Senate Standing Committee on Economics
Inquiry into Tax Laws Amendment (2008 Measures No. 5) Bill
Submission by New South Wales Treasury Corporation

Executive Summary

The Impact of Interest Withholding Tax (IWT) on Semi Government Bonds

The Australian states are on the cusp of the largest public borrowing program since the 1980s. The program's ambition is to finance major infrastructure projects that will boost Australia's long-term productivity growth and export capacity for decades to come.

Semi government bond markets will become steadily more important in Australia's financial system. The Commonwealth IWT on domestic issuance by the State governments has become a significant constraint to the evolution toward a more sophisticated financial system.

The Commonwealth IWT on domestic semi government bonds is counterproductive to the development of an improved financial system and access to international sources of funds:

- It fragments the semi government bond market.
- It reduces liquidity in semi government bonds.
- It raises the cost of borrowing by Australian State governments.
- It creates inefficiencies in financial markets that raise the total cost of capital in Australia.
- It discourages international bond investors from allocating money to Australia.
- It raises almost no revenue for the Commonwealth.

Impact of the Abolition of IWT on Semi Government Bonds

Overall, we consider the abolition of the Commonwealth IWT on semi-government bonds would have the following impact:

- The increased supply of domestic NSW Treasury Corporation (TCorp) and Queensland Treasury Corporation (QTC) bonds would alleviate some of the pressure currently being applied on the Commonwealth to maintain and over time further increase Commonwealth Government Securities (CGS) issuance.
- Australia would benefit materially, because it would lower the cost of financing the infrastructure projects that are being planned. It would also enable the State central borrowing authorities to better tailor innovative financial solutions to their client agencies.
- Overwhelmingly the largest benefit would be derived from the efficiency gains that flow to Australian financial markets from having a deeper, more liquid and better functioning bond market. Removing IWT from semi-government bonds has the potential to lower borrowing costs for *all* bond issuers, including the Commonwealth. These conclusions are consistent with the findings of the "Review of the CGS Market" conducted by the Commonwealth Treasury in 2003-04.
- Maintaining the IWT on CGS protects the Commonwealth's revenue position. More importantly, it maintains the existing liquidity pool of bonds necessary for the smooth

operation of the SFE futures market. (The CGS pool is already quite scarce, having declined below 5% of GDP and 5% of funds under management).

Background Information

1. Evolution of the Semi Government Bond Market

The semi government bond market has altered radically over the past 10 years, in much the same fashion as the Commonwealth Government Securities market.

In response to strong offshore demand, the two largest semi government issuers, Queensland and New South Wales, experienced a large rise in their IWT-exempt Global Exchangeable bond programs. Global Exchangeable bonds have the same coupon and maturity as their Domestic benchmark bond equivalents, but compete head-on with "Kangaroo" issues (A$ debt issues by non-Australian issuers) for international investors by being IWT-exempt.

Between them, Queensland and New South Wales have over $29bn of Global Exchangeable bonds on issue, and A$38bn of Domestic bonds outstanding.

30 June 2008 A$bn	Domestic bonds (IWT-liable)	Global bonds (IWT-exempt)	Total benchmark bonds outstanding	2008-09 issuance (est.)
New South Wales	14.4	14.8	29.2	4.9
Victoria	11.3	-	11.3	4.4
Queensland	24.3	14.4	38.7	16.3
South Australia	3.4	-	3.4	1.2
Western Australia	9.9	-	9.9	7.4
Tasmania	2.4	-	2.4	-
Total Semi Govt	**65.7**	**29.2**	**94.9**	**34.1**
Commonwealth	49.3	-	49.3	10
Corporate	-	77.9	77.9	10
Kangaroo	-	47.5	47.5	15

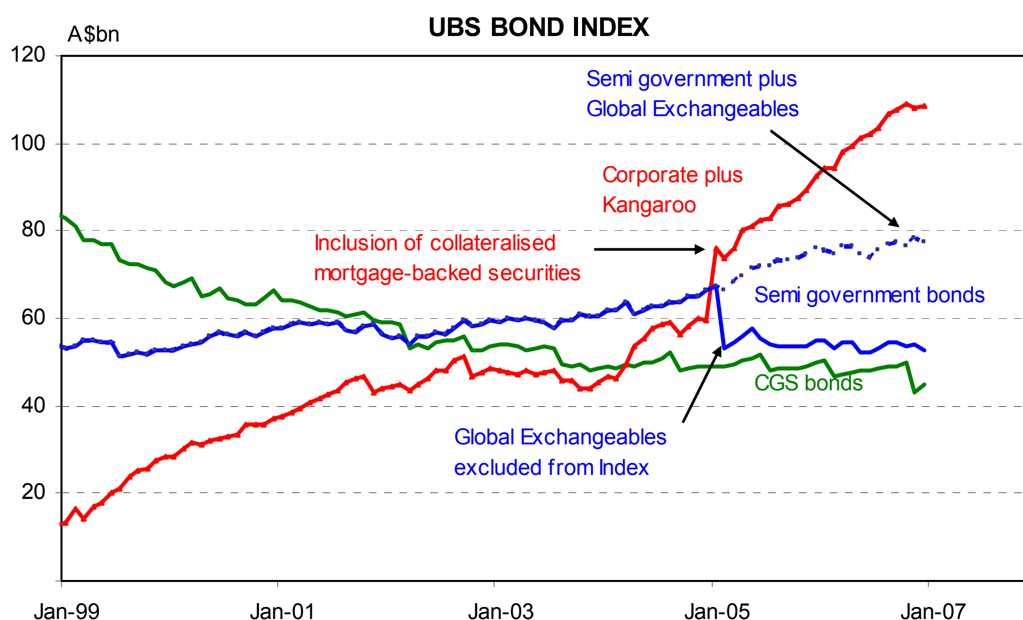
2. IWT on Australian Bonds

Prior to 1999, IWT applied equally to semi-government and corporate borrowers. The regime only granted an IWT concession for publicly offered bonds that were issued offshore. In 1999, the recommendations of the Ralph Review were implemented, which saw the IWT concession for corporate borrowers extended to include domestic issuance. The States were expressly excluded

from this, and continued to operate under the old domestic/offshore distinction. Consequently the States have been significantly disadvantaged relatively to corporate and other wholesale borrowers. The IWT on semi-government domestic bonds raises the cost of capital to the State borrowers, while providing the Commonwealth with negligible tax revenue.

There are several ways in which IWT significantly restricts States' funding flexibility:

- By splitting the benchmark bond program between Domestic and Global Exchangeable bonds, the IWT restricts investor demand. Offshore investors do not have access to the liquidity of the Domestic program, and domestic investors do not have access to offshore demand in the Global Exchangeable program.
- The widely-used UBS Bond Index specifically excludes the $25bn of Global bonds from the semi government and Australian bond indexes as they are not subject to Australian law. By giving semi government and Australian bonds a smaller weight in the global index, international investors can more readily ignore Australian fixed income investment (Kangaroo and Corporate bonds are also IWT-exempt, but are included in the UBS Bond Index, thus creating an anomaly in the market.)



- By splitting the benchmark bond program between domestic and Global bonds, the IWT inhibits the development of more sophisticated tailored financial solutions for the semi-government borrowers' government agency clients. Each of the domestic and Global bond lines has to be maintained with adequate issuance independently.
    - If they were consolidated in an IWT-exempt environment, the States could diversify borrowings, for example by directing more borrowings toward CPI-linked securities that have particularly desirable features for utility Public Trading Enterprise clients.
    - In an IWT-exempt environment, the States could potentially offer a larger number of benchmark bonds, rather than the 4 or 5 benchmark bonds on issue at any one time by TCorp and QTC. States would be better able to smooth the liability portfolio across the maturity spectrum.

    - Consolidation of Domestic and Global Exchangeable bond markets would give the States better flexibility to issue very-long nominal and indexed bonds. Currently, the constraint of maintaining the dual bond lines means that very little is issued beyond 10 or 11 year maturities.

- By splitting the benchmark bond program between Domestic and Global Exchangeable bonds, the IWT operates as a deadweight administrative burden on the States.
- Whilst not a significant commercial risk, the notion of NSW having over one-third of its liabilities subject to English Law and being administered and maintained in an offshore jurisdiction outside of the Australian clearing and settlements system at best is inconsistent with the notion of developing a strong and vibrant infrastructure around the Australian bond market.
- Currently, if States were required to buy back issued debt (related to a funding windfall or privatisation for instance), from a liquidity perspective it would only be feasible in the Domestic bond lines. In an IWT-exempt environment, the States would be better able to access liquidity from the combined pool.

3. Competition for the Semi Government Bond Market

The State government issuers do not try to compete with Commonwealth Government Bonds. The CGS hold a unique position, due to holding Sovereign status and being institutionally embedded in the SFE interest rate futures contracts. The challenge for the State government issuers is to compete on equal footing with other similar credits in the marketplace, which is hampered as follows:

- The semi government Domestic bonds are disadvantaged relative to the Corporate and Kangaroo bond markets because Corporate and Kangaroo bonds are not subject to IWT.
- The semi government Global Exchangeable bonds are disadvantaged relative to Corporate and Kangaroo issuers because the Global Exchangeable bonds are considered English rather than Australian-domiciled bonds. As such, they are not included in the UBS Bond Index.
- Public-Private Partnership (PPP) participants and other offshore issuers are beginning to consider issuing debt in Australia, securitising Australian public utilities. While this is a welcome development if it lowers the cost of finance, part of the PPP competitive advantage is based on their exemption from IWT. That is, PPP and offshore issuers can replace the State central borrowing authorities, and issue IWT-debt that the States cannot do themselves. That debt would not only be IWT-free, it would be included in the UBS Index. As such, these issuers can take advantage of the current arrangements by knowing that central borrowing authorities do not compete on a level playing field. The recent example is Reliance Rail which has the concession to design, construct, deliver and maintain trains for the public rail service in New South Wales. This was funded through IWT-exempt credit-wrapped AAA-rated bonds, benefiting nevertheless from the underlying credit quality of the NSW government rail operator, RailCorp.

4. Advancing Australian Financial Market Efficiency

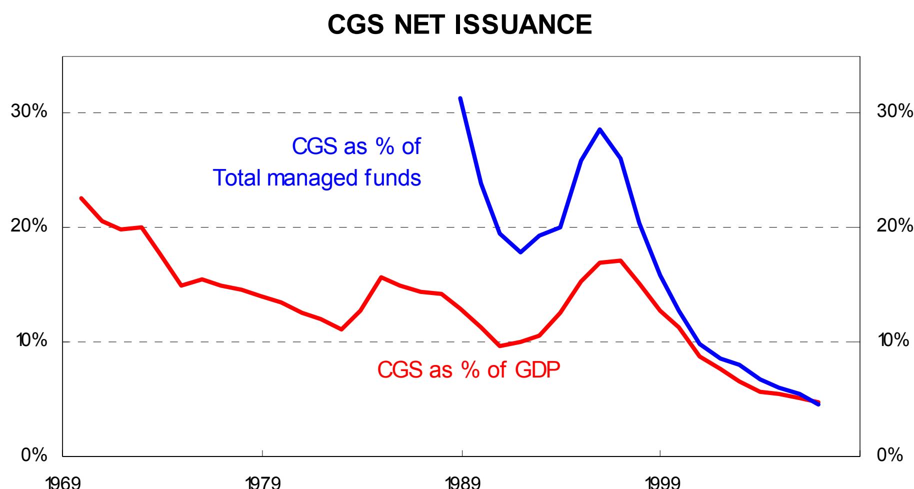
Demand is expanding rapidly for benchmark government bonds from offshore (IWT-exempt) official holders (typically Asian and Middle-Eastern central banks) and to support the burgeoning swap

market. Diminishing outstanding bond issuance has deprived traditional superannuation funds and other investors of the opportunity to hold government bonds.

In 2002-03, the Federal Government considered the future of the CGS market in consultation with key stakeholders. Following the public review, the Government decided to maintain the CGS market. The arguments that were accepted centred on recognising the CGS market as a cornerstone in Australia's financial market efficiency. All the reasons for maintaining the CGS market outlined in that document are directly relevant to the argument for removing IWT on semi bonds:

- Allows for financial innovation in the absence of a deep and liquid CGS market.
- Allows Australian financial markets to manage and diversify interest rate risk, particularly during times of greatest instability and financial breakdown, contributing to a lower cost of capital in Australia.
- Encourages offshore investment into Australia by increasing the capitalisation of AUD in the UBS bond index (by properly counting A$25bn of Global bonds as Australian issues rather than English issues).
- Lowers the cost of capital generally, both for State issuers and the economy more generally.
- Advances Australia's claim as a leading global financial centre.

As recently as the late-1980s, the CGS market was one third of the size of the Australian managed funds industry, including life offices and cash management trust accounts. The fall in CGS bonds and rise of the managed funds industry has seen that proportion fall to less than one twentieth.



5. Estimating IWT revenue from semi government bonds

In 1998 the Commonwealth considered proposals to abolish IWT on both CGS and semi government bonds. The submission to the Commonwealth estimated that IWT revenue collected from CGS and Semi government bonds was 'anywhere between $60m and $150m'. Of that, only $36m was estimated to have been derived from semi government bonds.

Issuer	Bonds on Issue	Average Coupon	% Held by Offshore Investors paying IWT	IWT Revenue
CGS	$75b	7.5%	20%	$112.5m
Semis	$48b	7.5%	10%	$36.0m
	$123b			$148.5m

There are several factors that have caused IWT receipts on semi government bonds to decrease to negligible levels since 1998:

- International investors have more ready access to the IWT-exempt Global Exchangeable bond equivalents issued by Queensland and New South Wales. Outstanding issuance of both TCorp and QTC Global Exchangeables has increased significantly over the period since 1998 (NSWTC from $3.5bn to $13.0bn, QTC from $6.2bn to $11.3bn).

- International investors who hold Domestic bonds readily undertake a "coupon-wash" to avoid paying IWT. As dealing margins narrow, it makes this activity easier than ever.

- The average coupon yield on Domestic bonds has fallen significantly, from 7.5% in 1998 to around 6.25% currently.

TCorp has conducted a review of IWT revenue from semi government bonds, based on discussions with nominee custodians. The update revises estimates of domestic issuance, offshore ownership, and IWT collection rates. Around 35% of Domestic bonds are held in nominee custodial accounts. Those custodians have given detailed accounts of holdings by offshore accounts, with just 10-15% of their holdings on behalf of offshore entities. Further, the IWT capture-rate of those offshore holders was observed by one custodian at just 15%. Explaining the low capture rate, some may be explained by Offshore Official Holders being IWT-exempt. The rest is probably due to the common practice of "coupon-washing".

Collectively the IWT revenue from semi government bond markets is estimated at just $2-3 million. Falling coupon rates and a dramatic fall in bonds subject to IWT have caused estimated IWT revenues to fall. The biggest change has been the substitution of Domestic bonds for the IWT-free Global Exchangeable equivalent bonds.

Issuer	Total Benchmark Domestic Bond Outstandings	Estimated Nominee Company Holdings		Estimated Offshore Holders	Face Value of Offshore Holdings	Average Coupon	IWT collected on 100%	IWT collected on 15%
		Ratio	Amount					
TCorp	11,507	35%	4,027	15%	604	6.40%	3.9	0.6
QTC	17,280	35%	6,048	15%	907	6.21%	5.6	0.8
TCV	10,341	35%	3,619	15%	543	6.50%	3.5	0.5
TasCorp	2,151	35%	753	10%	75	6.25%	0.5	0.1
SAFA	6,836	35%	2,393	10%	239	6.41%	1.5	0.2
WATC	7,256	35%	2,540	10%	254	7.25%	1.8	0.3
NTCorp	1,213	35%	425	0%	0	6.06%	0.0	0.0
Total	**56,584**		**19,804**				**16.9**	**2.5**

No change is proposed for the application of IWT to the CGS bond market. Maintaining CGS in the IWT base preserves the existing revenue base of the IWT. Further, it avoids the potential negative impact of foreign demand for CGS bonds from offshore investors that may further restrict liquidity. This preservation of domestic liquidity is a desirable outcome for the operation of the SFE Australian Bond Futures market.

6. Conclusion: Impact of the Abolition of IWT on Semi Government Bonds

Overall, abolition of the Commonwealth IWT on Semi government bonds would have the following impact:

- The reform would have a negligible negative consequence for the Commonwealth's revenue position.
- The increased supply of Domestic TCorp and QTC bonds would alleviate some of the pressure currently being applied on the Commonwealth to maintain or increase CGS issuance.
- Australia would benefit materially, because it would lower the cost of financing the infrastructure projects that are being planned. It would also enable the State treasuries to better tailor innovative financial solutions to client Public Trading Enterprises.
- Overwhelmingly the largest benefit would derive from efficiency gains that flow to Australian financial markets with a deeper, more liquid and better functioning bond market. That in turn lowers interest rate costs for all Australian borrowers. Importantly, it provides a level playing field for the States and similar credits (e.g. supranationals) who are regular issuers in the A$ bond market.