Review of the Commonwealth Government Securities Market

Retail Employees Superannuation Trust ("REST") has over 1.2 million members with more than $4.3 billion in assets and is, by membership, the biggest superannuation fund in Australia. REST's members constitute approximately 12% of the Australian workforce, and when including REST's members' dependants, it is conservatively estimated, that REST influences retirement and death/disablement benefits of more than 11% of Australians.

REST's investment strategies will directly impact a large number of future Australian retirees. REST as a major superannuation fund and investor in CGS is making this submission out of concern regarding aspects of Treasury's Discussion Paper and the impact on REST's members if certain actions contemplated in the Paper are adopted.

REST's Core investment option (which is the option in which most members' money is invested) has exceeded its investment objective (CPI plus 3% p.a.) over periods of four years and longer as shown in the table below:

REST's INVESTMENT PERFORMANCE TO 30 SEPTEMBER 2002

	1 Yr % p.a.	2 Yr % p.a.	3 Yr % p.a.	4 Yr % p.a.	5 Yr % p.a.
Fund	4.1	4.6	6.1	6.9	7.0
CPI + 3% p.a.	6.4	6.0	7.0	6.4	6.0

REST's Core option has also achieved very good performance over the medium term compared to other superannuation funds.

COMPARATIVE INVESTMENT PERFORMANCE TO 30 SEPTEMBER 2002

Survey – Weighted Mean	1 Year % p.a.	3 Years % p.a.	5 Years % p.a.
REST- Core	4.1	6.1	7.0
Mercer – Balanced	-3.8	2.5	4.6
Mercer – Capital Stable	1.4	4.0	4.5

REST has achieved its medium-term investment objectives and has achieved better returns than other superannuation funds.

REST's Investment in Commonwealth Government Securities

REST's asset allocation to the fixed interest asset class as at 30 September 2002 is $1.5 billion. This is approximately 33% of its total assets.

Of the fixed interest portfolio approximately $320 million is invested in CGS representing around 21% of the fixed income portfolio and around 7.5% of REST's total assets. REST is a significant investor in CGS. REST anticipates an approximate doubling in total assets to around $8 billion by 2007. Accordingly, REST's demand for CGS is likely to increase.

The absence of a CGS market will have significant implications for REST's members (and other superannuation fund members) and their investment strategies. REST believes the Discussion Paper under-states the significance of CGS holdings by superannuation funds and the consequential impact on financial markets and investors in Australia.

Holdings of Commonwealth Government Securities

The table below (reproduced from Treasury's Discussion Paper) identifies holders of Commonwealth Government Securities ("CGS").

Holdings of Commonwealth Government Securities by sector (2001/2002)		
	$b	**(%)**
Offshore investors	23.8	37.3
Pension funds	11.6	18.2
Central banks	10.4	16.3
Life insurance corporations	7.8	12.2
Banks/depository corporations	3.6	5.6
Other insurance companies	4.4	6.9
Other	2.2	3.5
Total	**63.8**	**100.0**

Source: Australian Bureau of Statistics, 2002.

At the end of the March quarter 2002, official figures (APRA) indicated that the assets of superannuation funds totalled approximately $500 billion. The table above suggests the holdings of CGS by superannuation funds to be $11.6 billion which is less than 5% of the total assets of superannuation funds.

Based on alternatively sourced data, REST believes investment in CGS is higher than suggested in the Discussion Paper. Information obtained from the investment products offered in the Australian market has shown that the allocation to Australian Fixed Interest within the product is still substantial. The average asset allocation to Australian Fixed Interest within the products as at 30 September 2002 is detailed below:

Products	Average Allocation to Fixed Interest Sector (%)[1]	Average Allocation to CGS (%)[2]
Balanced	17.4	6.1
Growth	11.2	3.9
Capital Stable	29.5	10.3

[1] *Source: Rainmaker Analysis*
[2] *Based on the average composition of CGS in the UBSWA Composite Benchmark Index for the year to September 2002.*

Based on the above data, superannuation funds' investment in CGS is likely to be in excess of 6% of total assets.

Role of a risk-free asset

In the asset allocation decisions of superannuation funds, it is important to have a secure and stable bond market. Such risk free assets are important to reduce risk to investors such as insurance companies, superannuation funds and those in capital stable products because:

- Dismantling the CGS market will have an effect on the depth and efficiency of the financial markets and the Australian economy's ability to withstand financial crises. In his speech in October 1999, Chairman Alan Greenspan remarked "Australia serves as an interesting test case in the most recent Asian financial turmoil. Despite its close trade and financial ties to Asia, the Australian economy exhibited few signs of contagion……….arguably because Australia already had well-developed capital markets as well as a sturdy banking system….".

- When combining the factors of compulsory superannuation contributions and the ageing population in Australia (older working Australians are inclined to be more risk averse in planning for their retirement), the need for lower risk assets is predicted to increase.

- During periods of uncertainty and volatility in the financial markets, CGS have been a safe haven for risk-free investment.

- Portfolios that are designed to hedge against financial trauma and provide portfolio protection, are likely to have a significant allocation to CGS.

The demand for risk-free assets will continue to grow. In the absence of the CGS market, the markets for other financial instruments such as debt securities and debt obligations would be required as substitutes. The appropriateness of the substitutes as risk-free investments (suggested in the Discussion Paper) is discussed below.

Semi Government Bonds

Semi Government bonds are not always considered risk free. Yields on semi-government bonds reflect the credit standing of the individual States and these higher yields reflect in part the higher risk of Australian states in comparison to CGS and the lower liquidity of semi-government securities. The credit ratings of the States range from AA- to AAA. In the late 1980's and early 1990's some States' inscribed stock traded at yields in excess of 1.25% p.a. over the comparable CGS and there was also a wide divergence in yields between the States.

The lines of semi-government bonds on issue is triple that of CGS illustrating the lack of homogeneity which may well result in liquidity problems. Attempts to create homogeneity through consolidation of State debt has been rejected by the Australian States in the past and as recently as August 2001.

Swaps

The OTC interest rate swap and cross currency swap markets in Australia are well established and highly liquid. The CGS, swap and corporate bond markets are not independent pools of liquidity but are highly interdependent. The liquidity of the swap market, referred to in the Discussion Paper, has been largely driven by the existence of the CGS market and market intermediaries' ability to utilise CGS in facilitating transactions. The absence of the CGS market would see the liquidity of the swap markets dry up. Furthermore, because of the increased risk that would be experienced by market intermediaries in setting prices in the swap markets, the cost of transacting in OTC swaps will increase (from a level that is already high) and further reduce liquidity not only in the swap market but also in the CGS market, the corporate bond market and other derivatives markets.

The OTC swap market has deficiencies as a substitute for the CGS market in that it has liquidity and default risk and lacks credit homogeneity. Having regard for these factors, the OTC swap market is not a suitable replacement for the CGS market in providing a risk free liquid yield curve.

Corporate Bonds

The volume of corporate bonds has increased from $8.5 billion in 1997 to the current level of $72 billion. However, only a small portion of this is high-grade corporate debt. The increase in volume was due to investors' demand for debt instruments and a desire by borrowers to diversify away from bank loans as a source of debt capital

The maturity profiles of outstanding corporate bonds tend to be heavily concentrated in maturities of less than five years, although, this has recently lengthened. Any corporate

bonds longer than five years to maturity will tend to be illiquid. Commonwealth data has shown the liquidity ratio of the corporate bond market to be 1.5 whereas the liquidity ratio of the CGS is just under 9. As discussed above, the liquidity in the corporate bond market to a large degree is driven by the existence of the CGS market, the absence of which will decrease liquidity in the corporate bond market.

Corporate bonds have characteristics similar to OTC swaps in that they have increased default and liquidity risk (relative to CGS) and lack credit homogeneity. The price of corporate bonds are affected by the general level of interest rates but are also influenced by other factors, including macro-economic conditions, the issuer's financial standing, cyclical conditions affecting the issuer's industry sector, etc.

Corporate bonds are not a suitable replacement as a liquid risk free investment.

Bank Loans

In the absence of a pricing benchmark for corporate bonds, borrowers might revert to bank loans. Banking is by far the largest sector in the ASX/S&P200 and 300 indices. Superannuation funds may become excessively exposed to the banking sector through their allocation to both the fixed income and shares asset classes resulting in a potential concentration of investment in Australian Banks.

As for corporate bonds, bank loans are characterised by credit risk, a lack of liquidity and credit homogeneity. Bank Loans are usually in a floating interest rate form (thereby requiring a swap to convert to a fixed interest rate asset), carry prepayment risk (and interest rate risk if swapped), are less accessible to smaller investors and lack market scrutiny and analysis. Accordingly, bank loans are, in REST's opinion, an inappropriate substitute for CGS.

International Bonds

International Bonds play a role in a broadly diversified global fixed income portfolio. Because they exhibit different risk/return characteristics they are not a substitute for CGS.

International bonds do not play the same role in fixed income portfolios designed to protect against domestic inflation or financial trauma since conditions overseas may differ from the domestic macro-economic environment. In order to create a proxy for a risk-free asset that reflects the characteristics of CGS, foreign bonds would need to be accompanied by financial instruments that mitigate exchange rate and long-term interest rate risk. The consequence of the absence of the CGS market may well force Trustees of superannuation funds to seek alternative investments that as closely as possible exhibit risk free characteristics.

Treasury's Discussion Paper assumes that investors will be able to acquire foreign bonds and hedge the currency and interest rate risks back to Australian dollars. Transacting in foreign jurisdictions increases the complexity of portfolio administration and increases settlement risk. In the absence of a CGS market, and the consequential drying up of liquidity in the swap market (and the forward foreign currency market), the ability with which investors will

be able to effectively hedge their exposures will be greatly diminished. Treasury's Discussion Paper fails to take account of the consequential effects on derivative markets.

As a consequence of the change in the risk return characteristics of the fixed income asset class resulting from the absence of CGS, Trustees of superannuation funds, insurance companies and other sponsors of investment products will, in all likelihood, have to change the asset allocation strategies for almost all products that have an existing component of CGS.

Having committed to a change in their asset allocation strategies, Trustees will be reluctant to make further ad-hoc changes. Trustees establish strategic asset allocation levels having regard for the expected long-term risk-return characteristics of each of the asset classes. The Government should not think that the re-establishment of the domestic CGS market would occur just because the Government needs to borrow at some point in the future. Trustees will be reluctant to invest in the CGS asset class if there is a demonstrated lack of commitment on the part of the Government to maintain a liquid market (or any market for that matter). In anticipation that the Government will need to borrow at some stage in the future, access to the capital markets may be hampered in the absence of an ongoing commitment to the CGS market. Future Governments will be forced to raise some or all of their funds offshore in foreign currencies with all the risks associated with managing a foreign exposure (and without the same capacity to hedge exposures that exist today due to a drying up of liquidity in the swaps markets arising from the demise of the CGS market).

Conclusion

Treasury's Discussion Paper has the following potential implications:

- Trustees of Australian superannuation funds may redirect investments into foreign bonds (effectively financing offshore governments);

- There will be an absence of a homogeneous and liquid risk-free security;

- Pension funds moving offshore and hedging to AUD would be expected to incur increased transaction costs. Such investments will not be risk free (due to credit risk to the swap counterparty) and in all likelihood will result in an imperfect hedging arrangement due to liquidity constraints in the swap market resulting in increased risk to superannuation fund members;

- The overall income return from the fixed income sector is most likely to decrease as transaction and management fees increase with the complexity of the transactions and specialised monitoring of a diverse range of securities. This will almost certainly result in higher management expense ratios directly impacting on members' retirement benefits;

- Capital stable products will have to be restructured;

- Capital guaranteed funds of life insurance companies might have difficulties matching their liabilities for lack of risk free longer maturity securities;

- In the fixed income sector, the introduction of credit risk, call risk, and currency risk diminish disaster-hedging attributes.

The attached appendix comments further on selected questions raised in the discussion paper.

APPENDIX

Further Comments on selected questions referred to in the Discussion Paper

Pricing & Referencing other Financial Products

The discussion paper pre-supposes that the swap market, corporate bond market and CGS market, are all independent pools of liquidity. In fact, the markets are inter-dependent. The effect of removing the CGS market, in practical terms, will leave market making entities without an adequate hedging mechanism that facilitates trade in interest rate swaps, corporate bonds etc. The swap market will become less efficient resulting in an increased cost of capital to borrowers and or a lower return to investors. The existence of the swap market and the corporate bond market will be threatened by the removal of CGS.

The foundation for pricing other debt securities are both the CGS market and the swap market; the CGS allows the investor to identify the additional risk and return characteristics associated with an alternative debt instrument and the interest rate swap curve allows the investor to form a view on the relative value of alternative securities.

The possible alternatives suggested in the paper such as pricing-off other debt securities issued by a corporate with a similar credit profile, are based on hope. One merely needs to observe the corporate bond market in the USA, which is vastly larger and still uses US Treasury Bonds as a reference point for the pricing of other financial products.

Managing Financial Risk

Development of a liquid futures market is a difficult exercise. Various attempts have been made in Australia in the past to develop alternative futures markets including a semi-government futures contract. Suggestions that alternative instruments may be encouraged to develop if there was an absence of a CGS market is a high risk strategy with significant implications in the event of failure.

The interest rate swap market would be significantly affected by the winding down of a CGS market for reasons mentioned above. Typically the development of most derivative instruments used for financial management are based on a risk free yield curve (the CGS curve). Removal of the CGS as the risk free yield curve will hamper participants' ability to manage financial risks.

Providing a long-term Investment Vehicle

Refer to our earlier comments.

Providing a safe haven in times of Financial Volatility.

Refer to our earlier comments.

The discussion paper suggests alternative safe haven assets could include AAA rated corporate bonds, mortgage backed securities or cash and commercial banks during financial distress. There are only a handful of AAA rated corporations in the world, most of which are either banks or insurance companies. These investments will not be considered a safe haven by institutional investors. Nor would placing cash on deposit with banks be an ongoing viable alternative as a safe haven. Indeed at a time of financial crisis institutional investors would be uncomfortable with concentrating their risk in the banking system.

Options available to the Commonwealth

Option 1: Wind down the Commonwealth Securities market.

Refer to our earlier comments.

Option 2: Consolidate Commonwealth and State Government markets.

State Government heads have already rejected the possibility of consolidating debt to facilitate a larger and more liquid CGS market. It is also believed that alternative structures to develop a risk free yield curve by requesting the States' to give up some of their independence is thought to be unlikely.

Option 3: Maintain the Commonwealth Government Securities Market and fund the Commonwealth's unfunded superannuation liabilities.

Introducing a policy of funding the unfunded superannuation liability is a positive and fiscally responsible step available to the Government. The reference to dealing with governance issues associated with substantial Government asset holdings seems to be overstated in the sense that the assets would sit within the superannuation fund which would be managed by an independent board of Trustees (eg CSS/PSS), accordingly, the Trustees would manage the asset portfolio in accordance with their obligations under the Trust Deed having regard for the long term investment objectives of the fund. This structure does not impose any special obligations, or create any perceived conflicts of interest, on the part of the Government.