

All the world's a stage

Stephen Hart explains why a long bond market is needed for Australia to become a regional financial centre.

The Australian dollar's ever increasing liquidity is fuelling Australia's ambition to position itself as a regional financial centre. To achieve this ambition, however, Australia needs a long bond market: that is, a series of deep nominal bond issues from multiple sectors in the 20-year-plus maturity range.

The absence of a long bond in the Australian bond market leaves the structure of our financial markets exposed to refinancing risk in Australian dollar debt. Part of the reason for this lack of depth in the bond market is Australian investors' appetite for equities. This appetite exists despite the abundance

of information on global best practice. The situation is compounded by the lack of comprehensive policy direction from the Federal Government. While some measures have been introduced to assist with growth of the bond market, much more work is needed. Hoping that the long bond market will 'emerge' or 'evolve' by itself is simply wishful thinking. Without a comprehensive and focused approach, the Australian dollar financial market will continue to lack the crucial component of financial markets: a long bond market.

The good news

Investors who consider buying Australian

dollar investments need to be able to hedge them with a liquid currency and with a liquid futures market. The good news, as the Australian Office of Financial Management (AOFM) has recently pointed out, is that the Australian dollar is the fourth most actively traded currency in the world (see figure 1).

Moreover, the liquidity of the Australian dollar is high in gross domestic product (GDP) terms in comparison with other major economies. For example, Canada's gross domestic product is 34 per cent greater than Australia's GDP – while the turnover in



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the Canadian dollar is 25 per cent less than the turnover in the Australian dollar.

The bad news

The downside is the absence of long-term Australian dollar bonds. In general, the markets that rank ahead of the Australian market in terms of liquidity have liquid long bond markets, and modified duration can be of assistance in determining the existence of a long bond market.

The Australian fixed credit index is about half the modified duration of most global indices, and the government index is just over half the modified duration of most global indices. In market parlance, the Australian dollar bond market is 'short' relative to global comparisons, and the shortness of the bond market has several implications for the structure of the Australian economy, including the

following:

- Corporations and governments face refinancing risk with shorter debt maturities;
- Corporations and governments need to solve their longer term funding requirements from offshore markets;
- Investors in the Australian currency are unable to access bond terms available in other currencies;
- Investors have shorter debt portfolios, which fail to offset the volatility embedded in equity holdings that are large, based on OECD comparisons; and
- Australia is unable to obtain the status of a regional financial centre because it fails to offer a bond market of adequate length.

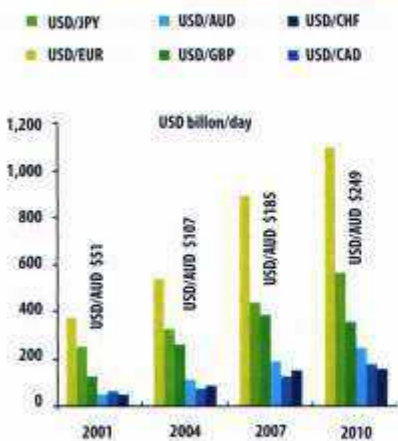
Why does our appetite for equities affect development of a long bond market?

Figure 2 shows how overweight Australian pension funds are in equities in comparison with 20 OECD countries. Inevitably, the result is a significant underweight allocation to fixed income assets. If Australian pension portfolios remain underweight in fixed income, this will continue to constrain both the size and length of the local bond market – thereby forcing banks and governments offshore to obtain funding (especially in long-dated bonds).

In other words, the absence of a long Australian bond market is an effective and significant constraint on the ability of Australia to become a financial centre and may, over time, constrain the relative growth in liquidity of the currency. If investors cannot access the long Australian bond products they are

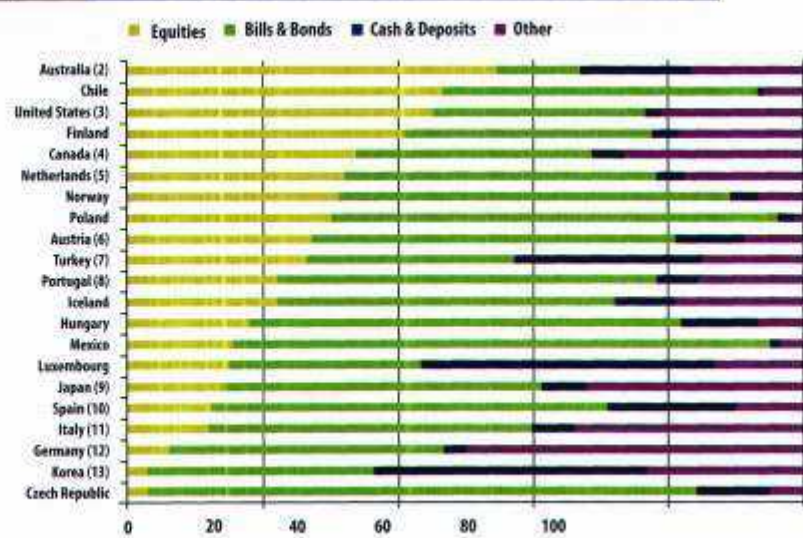
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Figure 1: Global FX market turnover by currency pair



Source: Australian Government Securities, Neil Hyden, Chief Executive Officer, The EuroMoney Australian Debt Capital Markets Forum, September 2010, p. 17.

Figure 2: Pension fund asset allocation as % of total investment



Source: OECD, Pensions markets in Focus, Number 7, July 2010, Figure 3, p.6

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seeking, the relative yield advantage of the Australian dollar could fade, thereby diminishing currency liquidity in the medium term. In some ways, the final report of the Australian Financial Centre Forum in November 2009 pointed to the problem:

“In contrast to our equity capital market, Australia’s domestic corporate bond market is not very deep or liquid. It is also dominated by bank issuance and tends to be concentrated at shorter ends of the maturity spectrum: the average maturity of Australian corporate debt on issue is just 2.5 years.”

In general, the forum asked many worthwhile questions – but not the crucial question regarding the lack of a long bond market. Specifically, while the forum concluded that a deeper and more liquid corporate bond market would be in the national interest, the problem is not one of being either ‘deeper’ or ‘more liquid’, as in the case of the long bond market. Rather, the problem is that a long bond market does not exist in Australia. Despite the protests of our equity colleagues, the fact remains that the bond market is the most crucial market in any financial centre, and Australia only has a short bond market. We are unable to offer the products that both investors need and issuers demand.

What is needed?

The Australian Commonwealth Treasury should devote more resources to supporting the creation of a long bond market, which could include:

- The introduction of additional measures, on a revenue-neutral basis, which reduce the taxation inequality between equity and debt, as identified in the Henry Review and the recent budget;
- Giving greater attention to asset-liability matching in the privatisation of

pension payments through the superannuation industry, thereby driving demand for fixed income; and

- Increasing the taxation of super funds that prefer aggressive growth asset allocations.

Also, a long Commonwealth bond futures market needs to be developed (possibly a 20-year contract) as a bridge between longer issuance and the current 10-year contract. Commonwealth and State governments need to commit to longer issuance. While the AOFM and some of the semi-governments are moving in this direction – especially in the inflation-linked bond issuance program – greater planning and commitment is required.

Institutional investors and consultants need to consider longer fixed income benchmarks, hopefully moving to a five-year-plus benchmark. At a minimum, there should be a change from the UBS Composite 0+ year to the UBS composite one-year-plus, as a one-year-plus index is widely used in global markets

There must also be a further reduction in issuance costs by reducing the current requirements for listed companies seeking to issue ‘vanilla bonds’.

For ‘vanilla’ bonds intended for retail investors, an exception must be provided to the current requirement for full documentation. In particular, the approach to regulation that focuses on the investor classification should be supplemented by an approach that focuses on product classification. The existing \$500,000 transaction limit has effectively prevented issuers connecting with investors. Specifically, a ‘vanilla’ senior bond issued by an Australian Securities Exchange listed entity is a conservative product, and should necessitate significantly less disclosure than a struc-

tured product (eg, a collateral debt obligation). Regulation, in attempting to protect the retail investor, is effectively halting product flow, thereby allowing higher risk products to dominate asset allocations. In other words, regulation that focuses on investor classification is contributing to the local focus on equities, as an unintended consequence.

Many other change are also needed – and all arms of government must be involved in a comprehensive approach. Specifically, the AOFM cannot just figure it out by itself, as appears to be the current approach.

Taking action

Australia has done well with its currency – liquidity is high at present. However, Australians should not be complacent. The continuing liquidity of the currency needs support from the financial markets in general, with the creation of a long bond market in particular.

The debate about Australia being a financial centre should not seek the development of a deep and liquid corporate bond market as one issue among many. Instead, the focus should be on how to create a long bond market, possibly embraced within a clear and comprehensive five-year plan. We cannot just ‘switch on’ a long bond market; we need to plan, and no-one is planning right now. Only by treating the issue seriously and embracing a comprehensive range of policies can we change the situation.

Leaving the problem to the AOFM will not deliver a deep long bond market or the desired status for Australia of regional financial centre.

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