds, corporate bonds or swap rates. A contract based on swap is seen as the most likely alternative and the SFE has recently introduced such contracts. While it is possible that these markets may develop, there are fundamental factors and historical precedents that suggest it is an overly optimistic conclusion to expect anywhere near the current liquidity in CGS bond futures can be replicated.

1.1.1 Fundamental problems with futures on Swap on Corporate Bonds

The special factors that make the CGS market better able to support a vibrant futures market are the homogeneity of credit, transparent pricing, deep liquidity in the underlying instrument, and international acceptance. With this in mind, the fundamental impediments the National sees to the development of a vibrant interest rate futures market based off swap rates or any other bonds are:

¹ We are mindful that the CGS market performs roles other than the facilitation of financial risk management.

- **Lack of credit homogeneity.** A five-year bond future contract based on Semi government debt was introduced by the SFE in the early 1990's and failed. This was due primarily to the differing credits that were backing the contract and participants' unwillingness to amalgamate the risk as one. Market participants wanted to analyse the credits separately and it was this lack of credit homogeneity amongst the State Government bonds that was the major contributor to the contracts failure. This precedent has important and obvious implications to any derivative contract that is based on bank credit, other corporate credit, swaps, or State Government bonds. This effect is magnified if any credit associated with the futures contract becomes distressed. International opinion is that the swap market is not sufficiently homogenised even in markets like the US to support a liquid futures contract².
- **Illiquid underlying physical assets.** The lack of liquid lines in an alternative underlying market that would form the base for a new futures contract would also inhibit the development of such a contract. The possibility of certain lines of stock becoming in short supply, or even failing to settle, would immediately stop many participants from dealing in the futures contract. This is applicable across both the Semi Government and corporate bond market where issuers have diverse governance and funding objectives leading to smaller and varied issues. This issue can also cause major problems on the close out expiry day when a relatively small physical trade can move the futures settlement price.
- **Pricing transparency.** The ability of large participants to manipulate the close out pricing of the swap contract is a concern for many. The sophisticated market position of the major investment houses and domestic banks in contrast to other less frequent users of swaps gives them disproportionate ability to move the swap rate during a close out process. Smaller houses that have very limited credit lines can also put up spurious quotes to influence a close out price.
- **This is a derivative on a derivative.** These instruments are thin eg options on futures. Reasons for this illiquidity include the distance between the financial instrument and the actual tangible asset and the reluctance of all but the most sophisticated financial market participants to be involved.
- **Ability to short the market.** Participants in fixed interest markets frequently use short positions in bond futures to hedge other long physical positions as it is far easier than shorting actual physical stocks due to repurchase (stock borrowing) costs. With swaps there is no repo cost of shorting via the swap, and so no incentive exists to use a swap derivative to short the market, which again reduces volume.
- **Offshore proprietary accounts will lose interest.** There will be an immediate and extremely large loss of support from offshore proprietary accounts. First, trading in government bond futures is widely accepted by all manner of investors, while trading in swap futures isn't. This lack of familiarity with the Australian swap market will see some investors exit the Australian market. Perhaps more importantly, it is the deep liquidity that attracts these investors presently and they are unlikely to participate in start up markets with thin volumes. This is a catch 22 as it is the involvement of these players that provides a good proportion of the liquidity. Feedback provided by an informal survey indicates that 30 -50 percent of futures broker business is from offshore and between 30-40 percent of that is discretionary traders who, as evidenced in other markets, are unlikely to remain within a non-government linked or less liquid market. This process has already adversely affected liquidity and volumes in the physical Commonwealth Bond market, with large offshore funds exiting the market over the last few years as the domestic bond market's relevance to global markets has decreased.

² Financial Implications of the Shrinking Supply of U.S. Treasury Securities, IMF, March 2001

- **It simply is not trading in a liquid manner now.** The ADX futures exchange recently attempted to introduce two new contracts based on Commonwealth Government debt. These contracts failed to obtain anything like a critical volume needed to attract participants. The NZ futures market is a classic example of where there has never been the depth and liquidity to attract participants from offshore or domestically to give the market life. It must be a major concern to anyone who promotes the ability of swap futures to survive, let alone replace the function of the existing bond futures, that one month after the start of trading of the two swap contracts introduced to the Sydney Futures Exchange, the three year contract has not traded and the ten year contract has an open interest of 645 contracts.
- **A reduction in the number of domestic players involved in the market.** A run down in the CGS market will remove a large number of market participants who will not migrate to other futures contracts, even if they were already trading and successful. This would include the bond intermediaries from the large financial institutions that provide the liquidity to the many end users of physical government bonds. Elimination of the CGS market would undoubtedly accelerate the concentration of market pricing in the bond market into the hands of a very small group of players.

This trend is already evident with the shrinkage in the CGS bond market to date contributing to the exit of a number of intermediaries. This concentration of market share will have its own implications for price efficiency and transparency in other bond markets.

Investment managers that have holdings of CGS will not migrate to other markets to manage their non-existent portfolios. Lack of mandates for fund managers – feedback from futures brokers suggests approximately 20 percent of the bond futures market is fund related – to trade swaps would subtract critical volume.

- **New futures contracts generally fail.** As a final point, it needs to be recognised that establishment of any new futures contract is notoriously difficult across global financial markets. Failed or illiquid futures contracts are more numerous than successful ones.

1.1.2 History warns against expecting swap futures to succeed.

Aside from the fundamental problems associated with a swap futures market, the little bit of history that can be referred to suggests that we should be cautious about their success in Australia. The lesson from these admittedly limited experiences is that if swap futures are not successful now, they will continue to be unsuccessful in the future.

European and US Experiences.

- The European and US experiences to date with swap futures have not been encouraging. Yet if there was any market in the world where a swap contract may have been expected to flourish it is in the Eurozone. Unlike all other markets where there is 1 government bond curve and 1 swap curve, the Eurozone has 12 sovereigns and 1 swap curve – that is the Eurozone Government Bond markets are not homogenous. Although it is early days, it is fair to say that Eurozone swap futures have underwhelmed.

Figure 1 and 2 show the monthly turnover in the 10-year bund and swap note contracts. Figure 1 shows that there was an initial surge in swap note activity but measured over the 22 months of its existence, activity peaked in the 4th month and has generally been in decline since. This is despite turnover in bund futures rising through the same period. Figure 2 shows the relative performance more clearly, with swap note turnover peaking at a meagre 2% of bund turnover in 2001 and then declining through 2002 to around ½-¾% of bund turnover presently.

Figure 1: Turnover in Euro Swap Futures and Bund Futures

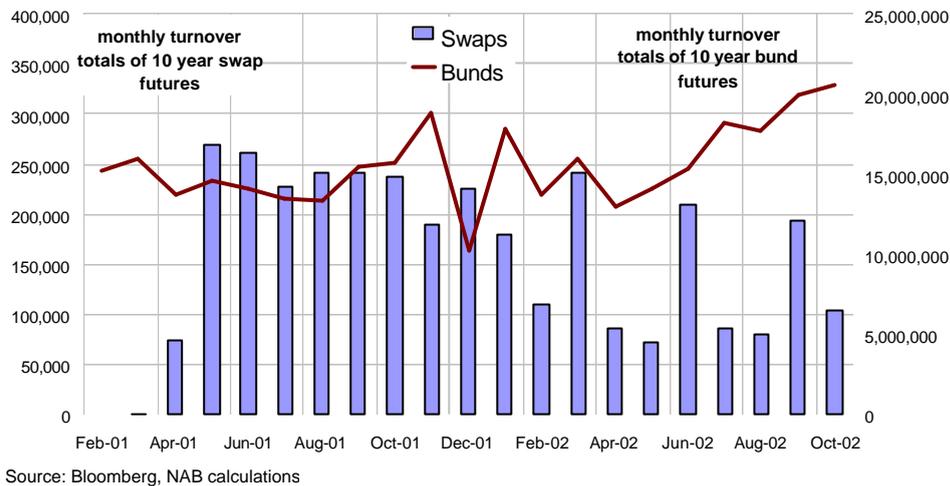
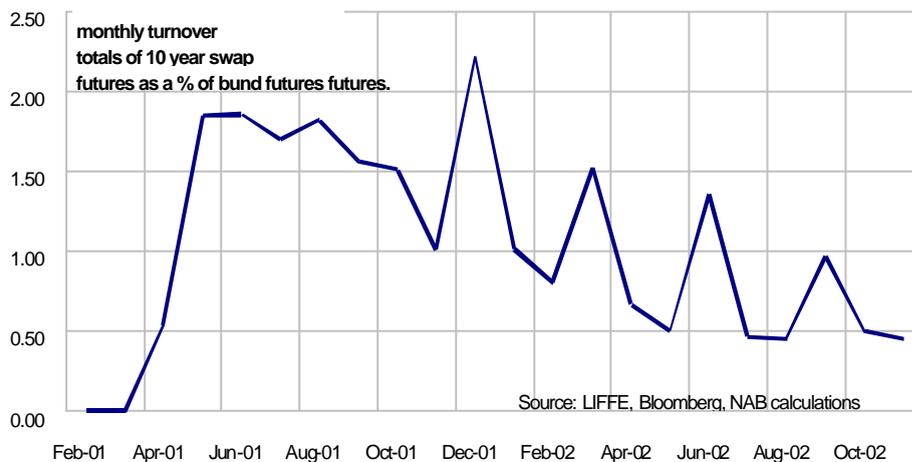


Figure 2: Euro Swap Futures Turnover as a Share of Bund Futures Turnover.



- The apparent weakening in support for Eurozone swap futures is disturbing and unfortunately there has not been enough time for us to draw solid conclusions as to why this has occurred, or indeed whether declining support in 2002 will prove aberrant. It could be that liquidity in swap futures suffered as credit spreads widened during 2002 and investors have favoured a “risk free” futures contract over a swap futures contract that embodies at least some credit risk. It also appears from the first chart that after a good spread of turnover across all months during 2001, during 2002 volume has become concentrated around futures closeout dates. This suggests that some investors/borrowers may be dominating the market - perhaps activity is centering more on arbitraging physical swaps to swap futures - rather than the contract being used by a wide range of investors, banks and corporates. Either way, the experience of 2002 suggests we should be cautious about the success of swap futures in Australia.

The US Money Market Experience May Be Relevant.

A recent BIS paper³ noted that during the 1970's the US Treasury Bill was the benchmark for pricing all money markets in the US and that in the early 1980's a flourishing futures contract developed in treasury notes. This is analogous to the present situation where the CGS and bond futures market underpin private sector interest rate markets, like swap and corporate bonds. After a series of financial crisis that saw the spread between treasury notes and private sector money market instruments balloon, market practitioners recognised that a futures contract that embodied some private sector credit risk would be a better hedge than the "risk free" treasury note futures contract. Accordingly, in 1982 a futures contract based on the certificates of deposits of large US banks was introduced, and after some immediate success the contract failed as investors began to distinguish between the credit ratings of the banks – i.e. the market on which the contract was based wasn't commoditised sufficiently. In late 1982, the better-designed eurodollar contract was introduced and by 1984 this contract had overtaken transactions in the Treasury Bill futures contracts. Traders and hedgers came to accept the eurodollar contract had a better correlation with other private sector money market instruments they used.

There are several important points from this experience.

1. Even though a private sector money market futures contract ultimately made a lot of sense, the initial contract failed. It is at least possible - probable even - that a futures contract based off the \$A swap curve may fail because of some of the "fundamental" problems identified earlier.
2. The Discussion Paper notes correctly that corporate bond yields have a higher correlation with swap rates than government bond yields. If so, it is surprising that a futures contract based off a private sector curve has not already developed and outgrown bond futures, as was the experience with the eurodollar futures. The fact that swap futures have not developed already should make us cautious about their likely success in the future.
3. The eurodollar contract flourished even while Treasury Note outstandings were growing. This indicates we need to treat with care the Discussion Papers suggestion that "the absence of the CGS market would encourage innovation and provide incentives to develop alternative instruments". In the US, the Treasury bill market did not crowd out the development of the eurodollar market and similarly it cannot simply be assumed that bond futures are crowding out swap futures.

In summary, the US money market history suggests that necessity is not the only criteria for success of a futures contract. It is at least possible, probable even, that government bonds have special factors that make them better able to support a futures market, even if the "economic" case suggests swap futures are the better instrument for managing private sector risk.

Summary Comment on Swap/Corporate Bond Futures Market

The National would be more confident of a successful launch of swap futures in Australia if swap futures markets were flourishing in the US and Europe but this is not the case. We also submit that it is important for the Government to recognise that bond futures are not necessarily crowding out private sector alternatives. Experience suggests "necessity" alone will not support swap futures in the absence of bond futures.

There is a significant risk that swap futures fail or at a minimum take some time to establish liquidity approaching that of bond futures. What seems extremely unlikely is that swap futures enjoy the immediate level of support that bond futures presently have. For this reason it is almost certain that liquidity in the swap market will be compromised to an uncertain degree by a wind down in the CGS market, and this will increase the cost of financial risk management.

³ Benchmark tipping in the money and bond markets, BIS Quarterly Review, March 2001

1.2 The outright swap market is not an alternative to the CGS market.

Is the swap market liquid enough at any maturity to facilitate interest rate risk management?

The current thin nature of the market past five years and extreme illiquidity past ten years will be exacerbated by the reduced CGS outstanding as outright risk transference is reduced. Shorted dated swap will avoid this immediate problem however if they were to become the financial benchmark other liquidity problems would arise.

It must be understood and accepted that the swap market currently prices off bond futures and hence implicitly the physical Commonwealth bond curve. All quotes made between inter-bank counterparties and by the major intermediaries through brokers are made on an EFP basis to bond futures. All outright risk assumed by swap market makers is hedged in the bond market and its derivatives. There is no outright trading between the professional market based on outright swap yields. If any further justification is needed for the existence of the bond market to benchmark the swap yield, the swap futures close out is determined by quoting a spread to the bond futures contract.

This has serious implications for the width of spreads that will be quoted in an outright swap market if there is no liquid bond physical or derivative. For small parcels this will not matter, but as is shown later in our submission, spreads and rates that will be achievable by government, business and other end users can and will increase by a significant margin for transactions involving larger volumes.

The ability of the swap market to replace the functions performed by the bond market is also fundamentally inhibited by issues of credit. All counterparties need credit lines in place as a swap is a bilateral agreement between the two counterparties that require allocation of credit lines and hence allocation of capital. It could be envisaged that in a very short space of time many of the credit lines would be full if banks had to manage their outright interest rate exposure by a new bilateral agreement every time they went to the outright market. In some cases credit lines between major counterparties are full in the current environment. This means that confirmation of a trade's integrity is not instantaneous, with the respective counterparties having to apply to their credit departments for an increase in credit lines, which in turn can have one of two results; either a delay in knowing if your outright risk is hedged, or a rejection of the trade, resulting in participants having no certainty if their exposures are hedged or not.

This process is clearly inferior to the current environment and will again lead to less transparent and less liquid markets. This effect would quickly apply to fund managers looking to hedge their duration on an active basis as their limit exposure to the banks' credit was reached and the intermediaries reached a limit on their exposure to the fund. Regulators and Rating Agencies would also have concerns about financial institutions having both increased large exposures to single counterparties, as well as reduced access to domestic capital markets as credit lines fill up.

In times of financial stress on individual market participants these players will have credit lines frozen which will reduce market liquidity more. More dramatically this will eliminate the stressed entity's ability to manage its financial risk in any form effectively closing down its access to financial markets and adversely affect its viability.

In times of general market stress, especially that caused by doubts about a major financial institution, spreads will widen to reflect credit uncertainty and the market will exhibit discreet discontinuous price action or probably a complete failure.

1.3 Cost of Failure to Develop Liquid Private Sector Alternative to Bond Futures.

If swap futures do not gain the liquidity of bond futures the cost of managing financial risk will rise by an uncertain amount. The greater the liquidity in any market means that prices are less manipulable, the price discovery process is more efficient and transparent, and larger transactions have minimal price impact. It is also true that liquidity is a virtuous circle, where confidence in efficiency of a market encourages new entrants which further enhances efficiency. The virtuous circle does, of course, work in reverse and become a vicious cycle as liquidity reduces. As the IMF noted in a recent survey of US fixed income markets⁴, “if liquidity in the swap market – defined as the cost of putting on and removing hedges – does not achieve the degree of liquidity that has existed in the treasury market, then there may be a potentially significant effect on pricing in fixed-income markets due to a higher long-term cost of insurance”. These additional costs would be borne by users not just of fixed income products, but also by banks, corporates and households who now routinely use term derivative markets to manage their financial risks and price their cost of borrowings.

Recognising that reduced liquidity will add financial costs is relatively straightforward. Estimating accurately the additional costs, however, is exceedingly difficult for there are no examples of a developed financial market where the foundation market has been removed. This is more than a little problematic from a public policy perspective, for an accurate estimate of these additional costs would by definition allow us to put a dollar figure on the “public good” aspect of the CGS market. Unfortunately we cannot do this with any degree of accuracy, for as the IMF survey noted “there are no answers to this question (the increase in cost) in the various literatures, think tanks, and policy making institutions”.

The increase in costs for the management of financial risk will likely be borne in the following areas:

- a. The absolute level of the swap curve;
- b. Reduced liquidity in swaps will increase transaction costs;
- c. The size and maturity of deals that could be transacted would be reduced;
- d. The yield curve will likely be steeper, thus encouraging Australian households and corporate borrowers into more risky financial positions.

1.3.1 The level of the swap curve.

Whether the level of the swap curve would be impacted by reduced liquidity in the swap market is unclear. Volatility of the swap curve would likely rise with reduced liquidity. In theory at least, as this would increase the cost of hedging for swap rate suppliers it should translate into a higher overall swap curve, all other things equal. That said, other factors are likely more important to the absolute level of the swap curve. For instance, if foreign investors desire to hold \$A assets is reduced in the absence of CGS and if domestic investors replace the “risk free” asset in their current portfolio with foreign sovereigns, the net effect will be a selling of \$A assets in favour of foreign assets. Depending on how these transaction are structured, we would expect a combination of adverse movements in the outright \$A swap curve, the bills/libor spread, or the fx forward. Whichever way the transition occurs the net result would be to raise the cost of term borrowing to Australians.

Our submission has only discussed the impact on interest rate markets so far, but an outflow of assets from Australia of this scale would clearly have at least a temporary impact, maybe permanent, on the level of the AUD. Basic balance of payment economics suggests that because Australia is a perpetual current account

⁴ Financial Implications of the Shrinking Supply of U.S. Treasury Securities, IMF, March 2001

deficit country, a flight of capital of this scale would see a combination of a lower currency and higher interest rates. ABS/RBA estimates indicate non-residents own around \$25bn of CGS presently. Some of this \$25bn would be replaced with non Government AUD bonds, but in our estimation the majority wouldn't.

The uncertainty is how large these impacts would be and whether they would be temporary or permanent. Financial markets have symmetry and so any increase in the \$A borrowing costs for Australian corporates also translates into more attractive investing opportunities for foreign and domestic investors. In a perfect world, we may expect these more attractive interest rates in Australia to be arbitrated away. However, where the asymmetry enters is whether foreign investors are either able or inclined to invest in these higher Australian interest rates (and likely lower AUD).

The ability to invest in Australia for many foreign investors is driven by the position of Australia within global fixed income benchmarks. The wind down in the CGS market would remove Australia from some of the key global bond benchmarks and therefore the ability of at least some global investors to invest in Australia falls to zero. Not all foreign investors are driven strictly by such benchmarks and some follow benchmarks that include corporate bonds and semi's. However, the difficulty these investors face is that they often do not have the resources or inclination to pick through a host of different corporate names in a market that makes up a negligible part of their overall benchmark index. Government bonds from this perspective are far easier for foreign investors for they are homogenous, have well established fundamentals, and are issued in large tranches which allows foreign investors to build meaningful positions if they require.

To reduce concentration risk to any one Australian corporate name to an acceptable level within a fixed income portfolio, foreign investors mandates would require them to hold many more corporate names as a replacement for their current CGS holding. This would require the foreign fund manager to devote more resources to their AUD portfolio than they currently do and for many managers this would mean an AUD fixed interest exposure would be consigned to the too hard basket. Feedback from our foreign clients is that around 80 percent of those who currently own CGS would not re-invest this money in non-government Australian fixed interest securities, if the CGS market were to go. If they were inclined to gain exposure to Australian companies in the future, they would be more likely to do this by buying Australian companies that have issued foreign currency in their own markets, rather than buying Australian companies bonds issued in Australian dollars.

In the end, there would be a balance of forces on the overall level of swap curve in the absence of a CGS market, but it is difficult to say unequivocally whether - with all other things equal - the absolute level of the swap curve would be higher or unchanged in the absence of a CGS market. At a minimum, there would be a temporary increase in the level of the swap curve.

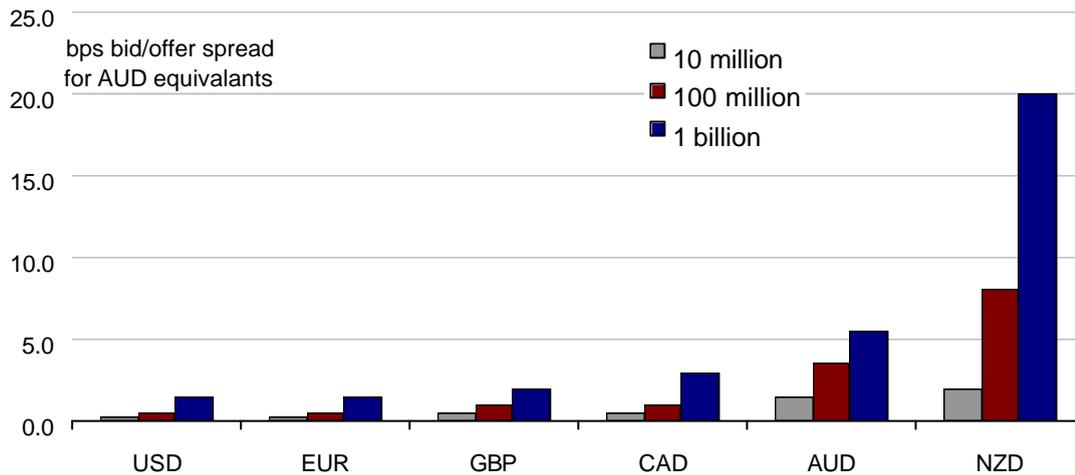
1.3.2 Reduced liquidity in swap will lead to higher transaction costs.

This is a self-evident proposition. If the supplier of the financial insurance finds it difficult to hedge their position in the market, they will need to charge a higher fee. A wider bid/offer spread in market jargon. Any increase in the fees for transacting small amounts during normal times is likely to be small. However, for large transactions the increase in transaction costs will be more significant, because if the swap counterparty cannot easily hedge the risk they will need to bear (warehouse) a greater financial risk than desired. The increase in transaction costs would also be greater during periods of heightened financial risk – eg during the Asian crisis, September 11 2001 – for during times like these available liquidity is even further reduced. The unfortunate aspect about this is that periods of heightened financial risk are very often the time when investors and borrowers are most keen to mitigate their financial risks.

Figure 3 shows the typical transaction costs (proxied here as the bid/offer spread) for corporate clients in the outright swap market, during “normal” times. The key takes from this are that even now transaction costs in AUD swaps are relatively high when compared to major markets; second, the transaction costs rise as the

size of the deal increases; and lastly in a more illiquid market swap market like NZ transaction costs can be substantially higher even than Australia⁵.

Figure 3: Transaction Costs in Swap Markets



Source: NAB

1.3.3 Size and maturity of deals will be impacted.

Reduced liquidity in the swap market would make it more difficult for companies and investors to initiate both larger and longer dated transactions. This would be a disturbing development for already it is difficult to transact longer dated transactions in Australia.

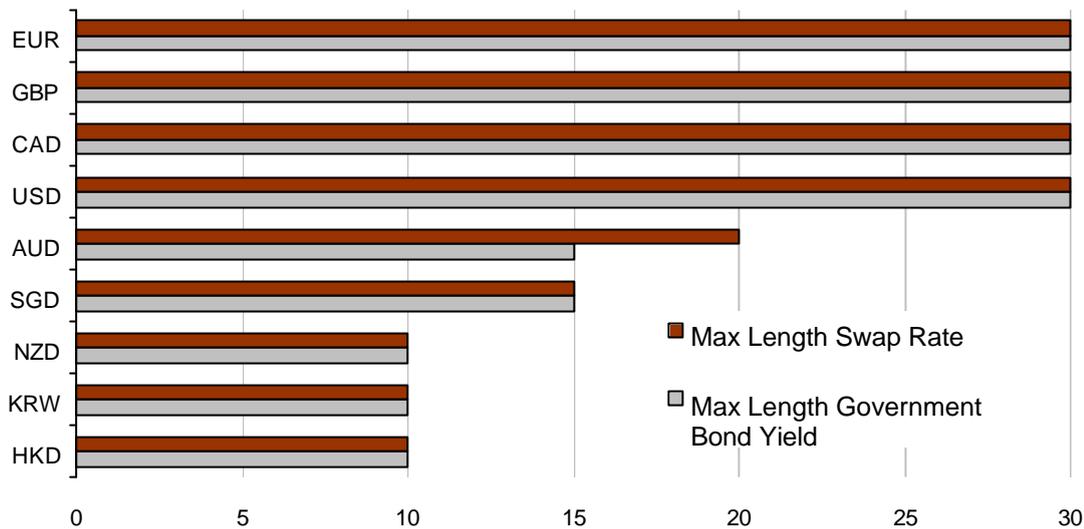
There is clear a positive correlation between the available liquidity in long dated swaps and the availability of long dated Government bonds. As a simple illustration of this proposition, Figure 4 records the maximum maturity where pricing is shown on Bloomberg’s generic curves. There is an almost 100% correlation between available pricing in government bonds and swap markets. For instance the only markets that routinely show pricing in 30 year swaps are those markets with 30-year government bonds. This result should be not all that surprising, for a swap supplier will clearly be more confident in offering 30 year swaps to clients if they can hedge the “outright” interest rate risk with a Government bond of similar maturity.

The Discussion Paper asked specifically whether there was already sufficient liquidity in longer dated AUD interest rate swaps. The simple answer is no. Liquidity is currently greatest in the 3 years where the bond futures are most active. Beyond this liquidity falls away and compared to other developed markets liquidity in very long dates is slight. This lower liquidity in longer dates is tied directly to the unavailability of much longer dated Government bonds in Australia. Slight liquidity in swap futures in the absence of a CGS market would compromise the longer dated swap market even further.

This downside here is self-evident, for companies and investors in a sophisticated economy like Australia have as much need for longer dated swap pricing as their counterparts in the US or the Eurozone. Reduced accessibility to longer dated swap markets would disadvantage Australian companies.

⁵ When considering NZ, it should be noted that even though bond futures are not liquid they at least have an actively traded Government bond market. Australia may have neither if the CGS market is run down.

Figure 4: Tenor of Pricing in Swap and Government Bond Markets



Source: Bloomberg Generic Curves

1.3.4 The yield curve would likely be steeper.

Whilst we conceded earlier it is unclear whether there would be an impact on the overall level of the swap curve, if there was it is probable that longer dated yields would be disproportionately influenced. Higher transaction costs for longer dated instruments and the close relationship between long dated swap activity and long dated government securities suggests this. The result of these influences is that the private sector yield curve would likely be steeper, all other things equal. Whilst we don't know to what degree the curve would steepen, what we can say is that at the margin a steeper overall yield curve will discourage borrowers from fixing their lending. At the margin, the price incentive to borrow "short" would put Australian borrowers into a riskier position than now.

Summary Comment on Costs

If an alternative pool of liquidity to bond futures does not develop, financial costs for corporates and households will rise. These additional costs will be borne in the following areas:

- There will be a temporary increase in the absolute level of swap curve but the longer-term impacts are less certain.
- Divestment from Australia would lower the level of AUD.
- Reduced liquidity will unambiguously increase transaction costs. The increase in transaction costs will be magnified during periods of financial uncertainty.
- Reduced liquidity will compromise the size and maturity of transactions that can be transacted in Australia, thus increasing volatility in financial risk management.

2. Other Factors Government Should Be Mindful Of.

2.1 A breakeven analysis from all of Australia's perspective

Whilst we cannot measure accurately the increase in financial costs to Australians if the CGS market is run down, what we can do is put some metrics around a break-even analysis of the costs and benefits of the CGS market.

Consider the following:

- GGS market outstandings stood at \$60bn at the end of September 2002.
- Private sector credit in Australia was \$800bn at the end of August⁶
- Private sector funds under management are around \$750bn⁷
- In total, both private sector debt and funds under management are around 13 times the size of the total CGS market, and growing.
- It follows that if the removal of the CGS market added just 1bps (A\$80 mill pa) to the borrowing cost of Australians, the breakeven cost to the Government for maintaining the CGS market in the public interest would be 13bps (A\$72 mill pa).
- Put more simply, the CGS foundation is actually very small compared to the size of the financial system that currently rests on it.

Now in reality, this metric is an over simplification of many aspects of Australia's sophisticated financial landscape. For one, much of the private sector debt will be short dated where additional costs would be minimal. Also the RBA could adjust monetary policy to account for this additional interest cost. That said, we have not included corporate bond issuers in these numbers, nor the derivative transactions that companies routinely use to manage their interest rate exposures. Most likely, additional costs due to reduced efficiency will be borne disproportionately by these derivative transactions.

What this metric does illustrate is that the level of private sector debt and funds under management is massive in comparison to the size of the CGS market. As a consequence, the potential loss of financial efficiency - i.e. an increase in borrowing costs or a reduction in risk adjusted investment returns - needs only be tiny to justify maintaining a CGS market that with sound governance structures could be run for zero cost and minimal risk.

The CGS market can be maintained with minimal risk and minimal cost

Our submission does not look at how the Government would go about maintaining the CGS market, but whichever way it is structured it would require the Government to buy financial assets. The National understands that there are many issues such a policy would raise for public policy and it would require clear and sound governance structures to be successful. However, through this debate it is important not to lose sight of the fact that the Government can effectively run the CGS market for minimal risk and zero cost - or more likely a profit.

The AAA Australian Government can at present can buy AAA assets in AUD or alternatively AAA assets in foreign markets that are swapped back to AUD, that offer yields higher than yield on current CGS bonds. For instance, "super" rated bonds from the World Bank, EBRD, Eurofima and EIB presently offer between zero and 30bps over current CGS yields over a range of maturities. Moreover, these Supra issuers often have

⁶ RBA Statistics

⁷ Source: Rainmaker

a lower credit risk than individual AAA sovereigns, given a number of individual sovereigns are typically shareholders of these agencies. So even an almost zero risk strategy of issuing CGS and buying highly rated Supra's would yield a profit for the Government. Widening the pool of assets that could be invested in would further increase these profits.

2.2 Reduced liquidity in the swap market will impede the development of an alternative high quality benchmark bond curve.

The Discussion paper asks whether alternative markets will develop to replicate the desirable "safe haven" and long-term investment characteristics of the CGS market. While possible, our discussion on transaction and financial costs would be a clear impediment. The potential high quality issuers could include Banks like the National or supranationals like EIU, World Bank, ADB, EBRD etc. All these issuers have access to many capital markets across the globe and are in search of the lowest costs of funds for their shareholders, wherever they may be found. Very often, their choice of market to issue in comes down to a matter of several basis points, once they account for all the currency and interest rate swaps they need to transact to get back to their funding benchmark – typically USD LIBOR. The reduction in liquidity in Australian interest rate markets and increased transaction costs will therefore be a disincentive for foreign issuers.

For the National, with an ongoing need for wholesale funding for its Australian operations to fund home mortgages and corporate lending, the Bank will always be driven by the cheapest cost of funds. The National accesses funds in local capital markets when it is opportune. We also access funds from a wide array of foreign debt capital markets with the funds then swapped back into AUD.

It is possible that the National will build more liquid lines of bonds on issue in the domestic market in the future, but there should be no reliance on the National or other issuers to support the domestic capital market if it is not opportune from a cost perspective. Because of this, we think it unlikely that a private sector issuer could become a true benchmark issuer in Australia as the Government presently is.

2.3 Reduced liquidity in the swap market will further encourage Australian companies and investors to use foreign bond markets.

This increase in transaction costs may encourage large Australian corporates to issue in foreign markets where liquidity is deeper and price discovery more efficient. Already this increasing trend for Australian companies to access foreign markets is evident⁸. Figure 5 shows that the initial spurt in domestic corporate bond issuance between 1998 and 2000 did slow the issuance by Australian corporates offshore, but as domestic issuance has appeared to have topped at \$20bn in recent years, Australian companies have begun to access foreign capital markets at an increasing rate.

Investors may similarly be forced to access bonds in foreign markets. Some will argue that the removal of CGS from domestic fixed interest portfolios will release monies that will then be available to be invested in Australia domestic corporate bonds. However, fixed income portfolios will still require some "risk free" component. This is not so much because "risk free" bonds are mandated to be in a portfolio⁹, but rather the risk free characteristic of government bonds is desirable at certain times. In particular, governments bonds can be negatively correlated with equity markets and credit spreads. The feedback from industry participants is that the loss of the CGS asset class in Australia would see a considerable flow of funds from Australia to

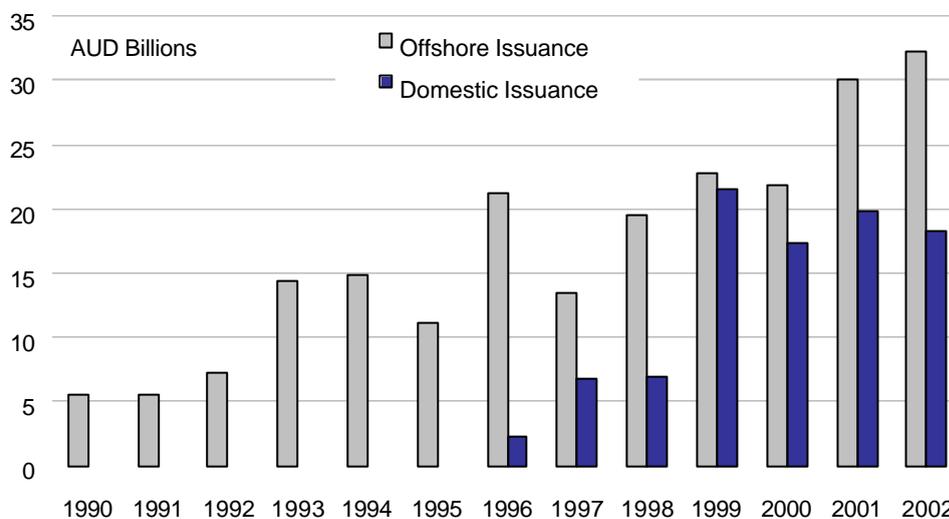
⁸ Speech by RBA Assistant Governor Financial Markets, Ric Battellino – Why do so Many Australian Borrowers Issue Bonds Offshore?, 26 November 2002

⁹ Often they are, however.

foreign “risk free” assets. If so, this would merely hasten an already material drift in funds towards foreign markets.

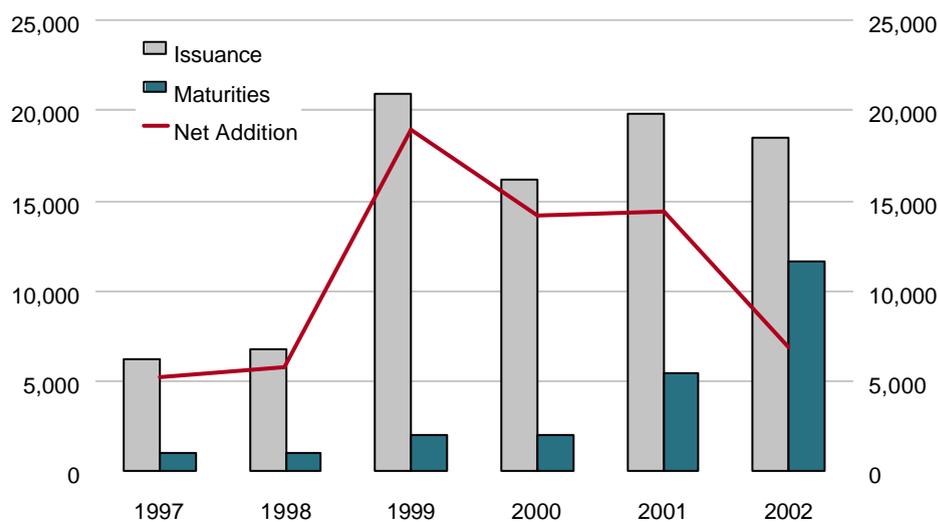
It is important that the Government discuss with Asset Consultants and Superannuation Funds what their attitude to country and asset allocation would be in the absence of a CGS market.

Figure 5: Offshore Bond Issuance by Australian Corporates and Financial Institutions compared to Issuance in AUD Corporate Bond Market.



Source: RBA. Note domestic issuance pre 1996 is not available, but is likely to be very small.

Figure 6: Issuance and Maturity of Corporate Bonds in AUD Market



Source: NAB. These are all corporate bonds issued in Australia, not including ABS.

2.4 Growth in the domestic corporate bond market already appears to be stalling.

Further suggesting caution about the ability of the domestic corporate bond market to replace the CGS market is the issuance pattern in recent years. This is depicted in Figure 6. The initial development of the domestic corporate bond market is well documented and understood: Increasing funds under management and a reduction in CGS on issue allowed the corporate bond market to develop rapidly. However, the initial spurt in gross issuance has stalled in recent years, despite a growing requirement for fixed interest investments. So far in 2002 there has been \$19bn of gross issuance, similar to the previous 3 years. With gross issuance capped at \$20bn and with maturities growing the overall growth rate in the corporate bond market is slowing. As noted earlier, feedback to the National from fund managers is that they are directing more of their funds overseas.

2.5. Inflation Indexed Market

An elimination of the Commonwealth Indexed Linked Market will eliminate any benchmark and liquidity in this increasingly important asset and liability class.

2.6. Concentration of Bond Market Pricing

The reduction in the primary issuance, liquidity and volume of the physical bond market has already seen the withdrawal and consolidation of many bond houses in Australia. It is easy to see this trend accelerated with the demise of the CGS market. Government needs to contemplate what the effect of concentrating pricing power and the access to the bond market within a small number of hands will mean for transparency and competition. This effect could again lead to increased costs of capital and transaction costs for others attempting to access capital markets.

Although not relevant now, a reduction in market participants will increase systemic risk in Australia, as financial risk exposure will be concentrated in fewer financial institutions. Analysis of the repercussions and adverse economic effects that would result should one or more of a reduced group of institutions fail should be undertaken and possibly a contingency plan established to maintain the efficient functioning of financial markets.

Summary comments on other important issues.

- The cost of maintaining the CGS market is small relative to the likely increased borrowing costs for Australian households and Australian corporates.
- Reduced liquidity and higher transaction costs will further encourage domestic issuers to fund offshore.
- Australian fund managers are increasingly accessing non-Australian dollar denominated assets.
- The growth in the domestic corporate bond market has already stalled.
- The elimination of the Commonwealth Indexed Linked Market will take away the only material benchmark liquidity in this increasingly important asset and liability class.
- Concentrating bond market pricing in fewer hands may further increase transaction costs in debt capital markets as well as increasing systemic risk in the financial system.

About the National Australia Banks' Wholesale Division

National Australia Bank Limited (the "National") is an international financial services group, providing a comprehensive and integrated range of financial products and services. The National has more than A\$377,000 million in assets (as at September 30, 2002) and ranks as one of the world's top 50 financial services companies by revenue (*Fortune Magazine, July 2002*). In Australia, the National has a balance sheet and market presence that underpins its strong credit rating. It is the only Australian bank with an AA Standard & Poor's long-term credit rating as at September 30 2002.

Wholesale Financial Services (WFS) is the global business unit within the National, responsible for managing relationships with large corporations, financial institutions, supranationals and government bodies. The business employs almost 2500 full-time equivalent employees and operates across Australia, New Zealand, Europe, the United States and Asia.

Key areas of Wholesale Financial Services' activities are:

Markets Division

Provides foreign exchange, money markets, commodities, derivatives and capital markets products globally. The Markets Division is a significant user and distributor of Australian Government Bonds. We have sales and trading teams in Australia, London, New York, Singapore and Tokyo who distribute CGS and other interest rate products to investors. We also play a major role in Australia's derivative markets by providing risk management solutions to companies and investors as well as access to debt capital markets.

Financial Institutions

Focuses on the specialist needs of financial institutions (including banks, investment banks, insurance, fund managers and governments). Global Bank Group offers specialised relationship management services to the National's bank clients which operate outside of Australia.

Corporate Banking

Focuses on the development and delivery of client solutions across the depth and breadth of the Group's capabilities and assists clients with their financial services strategies.

Specialised Finance

Brings together a range of financial solutions utilised in complex transactions such as project finance, structured finance and acquisition finance.

Custodian Services

Provides a comprehensive range of custody and related services to institutions within Australia, New Zealand and Great Britain.