18 December 2002

Commonwealth Debt Management Review
C/o Department of Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir/Madam,

Review of the Commonwealth Government Securities Market

AMP Life believes that the proposal to eliminate the Commonwealth Government Securities (CGS) market is not in the best interests of the wealth management industry and its customers. We support the views in the submission from the CGS Industry Steering Committee that the CGS market should not be eliminated.

The CGS market is central to having an efficient investment market and providing appropriate investment opportunities to consumers, particularly in retirement.

The CGS market is critical in two main areas, which are expanded upon, below:

- providing CPI-linked guaranteed annuities which are an integral product in providing retirement income to many consumers
- providing a low risk asset which if not available would impair the ability of consumers and life insurance companies to invest with low risk if they so wished. This could potentially flow on to holding less higher risk assets (such as shares and property) to compensate and/or increase capital requirements which could lead to higher charges to consumers.

Reasons against eliminating the CGS market include:

1. Use of CPI Linked bonds for annuities

Life insurance companies use CPI-linked bonds to back the sale of CPI-linked guaranteed annuities. The major supplier of these bonds is the government sector and it is likely that without this supply of high credit quality bonds, life companies would not issue CPI-linked annuities.

There are very few issuers other than governments that have the financial size, diversification and inflation linked revenues to issue long term CPI-linked securities in sufficient quantities to make a liquid market. Without the government CPI-linked bonds, the remaining market would lack the liquidity and diversity to warrant life companies continuing to issue these types of annuities due to higher credit risks and greater difficulties of closely matching the liabilities.

The ageing of the Australian population is a significant demographic feature which will place significant pressure on the Government's ability to provide post-retirement income. This will place more onus on people to provide their own post-retirement income. CPI-linked guaranteed annuities are a very desirable product that enables retirees to earn income that is guaranteed for the rest of their life and keeps up with inflation.

If wealth management companies cannot provide this product to retirees because of the unavailability of CPI-linked securities, consumers will lose an integral method of providing secure inflation linked income and significantly impact consumer choice.

In addition, the proposed legislation for structured settlements in lieu of lump sum payments requires some level of inflation linking and can only be provided by a life insurer.

2. Impact on other assets

For wealth management liabilities, Commonwealth Government Securities have provided for many years an appropriate component of the portfolio which allows risk to be appropriately managed (particularly for our capital guaranteed liabilities). Without Commonwealth Government Securities there may not be enough depth in the non-government market to allow for these assets to be replaced without some impact on other securities. This would require a review of the overall impact on the risk profile of our funds (especially capital guaranteed funds) and may have knock on effects to other asset classes.

Commonwealth Government Securities assets may not necessarily be replaced by corporate bonds, but instead lead to less equity and property exposure (for example) in a portfolio, which may have a distorting impact on the market. This, in turn, may lead to inappropriate pricing of credit risk due to supply and demand factors, rather than the true underlying financial factors.

3. Increased capital requirements

The absence of Commonwealth Government Securities will increase portfolio risk because:

- it will reduce the pool of assets available to match liabilities and hence increase mismatching risks, especially for annuity business which cash flow matches most of its liabilities
- they will be replaced with corporate bonds (or other securities) which have higher risk
- the absence of a risk free benchmark rate would increase volatilities in other securities
- risk management vehicles such as derivatives will increase in volatility (and price)

Given APRA's approach to capital adequacy, this will result in increased capital requirements to be borne by shareholders. The higher risks may also impact on policyholder security and the higher capital requirements may lead to higher charges to customers.

1. Current regulation requires the use of risk-free securities

Under both life and general insurance regulations reference is made to the use of yields on Government Guaranteed Securities (for discount rate purposes mainly). Examples of these regulations are the solvency and capital adequacy standards of life insurers under the Australian Life Act 1995.

Although it would be possible to use an alternative benchmark, these standards assume that a company has the ability to minimise their risk exposure and associated capital requirements through investment in Commonwealth Government Securities. At a minimum, the regulations would need to be changed to accommodate a situation where no such benchmark exists.

Future developments in accounting standards are also expected to assume that liability cash flows could, if desired, be replicated by matching risk free assets.

There may also be flow on impacts on the ratings of insurer's financial strength.

AMP Life believes that Treasury should retain the CGS market to ensure consumers continue to have the financial products available to meet their financial needs especially those requiring low risk and retirement income.

Yours faithfully,

John McDonald
Finance Director
AMP Financial Services