ASFA Submission on the future of the Commonwealth Government Securities market

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The Association of Superannuation Funds of Australia (ASFA) is a non-profit, non-party political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. ASFA's over 500 constituent members are estimated to be responsible for around $420 billion of assets, or about 80% of total superannuation funds under management. ASFA's coverage by percentage of assets and members varies between categories, ranging from around 70% for corporate funds to around 90% for industry, public sector and retail funds.

The nature of ASFA's interest

ASFA's interest in the future of Commonwealth Government Securities (CGS) market comes from the fact that superannuation funds (and life insurance companies providing superannuation products) hold very substantial quantities of CGS and are active participants in a variety of financial markets. This interest is primarily driven by considerations relating to superannuation funds being investors rather than borrowers. Superannuation funds are only able to borrow funds in very limited circumstances, and only over the short term.

As will be discussed further below, superannuation funds have both a direct and indirect interest in the CGS market. Their direct interest comes from most superannuation funds having direct holdings of CGS. Their indirect interest comes from the role CGS play in pricing other debt instruments held by superannuation funds, and in the pricing of various interest rate and foreign currency derivatives used by superannuation funds to contain financial risks and enhance fund returns.

How imminent is pressure on the stock of CGS?

ASFA appreciates that the Government needs to be prepared for a variety of developments, and that such preparations do not necessarily imply that what is being prepared for is certain to happen, or even probable. However, it could be argued that the Discussion Paper appears to regard a substantial running down of the stock of CGS as inevitable.

Such a conclusion appears to be somewhat stronger than objective consideration of recent and prospective developments would support. For instance, it is not unusual and almost unavoidable for the forward estimates to indicate a strengthening budget position and/or future surpluses. This is because future revenue is assumed to be unaffected by any tax cuts or the like, while future expenses are assumed not to include any new policy measures. Indeed, it is generally the case that expenditure is forecast to decline with the expiry of expenditure programs which have a legislated life, even if it is likely that they will be renewed or replaced by like programs.

There is also the very real issue of what level of CGS is implied by the Government's fiscal strategy of maintaining the budget balance, on average, over the course of the economic cycle. It could be argued that maintaining a stock of CGS around current levels relative to GDP and incurring budget surpluses and deficits which in the future more or less cancelled out each other over the course of the economic cycle is equally consistent with the Government's stated objective as is fluctuating around a nil balance of CGS. ASFA would not dispute that there have been benefits from reducing the stock of government debt. The question now is whether there would be net benefits from further reductions in debt. Given that Australia is already regarded as being in a sound financial position so far as government borrowings and finances are concerned, further reduction in government debt might not deliver any substantial benefits in terms of enhanced economic performance.

This point is acknowledged to a degree at page 77 of the Discussion Paper, where it is noted that the fiscal strategy does not provide definitive guidance on the Government's desired net debt position over the cycle. The paper appears to slip into assuming that budget fluctuations will be around a zero nominal or real stock of debt, rather than a level of debt (or assets) maintained at some real or nominal level.

The Discussion Paper (at page 81) also notes that there would be significant transitional costs for the Commonwealth if the CGS market were run down over a relatively short period. Given that securities currently on issue have maturities running out until 2015, substantial repurchase premiums would be required to be paid by the Commonwealth in order to bring about the early cancellation of such securities.

Holdings of CGS by superannuation funds

Holdings of CGS by the superannuation sector are higher than suggested by Table 3 at page 51 of the Discussion Paper. Around 80% of the business of life insurance companies is superannuation products or superannuation related. When these two components of superannuation are combined, they take the share of CGS held by superannuation entities to around 30% of the total CGS on issue, and around half of CGS held domestically. A proportion of the CGS holdings of financial intermediaries also might be attributable to managed investments made by superannuation funds. This suggests that the total holdings of CGS of the superannuation sector are in the range of $18 billion to $20 billion.

Table 1 provides figures for the superannuation sector as a whole. Interest bearing securities amount to some $84 billion in aggregate. Once allowance is made for holdings of corporate debt and semi-government debt this is consistent with the estimate of CGS holdings by superannuation funds derived from records of the Commonwealth.

Table1: Asset Allocation

Asset Class	Amount ($billion)	% of total
Australian Assets		
Cash & Deposits	38	7%
Loans and Placements	21	4%
Interest Bearing Securities	84	16%
Equities & Units in Trust	231	44%

Land & Buildings	28	5%
Other Assets	16	3%
Overseas Assets	101	19%
Total	**519**	100.0%

Source: APRA Superannuation Trends, June Quarter 2002

The relevance of CGS to superannuation funds

CGS play an important role in superannuation funds matching their investment portfolios with their liabilities in terms of current and prospective benefit payments. Appendix A provides an analysis of both recent and long term trends in holdings of CGS.

As noted above, CGS currently are a significant component of the asset holdings of most major superannuation funds. Fixed interest assets for a balanced superannuation fund are typically in the order of 15% of assets, and considerably higher in the case of capital stable or guaranteed funds or investment options within funds. It is not uncommon for fixed interest holdings to be about one-third CGS, one-third semi-government securities, and one-third corporate bonds. However, there are variations between funds in such proportions, and also an increasing tendency for funds to have holdings of sovereign and corporate debt issued in other countries. When overseas debt instruments are held there usually will be a hedging arrangement in place which provides some protection against currency fluctuations. However, this hedging may not be for the full period of the debt instrument, but instead may consist of a rolling over of hedge arrangements covering shorter periods.

CGS and other government securities in particular are also an important component of the assets backing annuity products provided by the superannuation sector to retirees. Life insurance companies are the main providers of such products in the retail sector of the superannuation market. Securities providing returns linked to movements in the Consumer Price Index can be useful for funds and life insurance companies providing income streams linked to movements in the cost of living. Other types of assets offering both capital security (as required by both regulators and retirees) and movement in investment earnings in line with the cost of living would be hard to come by in the absence of a CGS market.

In particular, a high degree of capital security is required when an insurance company or superannuation fund provides what is known as a complying pension. Complying pensions receive concessional treatment under the means test for social security payments and for the calculation of Reasonable Benefit. Required characteristics include a very high certainty as to regular payment of income which cannot be varied other than by a CPI or like increase from year to year. CGS typically are an important part of the asset portfolios backing such products. If substitution of other debt securities occurs due to non-availability of CGS, then the prudential methodology of valuation used by actuaries would most likely result in lower annuity rates as the higher risk factor on the non government securities would be taken into account in the probabilities of investment returns achieved.

This would therefore result in lower and thus more unattractive rates for lifetime and life expectancy based income streams, which would run counter to the government's retirement incomes policy of encouraging the use of incomes streams.

ASFA understands that APRA will be making a submission to the Review. Public release of that submission would assist superannuation funds and other regulated entities in developing appropriate asset portfolios, particularly when they are offering long term retirement income products.

The demand by superannuation funds for securities with characteristics of the type provided by CGS, both nominal and indexed bonds, will inevitably increase as the superannuation system matures, and as Australia’s population structure ages, due to the increased demand for retirement income streams. It is also likely that future policy developments will favour the taking of income streams and may even require this, at least to some degree.

CGS also play a role in facilitating other financial markets that superannuation funds use either frequently or from time to time. Many superannuation funds make use of hedging arrangements in regard to investment returns and/or exchange rate risk. The existence of the risk free return associated with CGS facilitates the provision in financial markets of such hedging arrangements and helps minimise their cost. Funds would be concerned if a running down of the CGS limited the availability of other financial products and/or increased their cost.

ASFA responses to key questions posed in the Discussion Paper

Pricing other financial products

Information provided by ASFA members indicates that CGS is used extensively as the primary benchmark for pricing the debt securities of other issuers. The interest rate swap curve may currently be used for pricing to some degree, but the swap curve itself relies to a substantial degree on the existence of a market for CGS. Both the liquidity and the depth of the swap market are closely related to there being a supply of CGS.

A decline in the stock of CGS or the elimination of CGS would lead to wider margins in swap transactions, less liquidity and greater volatility in the swap market. Greater involvement by the banking sector in the swap market might make such a market work more efficiently, but this would be at the expense of direct involvement by banks in deposit and lending transactions. Banks may be unwilling to do this. It is likely that there would be fewer participants in interest rate swap markets, wider bid/ask spreads, the introduction of counterparty risk and hence the need for use of capital by participants, and more complicated documentation, accounting and settlement requirements. Such a market could operate, but it would be thinner and less efficient than the market which currently operates.

Other options might involve pricing off the interest rate of borrowing by State semi-government borrowers and/or by blue chip corporate borrowers. However, the effectiveness of such arrangements would be diminished by the need to establish the exact creditworthiness of each such borrower, by such borrowers generally not borrowing in volume across the entire maturity range, and by the lack of liquidity and ongoing trading for such bonds. The underlying problem is that with the elimination of CGS there would be a lack of sufficient reference points to accurately price debt securities.

Managing financial risk

The suggestions in the Discussion Paper that interest rate swap markets and interest rate futures markets could be developed as replacements for markets based on CGS assumes that such markets would be possible or efficient in the absence of CGS being available. ASFA members have indicated that they consider that the absence of CGS would lead to a significant diminishing of the risk management tools available to deal with the impact of changes in interest rates. In particular, they have indicated that the viability of the interest rate swap market would be affected.

While the market may develop alternative risk management tools, they are likely to involve additional costs and/or leave residual or new risks with market participants. For instance, derivative markets based on corporate bonds are likely to have risks related to default of the issuer and/or counterparty to the transaction.

It is also possible that market participants might seek to use overseas derivative and other markets to manage financial risks. However, this would involve additional costs, and would involve the need to deal with exchange rate risks. In the absence of CGS, domestic (and overseas) markets dealing with exchange rate risks between the $A and other currencies might be relatively expensive and inefficient.

If alternative risk management tools were not available, it is likely that cost of capital for corporate bond issuers would be driven up, and the return to investors would fall to some degree. Higher transaction costs would be the reason for this wedge developing. Whether the incidence of the increased costs falls more on the bond issuers or on investors will depend on a variety of market factors which are difficult to predict.

Providing a long-term investment vehicle

The significance of CGS as a long-term investment vehicle for superannuation funds and life offices has been discussed earlier in this submission. It is an important asset class for superannuation funds, and its elimination from the investment market would raise the risk level and/or depress the investment returns received by funds for a given risk profile. Other fixed interest assets are available, but higher transaction costs would depress the net return from such assets or they would involve a higher level of risk. In regard to the latter point, a fund might have to hold a higher proportion of fixed interest relative to higher yield equities in order to obtain an appropriate risk profile.

An absence of CGS would also make it more difficult for superannuation funds and life offices to meet prudential requirements of APRA, particularly when they offer long tail liabilities such as lifetime annuities that are indexed to the CPI.

There is most likely unmet demand for CPI indexed securities, particularly as the market for income streams grows. Such securities are relatively tightly held and are not actively traded. If they were more widely available ASFA members advise that they would be more widely held by superannuation funds and would be included in standard investment mandates.

There is potential for alternative long-term investment instruments to be developed. Many such instruments currently exist. However, their shortcomings relate to transaction costs and unavoidable risk characteristics. It is not possible to replicate risk free assets without them being issued by a sovereign government. Even semi-government securities have varying degrees of risk attached to them, and with the privatization of government enterprises and other developments at the State Government level the stock of such securities also may be static or decreasing.

Promoting Australia as a global financial centre

The existence of the CGS market appears to be of assistance in developing Australia as a global financial centre. Without a CGS market there would be less financial market trading in Australia. In particular, it is likely that superannuation funds and other investors would make greater use of overseas investment managers who had more direct access to required overseas bond and derivatives markets.

This shift in financial market operations in itself would not necessarily be a concern to superannuation funds. Any concerns they might have would relate more to any increase in costs and/or risks of investments.

Appropriate size of the CGS market

A CGS market at around the current level would appear to be viable, if it were maintained more or less in real terms over time. Any reduction in the size of the market could be expected to have an adverse impact on the continued operation of financial markets based directly or indirectly on the CGS market. Reduction in the size of the market could impact on the range of CGS maturities on offer and the degree of liquidity and market trading for securities of specific maturities.

Option 1: Wind down the Commonwealth Government Securities market

ASFA members do not favour this option on the grounds that it would be likely to have a significant adverse impact on financial markets in Australia, and it is difficult to see what the benefits would be for the Commonwealth if implemented. The costs for market participants that would flow from elimination of CGS have been described earlier in this submission. There also are other options available which would provide benefits for the Commonwealth while allowing the CGS market to be maintained.

If the Government did decide to wind down the CGS market, an announcement of the intention to do so would need to come after rather than before the sale of a major asset by the Commonwealth. Given that unexpected developments in budget outcomes might substantially delay any winding down of the market, an early announcement would threaten the viability of a market which would still be needed for some time.

Gradually running down the market would run the risk of the CGS market not being sufficiently liquid to provide the basis for other financial market transactions, while at the same time affecting the potential viability of possible alternative financial markets. However, a very rapid running down of the market would be likely to require the payment of substantial premiums to acquire CGS stock which has some years to run to maturity. ASFA understands that already this possibility of a premium is in the minds of purchasers and holders of CGS, and it is unlikely that such purchasers and holders would willingly sell their CGS without a significant premium being paid.

Option 2: Consolidate Commonwealth and State government debt markets

ASFA would have no objection to this idea being reconsidered, particularly if it led to a viable and ongoing market for government debt. However, ASFA notes that this option has recently been rejected by the States. For it to work effectively the States would need to give up a degree of sovereignty to the Commonwealth in regard to the level of debt issued and the conditions on which it is issued. For its part, the Commonwealth would most likely have to provide some sort of guarantee for the debt that is issued.

Achievement of an outcome acceptable to all parties does not seem likely for the foreseeable future, which accordingly casts doubt on the viability of this option regardless of any potential for it to deal with transition problems associated with reducing the supply of CGS.

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

Whether the Commonwealth moves to having an asset fund that would be used to meet the already identified liabilities of the Commonwealth in regard to the superannuation entitlements of its employees and past employees is essentially a judgment for the Government. However, a decision to move to greater (not necessarily complete) funding of past and emerging superannuation liabilities would have advantages in its own right and in supporting the continued existence of the CGS market. The Commonwealth has not been receiving merit points from analysts because it has been running an unfunded superannuation scheme. A move to partial or full funding of the superannuation liabilities would be as well received in financial markets as an equivalent increase in the budget surplus.

In effect, a number of States now issue bonds, but are also making provisions towards their unfunded liabilities. Essentially, this is an efficient form of arbitraging the expected return from asset classes and significantly lowers the long term cost of the superannuation benefits. To achieve this, the Commonwealth Government has a number of alternatives for holding assets.

1. Make payments to the superannuation fund - This would avoid year to year fluctuations in the operating statement of the Commonwealth, but would be reflected in a lowering of the unfunded liabilities. To give a true accrual accounting picture of the Commonwealth Government's financial position, these liabilities should be comprehensively included in the published financial accounts of the Commonwealth.

   While the surplus would be smaller or the deficit larger because of payments made from the budget sector to the superannuation fund, analysts would be aware that assets were being built up in the superannuation fund.

   It could be argued that the concerns in the Discussion Paper concerning fund governance are overstated. The fund governance system is based on trust law and reinforced by the Superannuation Industry (Supervision) Act and the Corporations legislation. It has served superannuation account holders well in the past. The Commonwealth already has in place investment management arrangements for the member and partial employer funding of the CSS and PSS schemes. These arrangements could be built on for the large tranche of financing that would be associated with a decision to maintain the CGS market at around its current level.

2. Hold the assets and associated investment earnings on budget – This would be in a manner similar to that currently applying in Queensland and more recently, New South Wales and is well understood by analysts. Lower investment returns due to developments in world investment markets would not be perceived as a failure of budgetary policy.

3. The assets could be held in a different trust arrangement – eg one managed by a Public Financial Enterprise. In this instance, the fluctuations on the Commonwealth's operating statement are minimized, but the overall assets roll up to the balance sheet, again offsetting the unfunded liabilities.

The concerns expressed in the Discussion Paper as to the potential impact of such a fund on domestic financial markets appear to be somewhat overstated. The Paper also appears to have underestimated the current and prospective scale of domestic investment opportunities available to the Government.

In relation to the concerns regarding the impact of such an asset base on equity markets, ASFA considers that questions such as appropriate limits on holdings of any single debt instrument or appropriate limits on equity holdings in any one company (if equity holdings were permitted) would be best addressed by the individuals who had the responsibility for the running of the fund. They would give consideration to the relative investment objectives (presumably to outperform the cost of the capital paid in from the CGS market by a certain margin) and risk/return asset class characteristics as well as depth and liquidity of different markets.

There are many more equity investment opportunities available than just the ASX 300. These include direct property holdings and property trusts, and private equity. There are also other forms of debt assets available in addition to those listed in the Paper, including cash deposits with financial institutions and securitised mortgages. While these would be unlikely to form the dominant part of a Commonwealth portfolio, such holdings would assist in both achieving diversification for the Commonwealth and avoiding an undue impact on specific segments of the debt market. The Commonwealth has managed to deal with any actual or potential conflicts of interest relating to significant shareholdings in listed companies. Examples include Telstra and the Commonwealth Bank.

The specific comment in the Discussion Paper that there be a 15% limit on Commonwealth holding of the total debt of any entity because "if the Government holds a significant proportion of an individual entity's debt, then the entity may perceive that acting against the wishes of the Government may lead to capital withdrawal" is somewhat strange. The Commonwealth (along with lenders generally) should contain its exposure to any one entity because of concerns about risk exposure. The nature of the debt instruments concerned also would not give the Commonwealth the right to call in the loan and demand immediate repayment. Even if the Commonwealth chose not to take up part of a new issue of debt, if it were fairly priced there would be others in the market who would.

In summary, the Commonwealth Government should seriously consider the funding of this superannuation liability through the continuation of the CGS market as one of the prongs with which it can attack the certain future budgetary pressures to be brought on by a simultaneously ageing population and workforce.

Appendix A: Trends in the types of assets held by superannuation funds

The percentage of superannuation fund assets in equities (that is, Australian and overseas shares) has gradually increased over time, both as a result of trustees focussing on longer term performance and as a result of choices made by individuals in regard to the fund they contribute to and/or the investment choice they make. The percentage of assets in direct and indirect property also is now higher than 30 years ago, although the share of property is down from the peak level achieved in the 1980s. A consequence of this has been a declining proportion of assets held in the form of debt instruments.

For instance, APRA data indicate that between June 1995 and June 2002 the proportion of superannuation assets in Australian shares increased from 36% to 44%. Over the same period the amount of overseas assets, principally overseas shares, increased from 15% to 20%. This growth was fairly steady, at around a percentage point each year. Partly as a consequence of this growth in holdings of equities, holdings of interest bearing securities fell from 26% to 16% over the same period.

Over a longer time frame, the fall in holdings of public sector securities (including CGS) has been even more marked. For instance, in 1953 some 73% of superannuation assets (which then totaled a relatively modest $493 million in aggregate) were in public sector securities. By 1960 the figure was still at some 64%. However, despite this relatively high level, the decline in the proportion alarmed the then Government, especially given that for some large superannuation funds the decline was even greater, falling from around 50% in 1956 to 34% five years later. These funds were replacing government securities with holdings of company debentures and shares.

The Government's response was to enact legislation in May 1961 which linked the exemption from income tax applying to superannuation funds to holding at least 30% of assets in public sector securities, with at least 20% of assets in Commonwealth securities. This legislation was in fact a catalyst for the formation of the Association of Superannuation and Provident Funds of Australia, now known as ASFA.

ASFA's objection to the legislation was that it led to decisions being made about holding government securities which were not strictly related to the relative return and risk profile of such securities. The fall in the return from government securities relative to other debt holdings such as debentures and mortgages and relative to equities was largely responsible for the fall in the proportion of assets held in government securities.

However, at no time have superannuation funds argued that government securities are inappropriate asset holdings by funds. The question has more been about the level that is appropriate given the benefit structure of funds and the risk and return attached to both government securities and other assets.

It is also important to note that perspectives on the appropriate level of different types of assets change over time. Superannuation funds in Australia and in other countries generally have tended to increase the proportion of assets held in the form of equities in response to what were sustained and relatively high investment returns from such assets. More recently the decline in equity markets in Australia and particularly overseas have led some funds to reconsider the composition of their asset portfolios. The existence of member investment choice also means that the views of members, as influenced by recent sharemarket declines, have an impact on the type of assets held by funds.

The recent decline in returns on equities can also impact on decisions taken by trustees of defined benefit funds. This has been evident in the United Kingdom where concern about the impact of volatile investment returns on reported pension liabilities of companies has led to a major shift away from equities to bonds. While the United Kingdom has a greater incidence of defined benefit schemes, particularly schemes paying a pension for the life of the retiree, such consideration is also relevant to some degree for a number of major Australian companies.