GLOBALISATION OF THE FINANCE AND CAPITAL MARKETS

Australian Capital Markets

WAYNE HOY

Chief Manager, Financial Markets Division
Commonwealth Bank of Australia, Sydney

INTRODUCTION

This will be a brief practitioner's overview of what is happening in the Australian capital market.

We will start by looking at the changes occurring to the domestic bond market. This is an exciting time, with positive consequences for all of us. I will endeavour to outline the future seen from practitioner level, and then look at the product changes which will have particular relevance to the legal fraternity.

THE NEW MARKET PARADIGM

We are living through an enormous secular shift in the Australian capital market. Australia is headed towards that rare sovereign condition known as low net public sector indebtedness, fuelled by privatisation and a massive shift in both the formation and location of private capital.

The Australian bond markets are changing from an industry which had been force-fed on a diet of $200 billion of government debt in the 1980s, to one which must ultimately consist of private sector Australian and foreign sovereign/agency/supranational risk. The market paradigm is undergoing a huge metamorphosis which will see institutional funds take over from banks as the biggest holders of capital, at some time around 2001.

The primary drivers of change are:

- Reductions in government debt through privatisation and fiscal austerity.
- The introduction of mandatory retirement savings.
- Australian tax and financial system reform.
- European Monetary Union.
- Commoditisation.

Government domestic debt has contracted from the $200 billion peak level to approximately $120 billion today. Privatisation and fiscal rectitude at State Government level in particular have been the causes, with Victoria leading the way.

On the demand side, Australia is the first OECD member state to legislate mandatory retirement savings. Growth in superannuation is:

- rapid for a small economy, at $65 billion per annum;
- accelerating at 20% per annum;
- forecast to lift Australia's capital markets through the $1 trillion level soon into the new millennium.

The growth in superannuation savings has the potential to completely change our market in a relatively short span. The gross daily accumulation rate of $178 million illustrates the demand and supply equation facing the market.

MAJOR TRENDS

The combination of lower government debt and high retirement savings has produced a supply gap in the Australian capital market. Asset allocations for fixed income products have fallen to historical lows at around 11%, from their more typical levels of 35% and higher, in the mid-late 1980s.

While some would argue that such a low level reflects the "rate view" of portfolio managers, the lack of tradeable debt securities is a far greater influence. The argument is further supported by the strength of the current rally taking place, with no abatement in demand for new risk. The long term historical allocation for domestic fixed income in developed markets like the US is 15% of portfolios; if we were drawing a long bow, we could use the difference between Australian and US ratios to confirm the extent of the supply gap which has emerged.

Liquidity in the market is fast evaporating. The level of bond trading in 1997 was half that of the previous year, and 1998 is half that of 1997. Movements in rates now occur largely in synthetic markets rather than physical bond trades, because the prospect of not being able to replace any physical stocks is too big a risk.

The gap in supply is widening at a rapid pace. Superannuation growth on its own requires new debt stock of $10 billion per annum. The sale proceeds of Telstra II and the New South Wales and Queensland power industry privatisations are further systemic shocks, since they have the potential to withdraw another $75 billion of tradeable debt within a relatively short time. The Commonwealth and States may soon be forced to choose between liability and asset management.

Australian portfolio managers, now being weaned off the diet of risk free investments, are passionately hugging the bond index as a hedge against sub-industry performance. Such a herd instinct has implications for pricing of credit, but more so for liquidity.

The planned removal of AIWT from corporate debt securities will add to the problem. Investment grade assets are in scarce supply in international markets; the capacity of foreign investors to drain valuable supply from this market is extremely strong.

The "leakage" of securities issues into foreign markets like the US 144A sector is already evidence of the strength of international demand for Australian risk, and if anything this appears to have strengthened in the wake of the Asian economic crises.

The probability of a supply crunch has also increased with European Monetary Union. Central banks who depended on European currencies for diversification in their reserves baskets are now looking at CAD and AUD for diversification. International portfolio managers face the same currency concentrations and may choose to act the same way.

The effect of global institutions re-weighting their portfolios to include more Australian dollars will be to extract more supply from a very scarce source.

The final trend which might be of interest is the fusion of loans, derivatives and bonds. Loans are underpinned now by default swaps, bonds underpinned by loans and derivatives embedded into both. Products are becoming commodities at a rapid clip, accelerating what history might regard as the Age of the Great Arbitrage.

CHALLENGES FOR THE AUSTRALIAN CAPITAL MARKET

There are significant challenges for our capital market:

- Finding $20 billion per annum of new supply.
- Changing primary market practices.
- Broadening the investor market.
- Streamlining the public offering process.
- Lifting the international perception of Australia.

To meet the challenges for the Australian market, practitioners have had to move well beyond the traditional government bond tender market. The legal and practical frameworks for securities issuance have adjusted quickly. Tender panel processes are not sufficiently robust for offerings of private sector risk, and issuance techniques are therefore changing to underwritten and syndicated offerings.

Similarly, portfolio management practices are having to compensate for the greater diversity of risk, but especially the increased risk.

For the Australian market to evolve in a sustainable form, we must broaden the base of investors. This means moving beyond just the issuance and trading of Excluded Securities. The DIY superannuation sector is the fastest growth sector in Australia's retirement savings industry, and is now accelerating at 37% per annum (although off a small base of $36 billion).

Commonwealth Bank is now advocating the issue of Non-Excluded Securities by private sector borrowers to provide feedstock to the non-institutional investor franchise. This must bring a glint to the eye of the legal profession, because it means filing and registration of prospectuses with the ASC, and probably listings on the ASX. To make this work, however, we need streamlined delivery times and vastly more efficient (and proprietary) registry mechanisms. Time to market is crucial for the product to become viable.

The biggest challenge of all, however, is the task of capturing supply from international markets. Australia can probably supply a maximum of approximately $10-15 billion per annum of domestic private sector debt. We need much more than that.

In 1996 CBA pioneered the Kangaroo Bond sector. Kangaroo Bonds are debt securities issued under Australian laws by foreign borrowers. The sector is crucial to the future success of our market. We have the capacity to replace Australian government debt with issues by foreign sovereigns, sovereign agencies, supranationals and investment grade private sector debt.

However, we must compete strongly in world markets to get these borrowers, and we must lift the profile of this market in order to do so.

NEW DIRECTIONS

Let us look at some of the product directions which will be of interest to you.

The shift in the Australian bond market is also very evident in the paper or short term markets. Commercial Paper outstandings have accelerated at a rate of approximately $1 billion per month at the moment, taking the market to $34 billion. The domestic issuer market is largely mature, but there is substantial capacity for foreign issuers to tap Australia's investment pool: eg National Power PLC's $500m programme, and New Zealand's ASB Bank and Countrywide Bank with $1.5 billion programmes between them.

As well as promoting Kangaroo Commercial Paper, one of the initiatives which CBA is advocating is multi issuer Commercial Paper facilities for multinational borrowers. Australia is fast becoming a regional treasury centre. The depth of its capital market means we can now offer access for regional subsidiaries to a master programme.

This may see, for example, Asian subsidiaries of borrowers issuing under a single Australian debt programme sponsored by the parent or regional treasury in Australia. This sets some interesting challenges for lawyers, because issuers prefer a single set of documents, not a series of complex bilateral programme agreements.

We expect to see in the near future the first issues of debt securities in Australia launched under borrowers' European Medium Term Note programmes, or Global Medium Term Note programmes. These will be securities issued in Australia, governed by UK, US or possibly German law. This will necessitate the drafting of Registry Services Agreements under those laws in order to make the transactions feasible. This has already been discussed with Austraclear and accepted in principle.

The drafting of financial covenants into bond documentation is also topical. Unrated issuers or lower investment grade issuers can extract better value from debt issuance by granting certain performance benchmarks which offer better investor protection than merely the comfort of Standard & Poors or Moody's ratings.

Finally, we face more interesting challenges on the topic of Kangaroo Bonds by foreign sovereigns and agencies. Questions of sovereign immunity and sovereigns submitting to the laws of Australia will be interesting, as will Australia's capacity to structure multi-currency debt issued in this jurisdiction.

Australian Capital Markets

Presentation by
Wayne Hoy
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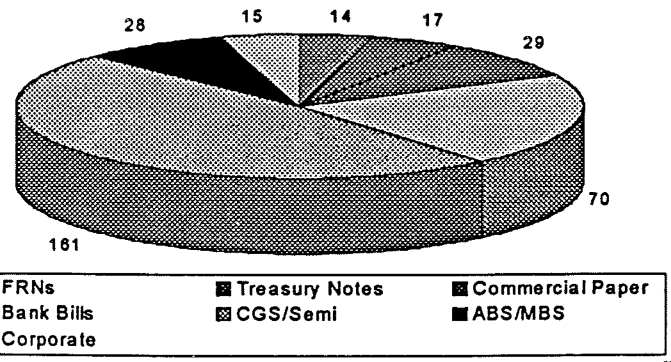
Composition of the Australian Debt Markets

Securities on Issue (A$ billion)

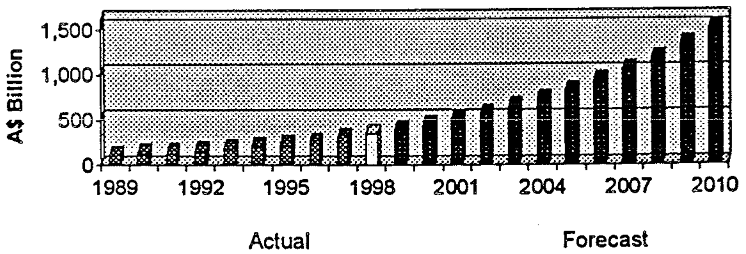


Major Trends

- Cutbacks in Government Debt
- Mandatory Superannuation
- European Moneary Union
- Australian Tax Reform
- Globalisation

Demand

Projected Growth in the Australian Superannuation Industry



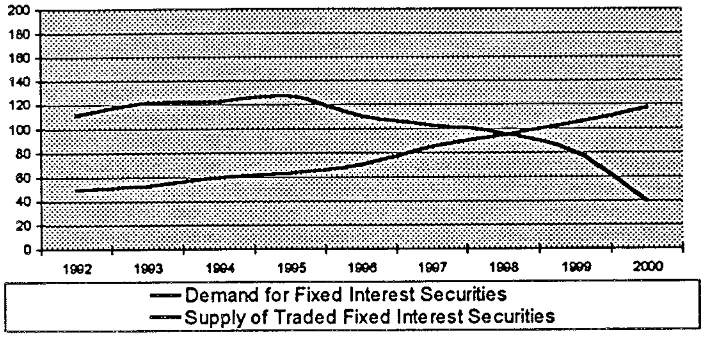
Challenges for Australian Capital Markets

- Finding $20 billion pa new bond supply
- Changing our primary market practices
- Broadening the investor market
- Simplifying the public offer process
- Lifting the international perception of Australia

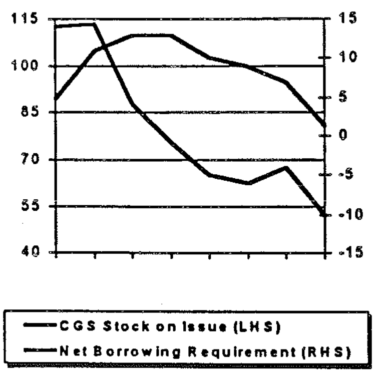
Major Product Changes

- Introduction of Registered Debt Offerings
- Movement towards multi-issuer debt programmes
- Application of international debt issuance programmes (eg EMTNs)
- Commoditisation - the Fusion of Loan Markets, Derivatives and Securities

The Emerging Gap between Demand and Supply for Fixed Interest Securities



TRENDS IN COMMONWEALTH GOVERNMENT DEBT



STATE GOVERNMENT DEBT AS A % OF GDP 1993-2000