

# Mixed Messages

A raft of regulatory and legislative signals suggest transformation may be on the agenda for Australia's fixed income market. But a lack of coordination and government commitment may neutralise – or even undermine – bond market growth.

BY KIMBERLEY GASKIN

**C**ooper. Johnson. Henry. Swan. They sound like a posse of explorers trying to blaze a trail through hostile territory. And that may indeed be the case for the quartet of regulators and legislators that are shaping Australian financial markets. The question is, are some of them getting lost on the way?

The raft of superannuation, taxation and financial markets proposals, reforms and legislation flowing from the pens of these men – combined with the Australian Prudential Regulation Authority (APRA)'s proposed new APS210 bank liquidity rules and the Australian Securities and Investments Commission (ASIC)'s new retail bond prospectus regime – all

have implications for the local fixed income market. But market users are far from convinced that these efforts are coordinated or even pulling in the same direction.

At this stage the fear is that no-one with legislative or regulatory authority appears to be stepping back and listening to the overall message. What is immediately obvious is that a range of sometimes contradictory signals are emerging.

As an additional counterweight to progress, other proposals that could have had a transformative effect on the fixed income market and its participants have been undermined by May's federal budget in its unwavering drive towards surplus. The government has forecast a return to a small surplus of A\$1 billion (US\$845 million) by 2012/13 – some three years earlier



**"IF THE COOPER REVIEW RECOMMENDATIONS ARE ADOPTED, IT IS POSSIBLE THE COMBINED EFFECT OF THESE CHANGES AND THE INCREASED SUPERANNUATION CONTRIBUTIONS COULD LEAD TO A PROPORTIONATELY GREATER INCREASE IN ALLOCATIONS TO DEBT PRODUCT."**

LOUISE MCCOACH CLAYTON UTZ

than initially expected. Most market participants applaud the commitment to surplus, but the drive towards it may have caused collateral damage by removing incentives to income securities investment that the government has deemed to be too expensive.

### ALLOCATION IMPLICATIONS

**T**he most uniformly benign impact for fixed income markets across the raft of new measures is the potential for greater allocation to the fixed income asset class inherent in the increase in the superannuation levy to 12 per cent of income by 2019/20, from the current 9 per cent. The initiative – proposed in the Review of Australia’s Future Tax System by treasury secretary Ken Henry (the Henry Review) – has been broadly embraced, although the means of funding it, potentially via a new federal tax on certain mining projects, has let loose the dogs of war across the resources sector (see box on p18).

As the aggregate pool of superannuation assets grows more cash will flow into fixed income allocations. However, many market participants agree there is little sign of a government incentive – or mandate – to increase Australia’s chronic under-allocation to defensive assets.

The default superannuation fund – via which some 80 per cent of Australians invest their retirement savings – remains in the grip of a 70:30 per cent growth:defensive split in spite of the ructions of the global financial crisis and the much more balanced split seen in key offshore markets, including the US and the UK. But any change in the overall allocation to fixed income is likely to be dependent on whether or not the recommendations of the Super System Review – conducted by Jeffrey Cooper (the Cooper Review) – are adopted.

The Cooper Review’s first recommendation is that the one-size-fits-all approach to superannuation employed by the Superannuation Industry (Supervision) Act 1993 and the Corporations Act 2001 is no longer appropriate given the degree of difference in how individuals choose to engage with their super. Investment strategies employed should reflect that level of engagement.

The review recommends that MySuper – which requires a diversified asset allocation – be the only kind of superannuation product which an employer can nominate as its default fund for making superannuation contributions. It also recommends that ‘hands-off’ member contributions must

default to a low-cost, conservative investment strategy. “If the Cooper Review recommendations are adopted, it is possible that the combined effect of these changes and the increased superannuation contributions could lead to a proportionately greater increase in allocations to debt product,” comments Louise McCoach, partner, structured capital markets at Clayton Utz in Sydney.

That ‘if’ is a big one, though, and fixed income market participants generally believe it is way too early to anticipate a new, halcyon era for defensive assets – particularly bonds. “The increase is very positive, but its gradual nature makes it less likely that we will see any sudden shift in asset allocation towards defensive assets,” argues Bradley Bugg, Sydney-based head of fixed income and currency at Ibbotson Associates (Ibbotson) – an asset consultant.

### THE RETAIL EQUATION

**T**he increase in super is only one proposal with potential to boost the allocation to fixed income among Australian investors. Changes relating to the retail market, including the encouragement of domestic retail corporate bond issuance and incentives to invest in interest-bearing product, present some opportunity to really shift the mindset on allocation to defensive assets. But despite a pincer movement of measures on retail bonds and interest-bearing securities, market participants remain to be convinced that enough has been done to see any real change.

There has been a distinctly muted response to the government’s response to the call for demand incentives for income product. Australia’s distorted allocation to equities over fixed income has been underpinned by the lack of tax neutrality across asset classes and it has long been an issue that interest-bearing products – including deposits, bonds, debentures and annuities – have been subject to less advantageous tax treatment compared with equities. Income derived from listed shares in companies with domestic investments benefits from imputation credits for dividends and a discount for realised capital gains.

Says Stephen Nash, Sydney-based head of strategy and market development at FIIG Securities (FIIG): “This supports the current aggressive allocation of assets to equities in Australia. Neutrality of taxation between asset classes should be a policy goal, to ensure that investments are made on the basis of relative investment merit and not on the basis of taxation.”

“THE OVERRIDING GOAL OF THIS BUDGET WAS TO GET INTO SURPLUS AS SOON AS POSSIBLE. PLACING A CAP ON THE AMOUNT OF INTEREST IS LIKELY TO REFLECT THE MAXIMUM AMOUNT OF TAX THE GOVERNMENT COULD FOREGO.”

BRADLEY BUGG IBBOTSON ASSOCIATES



# MINING PROFITS

BOND MARKET PARTICIPANTS ARE KEEPING A CLOSE EYE ON WHAT NEW MINING TAXES MAY MEAN FOR STATE FUNDING PLANS AND FOR PERCEPTIONS OF AUSTRALIAN SOVEREIGN RISK.

The most contentious of all the proposed reforms and taxation measures now in the Australian market are those which the government wishes to apply to the mining sector.

In a huge shock to the industry the Henry Tax Review recommended a proposed increase in superannuation contributions be funded by the mining sector via the introduction of a resources super profits tax (RSPT) – a 40 per cent federal royalty on profits over and above the 5.7 per cent 10-year government bond rate. In an attempt to offer something back to the mining industry, the scheme also includes a cash benefit to mining companies that incur exploration expenditure in the form of the resources exploration rebate (RER).

## State impact

Beyond the outlook on mining credits – which rating agencies swiftly said would be limited – there are two potential issues of interest to bond market participants.

The first is the extent to which the scheme could impact state funding programmes. While state funding agencies themselves say it is too early to tell what impact the changes may have, the general sentiment is that the real effect will be determined by the extent to which the scheme impacts the growth and revenue of the two key mining states – Queensland and Western Australia (WA).

In terms of direct revenue there is nothing in the initial proposal that will impact the existing system of royalties to states as the RSPT scheme would

operate in parallel with the existing state royalty system. The only change is that the federal government will provide a refundable credit to mining companies for royalties paid to state governments. This credit will be available at least up to the amount of royalties currently imposed.

However, in practice the states may feel some impact. “The RSPT should only affect state government royalty income – and therefore, indirectly, semi-government funding strategies and ratings – to the extent that the RSPT and other measures lead to a decline or expansion in new mining projects in the future,” argues Louise McCoach, partner, structured capital markets at Clayton Utz.

Resource lobby groups have already begun to argue that the tax jeopardises a huge pipeline of projects. For example, Queensland Resources Council chief executive, Michael Roche, has claimed: “The super profits tax is not good news for the best part of projects totalling A\$100 billion (US\$84.5 billion).”

The mainstream media is already rife with dire stories about cancelled or delayed projects, although the government maintains the RSPT will not adversely impact the level of mining activity in the medium term and is likely to lift activity in the long run by funding a reduction in the company tax rate to 28 per cent.

McCoach says it is too early to tell how resource-rich states may be impacted. But the new tax may not be disastrous in terms of growth in those

states. She comments: “The RSPT is linked with the introduction of the RER and the establishment of an infrastructure fund, both of which are measures to increase investment in Australia, particularly in Queensland and WA. Further, the RSPT is a tax on profits. When all these factors are considered as a whole, it remains to be seen what impact the RSPT will actually have on future state revenue or growth.”

## A sovereign question

A related issue is the extent to which the tax could impact views on regulatory or even sovereign risk. The biggest immediate impact of the Henry Review and the government’s response to it has been the shock at a change to the taxation environment which could be sufficiently significant to influence the international view of Australia as a stable regulatory regime.

Mining lobby groups jumped on this angle immediately. “As Australia’s most globalised industry, the minerals sector has an abiding interest in ensuring that tax reform makes Australia an even more attractive investment destination. That means keeping our tax rates competitive. It also means ensuring commercial decisions taken under existing tax arrangements are not compromised in a way that creates perceptions of sovereign risk,” commented Mitch Hooke, chief executive officer of the Minerals Council of Australia.

Market participants believe there may be more to the argument than just hot air, with several agreeing the mining tax could imply at least heightened regulatory risk as a deterrent to investment in Australia, if not heightened sovereign risk. Says McCoach: “There is a risk that investors could view Australian investments as being less

attractive as a result of the tax. There is also a perception that, as the RSPT will apply to existing mining projects, introducing the tax in its current form creates change in law risk and uncertainty regarding Australia, thereby harming not only future mining investment but all future investment in the country.”

The government’s argument remains that a resources tax that facilitates an overall lower company tax can only benefit sentiment on investing in Australia. “A lower company tax rate will improve incentives to invest in Australia,” says the government’s response to the Henry Review. “Increased investment in Australia will boost the capital stock available for Australians to work with. Greater capital intensity, induced by the lower company tax rate, will lead to higher labour productivity and therefore higher real wages for Australian workers, ensuring the benefits of strong resource prices are widely spread. Cutting the company tax rate will also help sectors other than the resource sector to attract investment.”

While the market may be squabbling over how real the risk is, there is no immediate expectation that it will translate into a significant impact on Australian sovereign or semi-government bonds, if for no other reason than the government would be unlikely to make such a drastic change if there is any real chance it will jeopardise the country’s strong position.

“The government won’t kill the golden goose,” comments Damien McColough, chief interest rate strategist at Westpac Investment Bank. “They won’t want a net loss of revenue and they won’t want to impact the Commonwealth government securities market.”

The Henry Review certainly recognises the problem. Its Recommendation 14 suggests a 40 per cent savings income discount to individuals for non-business related net interest income, net residential rental income (including related interest expenses), capital gains and losses, and interest expenses related to listed shares held by individuals as non-business investments. No limit is applied to the discount.

In his budget speech federal treasurer Wayne Swan acknowledged that the tax distortion particularly disadvantages lower-wealth and older savers who are more likely to hold their non-superannuation savings in interest-bearing products. But the policy response was tepid at best. From July 1 2011 Australians will be able to obtain a 50 per cent tax discount for the first A\$1,000 of interest they earn, including interest earned on deposits held in banks, building societies and credit unions, and on bonds, debentures and annuity products. “This change is expected to make interest-bearing products more attractive to savers, which will have positive flow-on effects for competition in our financial system,” said Swan.

Any incentive for retail to invest in fixed income is welcomed by the market – and some sources say the tax break could have a positive impact on the investment decisions of, in particular, younger savers. Even so, there is a palpable air of disappointment over this particular provision because it falls so very short of the Henry Review’s Recommendation 14. It also offers the marginal incentive equally across all income product, leading many market users to believe any change in investment behaviour it does engender will be to the benefit of the term deposit, rather than the bond, market.

The interest income incentive, along with the Henry Review’s recommended withdrawal of interest withholding tax on funding brought into Australia from offshore by banks, could also potentially have revolutionised the bank funding environment according to some sources. But the modest final form of the proposals as put forward by the government in the budget means few expect radical change to that market either (see box on p20).

Comments Adam Donaldson, Sydney-based head of debt research at Commonwealth Bank of Australia (CBA): “This is a very scaled-down version of the Henry Review’s recommendation on the taxation of interest. The 50 per cent discount on the income tax payable on the first A\$1,000 of interest received is a very small amount and is, in our view, unlikely to alter the savings patterns of Australia.”

James Morris, senior associate at Blake Dawson in Sydney, is also unconvinced the relief will promote a deep and liquid corporate bond market because the numbers are not large enough to inspire retail investors to change their strategy. He notes that for a retail investor falling in the 31.5 per cent marginal tax bracket, the impact of the 50 per cent tax discount will result in the investor pocketing a maximum of just under A\$160 in savings in a given year. Even if that investor is a high net worth individual falling in the highest current marginal tax bracket of 46.5 per cent, he or she only stands to pocket approximately A\$230 in savings.

Having set the scene for easier retail bond issuance via the ASIC proposals and the government-sponsored Johnson Report (see below), the government has effectively gutted the incentive on the investor side. That move is believed to have been motivated by the political need to project a medium-term surplus in the latest budget. “The overriding goal of this budget was to get into surplus as soon as possible. Placing a cap on the amount of interest is likely to reflect the maximum amount of tax the government could forego,” comments Ibbotson’s Bugg.

However, some sources are prepared to give credit to the sentiment behind the government moves over and above the limited impact the current policy will have. “Given that the budget was complicated by a range of issues, it might have been expected that a full solution to the lack of tax neutrality between asset classes, as identified by the Henry Review, might not have been fully implemented in this budget,” accepts Nash. “However, the door is now open and further development can be expected to emerge over time.”

## SUPPLY SUPPORT

The news is more progressive on the issuer side, with proposals flowing through – from ASIC and the Australian government’s Australian Financial Centre Forum (AFCF)’s report on securing Australia’s future as a financial services centre (the Johnson Report) – to the budget quite seamlessly, albeit with a few modifications.

In December 2009 ASIC proposed streamlining the prospectus process for strong corporates wishing to issue retail bonds, a concept embraced by the Johnson Report when it was published in mid-January this year. With the government having already welcomed the Johnson Report’s suggestions on retail, the May 11 federal budget expressed further sovereign

“NEUTRALITY OF TAXATION BETWEEN ASSET CLASSES SHOULD BE A POLICY GOAL, TO ENSURE THAT INVESTMENTS ARE MADE ON THE BASIS OF RELATIVE INVESTMENT MERIT AND NOT ON THE BASIS OF TAXATION.”

STEPHEN NASH FIIG SECURITIES



# DISAPPOINTING RESULT FOR **BANK FUNDING**

BUDGET PROPOSALS INDICATE A MIXED OUTCOME FOR BANKS' FUNDING MIX. TWO KEY ITEMS HAD THE POTENTIAL TO IMPACT BANK WHOLESALE FUNDING STRATEGIES – THE DISCOUNT ON INTEREST EARNED FROM INCOME PRODUCTS AND A REDUCTION OF INTEREST WITHHOLDING TAX (IWT).

There are some contradictions in the outcomes of the May 11 federal budget relating to bank funding, with both the IWT decision and the discount on interest item containing variations on recommendations from the Johnson and Henry reviews. Sources say these make both initiatives less likely to have an effective impact on bank funding strategies.

## Discount on interest

The budget did not fully adopt the Henry Review's recommendation with regard to the discount on interest. Although the headline budget discount is, at 50 per cent, higher, it is capped at A\$1,000 (US\$845). This compares with the Henry Review's recommendation of a 40 per cent discount with no cap.

Market users believe the Henry Review's recommendation had real potential to recalibrate Australian authorised deposit-taking institutions (ADIs)' funding strategies by providing a genuine incentive for retail investors to increase their use of interest-bearing deposit facilities. Larger deposit bases for banks, building societies and credit unions could translate into reduced wholesale and,

specifically, offshore borrowing requirements.

This is a critical issue for Australian ADIs, which have outstripped the combined domestic capacity in retail and wholesale funding, forcing them to rely on relatively expensive offshore markets. In 2009 total funding volumes in international bond markets by Australian credit issuers (predominantly financial institutions) reached the equivalent of around US\$125 billion, compared with little more than US\$50 billion in 2008, according to figures from Citigroup.

"Any relief from the burden of international pricing would have been welcome for larger ADIs. And since deposits typically represent a high proportion of funding for smaller lenders, this reform could have helped put downward pressure on their funding costs, allowing them to lend at more competitive interest rates to Australian households and small businesses," comments Damien McColough, chief interest rate strategist at Westpac Institutional Bank.

But the budget's partial adoption of Henry's Recommendation 14 means it is unlikely the incentive will be enough to really shift investors' saving behaviour and impact larger or smaller banks' sources of funding. National Accounts data indicates A\$1.01 trillion (US\$84.5 billion) in bank deposits at the end of December 2009 (see chart on opposite page). Households – the target of the interest discount measure – represent 47 per cent or A\$510 billion of this amount. But the share of bank deposits held by households has been in steady decline since 1988, when it represented 68 per cent.

"To the extent this decline was a result of the inequities in the tax treatment of interest income versus shares and property, there is certainly scope for deposits to grow," says McColough. "But the modifications to the Henry Review Recommendation 14 mean it is unlikely we will see significant enough growth in deposits to really affect banks' offshore funding requirements."

Funding teams at the big four banks confirm there is not much in the budget to alter their course in 2010. Comments Simon Maidment, Sydney-based head of group funding and execution at

CBA: "The discount on tax on deposit interest is a small step that acknowledges deposit savings are disincentivised under our tax arrangements. But it is a far cry from the proposals in the Henry Review which would potentially have been more game-changing."

## IWT insights

The news is somewhat more significant on the IWT front, yet still falls short of being transformative for bank funding strategies.

After extended lobbying from industry groups – as well as recommendations in the Henry and Johnson reviews – the government announced in the budget that it will introduce a phase-down in the IWT payable when Australian ADIs – and subsidiaries and branches of foreign financial institutions – bring borrowings from their overseas entities to Australia.

The changes apply whether the offshore entity is an Australian branch's parent or an international subsidiary of a domestic bank. However, they do not extend to corporate borrowers, which will still require exemption under section 128F of the tax code.

The government has committed to reducing IWT rates to 7.5 per cent from 2013/14 and 5 per cent from 2014/15 (see table in this box).

Both Henry and Johnson recommend financial institutions operating in Australia should not be subject to IWT on interest paid to non-residents on the grounds that the removal of on the tax on offshore funding by financial institutions will enable the banks to attract a greater

## IWT CHANGES

TYPE OF BORROWING	CURRENT IWT POSITION	FUTURE IWT POSITION FROM 2013/14	FUTURE IWT POSITION FROM 2014/15
Financial institution borrows from a foreign financial institution (where not exempt under a tax treaty)	10%	7.5%	5% (aspirational target of zero)
Foreign bank branch borrows from overseas head office	5%	2.5%	Exempt
Financial institution borrows from offshore retail deposits (proceeds used and traced to Australian operations)	10%	7.5%	5% (aspirational target of zero)
Financial institution borrows in a section 128F compliant manner	Exempt	Exempt	Exempt
Offshore banking unit (borrows and on-lends offshore)	Exempt	Exempt	Exempt
Financial institution borrows from non-resident retail deposits held in Australia	10%	10%	10%

SOURCE: AUSTRALIAN TREASURY MAY 12 2010

range of foreign funds at a cheaper rate. The government has not committed to Henry and Johnson's call for total elimination, but has indicated that abolition is an "aspirational" target.

Given the reductions begin in 2013, there will be no short-term impact on banks' funding strategies. In the wholesale arena, several domestic banks have told *KangaNews* it is already standard practice to structure transactions so they are IWT exempt, so a major change in where they source that funding is unlikely to ensue.

But longer term the change may enable Australian banks to access different, cheaper sources of funds – including private retail investors in Asia, Europe and the US – which are now uncompetitive due to IWT.

By the introduction of the measures the government wants to promote greater competition in the business and retail lending markets. The proposals potentially offer foreign branches and subsidiaries a reduced cost differential between funding via domestic programmes and using the proceeds of group borrowing internationally for Australian operations – in theory, aiding banking sector competition by widening the net of competitive funding sources beyond the congested Australian domestic market.

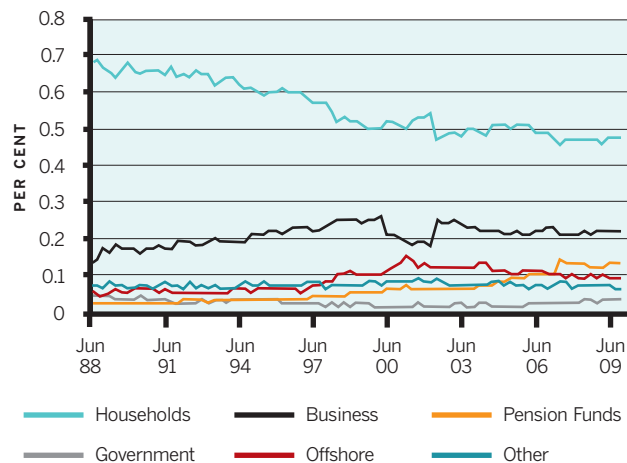
For financial institutions borrowing from offshore retail deposits and using proceeds in Australian operations, the tax rate will drop in the 2013/14 financial year to 7.5 per cent from 10 per cent, with a further drop to 5 per cent in 2014/15 and an aspirational target of total exemption. But for foreign bank branches borrowing from overseas head offices, the cut is more significant, dropping in 2013/14 to 2.5 per cent from 5 per cent, with total exemption proposed for 2014/15.

However, major ADIs are unimpressed by the quantum of the change or its potential to impact offshore borrowing programmes. "The cut in IWT is marginal," comments CBA's Maidment. And Ken Lord, Sydney-based partner at Mallesons Stephen Jacques, says: "It's a half-hearted measure that still doesn't bring us into line with international peers, and it is impossible to say how hard the zero target is at this stage."

Again, the drive for surplus is believed to be behind the slightly half-cocked approach. "Clearly the phased plan reflects the tension between what Treasury would like to achieve and what the Australian Taxation Office wants from the revenue perspective," comments Lord.

For many local branches and subsidiaries it has been cheaper to raise money via domestic programmes. And

**PERCENTAGE CONTRIBUTION TO BANK DEPOSITS**



SOURCE: WESTPAC INSTITUTIONAL BANK, AUSTRALIAN BUREAU OF STATISTICS

they have done so in considerable size, particularly under the aegis of the government guarantee (see chart on p34). Several have major maturities looming: Bank of Scotland Australia Branch, for example, has over A\$5 billion maturing in guaranteed and unguaranteed format in 2011 and 2012 alone, while ING Bank (Australia) has over A\$9 billion in guaranteed maturities, starting in 2012.

Patrick Mitchell, director, long-term funding at Rabobank Nederland Australia Branch (Rabobank), says the bank's Australian business will increasingly be able to take funds from Holland given the

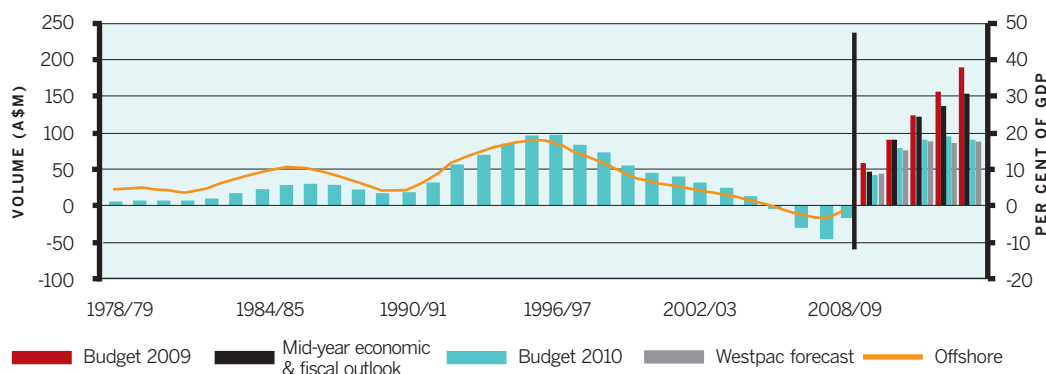
proposed changes to IWT. However, Rabobank will still need its own term funding and Mitchell believes the Australian market should continue to provide good diversity at a reasonable price.

He says: "I can't see us pulling back from the domestic market. We could issue Australian dollars to domestic investors from our global programme, but Australian investors have resisted – and I think still resist – issuance from programmes not documented under Australian law. If that continues we will also continue to issue to domestic investors from our domestic programme."

**“THE DISCOUNT ON TAX ON DEPOSIT INTEREST IS A SMALL STEP THAT ACKNOWLEDGES DEPOSIT SAVINGS ARE DISINCENTIVISED UNDER OUR TAX ARRANGEMENTS. BUT IT IS A FAR CRY FROM THE PROPOSALS IN THE HENRY REVIEW WHICH WOULD POTENTIALLY HAVE BEEN MORE GAME-CHANGING.”**

**SIMON MAIDMENT** COMMONWEALTH BANK OF AUSTRALIA

COMMONWEALTH NET DEBT



SOURCE: WESTPAC INSTITUTIONAL BANK, COMMONWEALTH GOVERNMENT BUDGET PAPERS

anticipate that ASIC may look at the issue again.”

The reduction in red tape is encouraging, but the Australian retail regime will still be far more stringent than the level of disclosure required for the wholesale market – both for domestic equity issuance and offshore retail bond jurisdictions. “Compare the position under the current prospectus directive regime in the European

support for the market. And in another indication that regulators and government are working hand-in-hand on the issue, ASIC published the results of its retail bond consultation and the updated version of its simplified prospectus regime for issuers on the same day as the budget (see KangaTrends p7).

In a joint statement Swan and financial services minister, Chris Bowen, said ASIC’s prospectus relief will “help develop a deep and liquid Australian corporate bond market”, which is, in turn, expected to “put competitive pressure on bank lending rates to business, and also reduce the amount of wholesale funding which our banks are required to raise in international capital markets”.

Responses to the latest iteration of ASIC’s retail proposals range from optimism about the likelihood of significant issuance being spurred, to distinct doubt. But most market participants say the strongest aspect of the regulator’s approach is its willingness to allow for future flexibility if it turns out that more needs to be done to kick-start the retail arena.

Nash at FIIG – which submitted a response to ASIC during its consultation – welcomes the regulator’s acknowledgment of the need for a retail market through the publication of its regulatory guide (RG) 213. He adds: “More detail will emerge over time. If problems emerge and blockages to the use of RG 213 are identified, further guidance will probably be observed. For example, if ASIC finds company directors are being dissuaded from issuing bonds by concern about the cost of protecting themselves against liability, I

Union, where the level of disclosure required for a listed wholesale issue is not significantly different from that required for a retail issue,” comments Blake Dawson’s Morris. “Until that gap is reduced, while pricing and liquidity in the wholesale bond market remain attractive for issuers and investors in those markets, many issuers are unlikely to discern sufficient benefit – other than, perhaps, diversification – from absorbing the additional cost and time involved in tapping retail investors.”

And despite the progress on corporate issuance, neither the Henry Review nor the budget directly addressed a measure that might be helpful to underpinning and therefore developing a liquid retail corporate bond market – a listed government bond market.

LIQUIDITY AND THE CGS MARKET

In part the lack of movement on retail government bonds is believed to be rooted in the expected reduction in the volume of Commonwealth government securities (CGS) the federal government will issue – and the rampant demand for sovereign bonds expected to be triggered in the banking sector by APS210.

Australia’s net federal debt, currently A\$90.5 billion, is forecast to peak at 6.1 per cent of GDP in 2011/12 – less than half the 12.3 per cent peak predicted 12 months ago and up to 20 times less than the projected levels in other developed economies. Gross Treasury bond issuance for the next financial year will be around A\$56 billion, a small increase on the A\$53



“THE 50 PER CENT DISCOUNT ON THE INCOME TAX PAYABLE ON THE FIRST A\$1,000 OF INTEREST RECEIVED IS A VERY SMALL AMOUNT AND IS, IN OUR VIEW, UNLIKELY TO ALTER THE SAVINGS PATTERNS OF AUSTRALIA.”

ADAM DONALDSON COMMONWEALTH BANK OF AUSTRALIA

## “THE COMBINATION OF APS210 AND THE FSA'S ANNOUNCEMENT MEANS THERE WILL BE WAY MORE BUY-AND-HOLD INVESTORS BOTH ONSHORE AND OFFSHORE, AND I DON'T THINK THE NEW RULES ON LIQUIDITY HAVE BEEN FULLY PRICED INTO GOVERNMENT OR SEMI-GOVERNMENT SPREADS.”



**DAMIEN MCCOLOUGH** WESTPAC INSTITUTIONAL BANK

billion likely to be issued in 2009/10, all but A\$7 billion of which has already been placed (see KangaTrends p2). “The character of issuance will change, however,” claims CBA’s Donaldson. “Although total issuance will rise slightly in 2010/11, the volume of new issuance will fall.”

Next financial year’s net issuance of CGS will actually fall to A\$38.4 billion due to an increase in maturities. Total bonds outstanding by the end of 2010/11 will be A\$125 billion – some A\$45 billion less than forecast in last year’s budget. Total bonds on issue in June 2010 will be A\$154 billion, increasing to A\$209 billion in 2011 and jumping to A\$222 billion in 2013 – down from the A\$256 billion predicted in the November 2009 mid-year economic and fiscal outlook and significantly below the A\$300 billion forecast for 2013 in last year’s budget.

Market participants anticipate that – barring any more exogenous shocks – bond issuance will then begin to drop as maturities slow and the need for new debt declines.

The expected return to surplus has some real positives for the bond market, particularly on the all-important sovereign risk front. Comments Donaldson: “We compare very favourably with debt profiles of other G8 bond markets – with the US and UK approaching 100 per cent of GDP. That should provide a relative advantage to the Commonwealth in the global competition for surplus investment funds.”

The downside of a long-term reduction in the federal borrowing requirement is the returning possibility of an illiquid sovereign bond market. The amount of CGS on issue is a far cry from the long years of A\$50–A\$60 billion of hotstock, which saw Australia almost drop out of global indices. But the downward revisions on supply are cause for real reflection on the challenge of maintaining liquidity, particularly in light of the proposed changes to APS210 which are expected to mandate far greater bank holdings of minimum-risk assets, including sovereign debt.

Although sovereign bonds on issue will be much higher than that low watermark, with APS210 on the horizon many market participants believe it will be difficult to maintain liquidity. And with Australia’s bonds expected to be in high demand due to concerns over eurozone sovereign risk, the picture for liquidity looks even murkier. The projected total face value of CGS on issue by the end of June 2010 – A\$154 billion – is well below the A\$250 billion or so some market participants anticipate bank liquid portfolios will require if

APS210 strips them of the ability to invest outside government and semi-government bonds.

That is just the demand level from Australian portfolios. In 2009 the UK regulator, the Financial Services Authority (FSA), announced the inclusion of Australian sovereign bonds in its liquid asset list. According to the Australian Bureau of Statistic’s National Accounts data, of the A\$112.7 billion issued by the government, A\$72 billion – or 64 per cent – is already held by offshore investors. So illiquidity is an understandable concern.

“The combination of APS210 and the FSA’s announcement means there will be way more buy-and-hold investors both onshore and offshore,” says Damien McColough, chief interest rate strategist at Westpac Institutional Bank in Sydney, “and I don’t think the new domestic and global rules on liquidity have been fully priced into government or semi-government spreads.”

Donaldson believes the combination of reduced net issuance and increased liquidity requirements should see a scarcity premium develop in Australian bond markets. He adds: “The scarcity of bonds will generally see the term premium suppressed, allowing the curve to flatten or even invert.”

The premium on CGS will only worsen if the global market starts to value accurately the strength of the Australian economy, McColough believes. He comments: “In the 10-year part of the curve there is still a 200 basis points differential between US Treasuries and Australian CGS. The market is still not properly pricing in Australia’s risk profile – although the latest federal budget may help.”

McColough anticipates that over time the widening in spreads across the curve could be substantial, given there will be a diminished amount of triple-A rated securities to satisfy the prudential requirements for bank liquid asset holdings when the new APS210 standard is adopted. “But the biggest impact on swap spreads will occur if these new plans alter the mix of bank funding, specifically if they increase the amount of deposits relative to other short-term wholesale funding, such as bank-accepted bills,” he says.

Wholesale funding strategies and the liquidity of CGS are absolutely critical issues as the market moves into a new liquidity regime. Although most of the ramifications of the wide range of reform proposals on bond markets are still potential, it is time for someone to shape a coherent message. •