AFMA

3 October 2008

John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

Tax Laws Amendment (2008 Measures No.5) Bill 2008 – Schedule 3

The Australian Financial Markets Association (AFMA) represents the interests of participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign banks, securities companies, state government treasury corporations, fund managers, traders and other specialised markets and industry service providers.

Schedule 3 of Tax Laws Amendment (2008 Measures No.5) Bill 2008, which the Committee is reviewing, extends the eligibility for exemption from interest withholding tax to bonds issued in Australia by state and territory central borrowing authorities ('Semi government bonds'). These measures are supported by AFMA, as we believe they are well-timed to assist debt market development, improve the efficiency of the fund raising process for states and facilitate innovation in debt security offerings to investors. We do not believe the measures have a material tax revenue effect.

While AFMA's interest is primarily in the improvement of our debt capital market, our members also have a keen commercial interest in the ongoing development of the economy and its productive capacity. In this regard, we note the states have significant infrastructure investment programs to further increase our productive capacity and economic growth. It is important that these are financed in the most efficient and least cost manner and the measures in Schedule 3 will allow for greater flexibility in funding infrastructure investment.

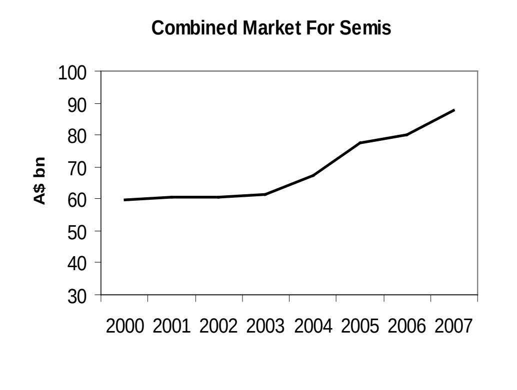
1. Tax Fragments the Market into Domestic and Foreign Segments

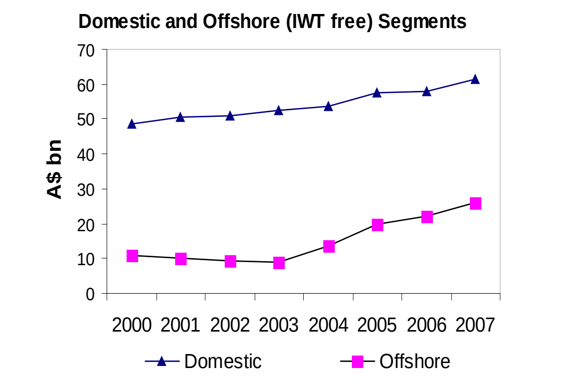
While Semi government bond issuance has expanded in recent years, most of this has taken place in offshore markets because of the interest withholding tax (IWT) disadvantage and has not contributed to the growth and development of the domestic market (see figure 1 below).

The tax law levies IWT on domestic Semi government bond issues but exempts offshore issues in recognition of the need to provide cost effective access to the full range of investors on the overseas capital markets. This arrangement has the practical effect of fragmenting the Australian dollar Semi government debt market into segments, or pools, to which withholding tax does and does not apply; ie into Domestic and Offshore segments.

Figure 1

Semi Government Bonds Outstanding – Combined Market and its Segments





Source: Derived from RBA and state treasury corporation data.

The market for Semi government bonds issued in Australia has exhibited a gradual increase in the amount on issue in recent years. State government budget projections imply solid annual growth in the stock outstanding but the actual amount issued domestically will depend upon the amount raised on the offshore market, amongst other things. AFMA survey data indicates that turnover on the market fell slightly over the period since 2000, though with some volatility in the intervening years.[1]

The Offshore Semi government bond market (ie the 'Global Exchangeable' bond market) has experienced significant growth in recent years, with the stock outstanding increasing at almost twice the rate of the domestic market in dollar terms since 2004. Global Exchangeable bonds are Australian dollar securities and have the same coupon and maturity as their domestic bond equivalents.

The IWT reform in Schedule 3 of the Bill would enable unification of the Offshore and Domestic Semi government bond market segments into a single market. This would have the effect of significantly increasing the size of the market in Australia, strengthen its presence in global bond market indices and provide a range of material benefits, as outlined below.

2. Benefit to Capital Market Development

The effect of market fragmentation caused by the different tax treatment is to create two trading segments and reduce overall liquidity. A unified market would allow state governments to issue more debt domestically and facilitate a range of improvements to lift the technical efficiency of the market:

- Investor access would be enhanced, as offshore investors could tap into the liquidity of the domestic market and Australian investors would have a larger market in which to invest;
- A wider range of benchmark stocks could be issued to smooth and balance market depth across the yield curve;
- Innovation and funding diversification would be easier in a larger market; for example, extending funding maturities and enabling greater use of CPI-indexed securities would be helpful in the context of funding infrastructure projects with revenue streams linked to inflation;

[1] The turnover data reported for Semi government bonds are predominantly domestic bond transactions but includes transactions in Global Exchangeable issues too.

- Bringing the Global Exchangeable bond programs 'onshore' would provide the State governments and Australia with a higher weighting in the widely used UBS global index;[2] increasing the international profile of the market and its potential to attract investment funds. This would also enhance Australia's standing as an international financial centre.

The value of these technical improvements to the market's operation is important from a financial system efficiency perspective. Relevant benefits include:

- Superannuation fund investors would have access to a deeper, low risk fixed interest market (notwithstanding greater foreign interest in the Domestic semi government bond market);
- A deeper domestic market would also assist the Reserve Bank to implement its monetary policy by increasing the amount of securities for its market operations;
- The enhanced capacity of financial markets to efficiently manage financial system disruption, given the high credit standing of Semis as government bonds and their value as a safe haven investment, assists stability.

The state treasury corporations have identified a number of market management improvements that would flow from the consolidation of the Semi government market. For example, the administrative burden of maintaining two markets would be eliminated and managing variations in funding needs would be easier in a larger market with a domestic focus.

Schedule 3 of the Bill would also mean that State government borrowing authorities could compete effectively with corporate, Kangaroo and institutional issuers on the domestic market, as the latter already have the ability to issue bonds free of IWT whereas investors in Semi government bonds are subject to IWT. For instance, a foreign government corporation can issue Kangaroo bonds in Australia that are free of IWT to non-resident investors, whereas state treasury corporations' IWT free bonds are constrained to the smaller Australian dollar offshore market.

3. Concluding Comments

The potential to promote further development of the domestic debt market is an important reason to implement the measures contained in Schedule 3 of the Bill. The proposed exemption would also provide more effective and efficient funding arrangements for the States to assist with infrastructure development, amongst other things.

We appreciate the opportunity to make a submission to the Committee's Inquiry. Please contact me if you require further information.

Yours sincerely

David Lynch

David Lynch
Head of Policy and Markets

[2] Global Exchangeable bonds are considered to be English rather than Australian domiciled bonds and, as such, they are not included in the UBS Bond Index.