HOW WILL THE SEMI AND LOCAL AUTHORITIES FUND THEMSELVES IN THE 1980's?

Paper Presented by

J.T. Dominguez

Senior Partner, Dominguez & Barry Partners,
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INTRODUCTION

The subject of the semi-governments and their funding in the 1980's is a topic which is of great relevance to us as underwriters and providers of semi funds. It is also today a subject of equal relevance for politicians. They are only now recognising the need to allow the government owned suppliers of electricity and water to set adequate tariffs and other charges for their services in order to be solvent. I believe that the 1980's will be the decade with the semi-governments become accountable.

Much has been written on the growth of public sector borrowings. Johannes Juttner of Macquarie University in a most erudite paper delivered to the ANZAAS Conference here in Sydney in May demonstrated that, expressed as a percentage of G.D.P., total public debt has declined from just on 97 per cent in 1950 to a current 35 per cent, virtually steady over the last five or six years. This relative decline in public debt needs to be interpreted very carefully. It does not mean that the appetite for funds of the public sector has diminished. Nor does it mean that the incursion of the public sector borrower has not had a crowding out effect as far as the private sector is concerned. That a BHP and CSR debenture borrower would have to pay an interest rate today something towards 18 per cent is a direct result of the pressing demands of the semi-government borrower. Therefore the relative decline in public debt during the 1970's is not an indicator of reduced demand for funds.

What are the factors that led to this relative decline in the market for Government securities in the face of a strong increase in demand by the Government issuer? The answers to this question are pointers to the real problems faced by the debt market, and particularly by the semis, in the 1980's. These include a shrinking captive market even pre-Campbell, and the emergence for investors of a wide range of more competitive investment alternatives such as deposits with building societies, credit unions and merchant banks, bank bills and in today's liberated atmosphere even bank CD's. Our generous non-means tested social security system must also have reduced the incentive for many to invest in government securities to meet their retirement. In addition, Professor Juttner points to high and volatile inflation rates (and corresponding interest rates), a philosophy of smaller government and particularly in recent times under the tap system, an inadequate and inflexible system of pricing and selling government securities as all contributing to the decline in the relative size of public debt.

The particular plight of the semis was highlighted by John McAuley, Chief Economist State Bank of N.S.W., in another interesting paper on Public Indebtedness to the same ANZAAS Conference. I command both Professor Juttner's and Mr. McAuley's papers to all those interested in this subject. Mr. McAuley showed that new issues of semis and locals over the last decade as a proportion of total securities issued, increased by almost 50 per cent that is from 17 per cent to 24 per cent. This is further demonstrated by the following table which shows the degree to which the increase in the semis' appetite for funds is consistently far outstripping that of the Commonwealth.

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TABLE 1
PUBLIC DEBT ON ISSUE

	Commonwealth Securities		Semis & Local Securities	
As at June 30	Amount $m	Increase over preceding year Per cent	Amount $m	Increase over preceding year Per cent
1966	9,134	5.0	3,672	7.5
1973	13,479	7.0	6,454	9.2
1977	21,420	12.7	10,121	17.9
1978	23,287	8.7	11,701	15.6
1979	25,752	10.6	13,689	17.0
1980	27,250	5.8	16,154	18.0
1981	27,820	2.1	18,619	15.3

Source: Reserve Bank Statistical Bulletin and Financial Supplement March 1981 et al.

Given a continuation of the above growth in the semis' demand for funds, how will it be satisfied in the 80's? In answering this, we must remember that the amount of maturing debt over the next few years is in itself mounting. I estimate that some 90 per cent of all public semi Loan Council borrowings in the last few years were in the shortest possible term, that of four years. This has lead to the following maturity pattern:

TABLE 2
ESTIMATED MATURING SEMI & LOCAL GOVERNMENT DEBT

Year Ending June 30	$ Millions
1982	561
1983	971
1984	1,300
1985	1,410

The figures given can only be estimates, based largely on our records of maturing debt and on the maturity patterns established for major borrowings over recent years. It is disappointing that Loan Council does not yet have any published statistics on this subject.

The enormity of the refinancing problem can be gauged from the fact that the total increase in securities officially issued in the last full financial year was only $2,465 million.

Consequently, any discussion on the funding problems of the public sector in the 80's will miss the point if it fails to acknowledge the presence of the mountain of maturing debt which must be renegotiated within the next few years. The problem of the shortening maturity structure is graphically demonstrated by the actual statistics which relate to Commonwealth Loan — from a 1970's high of 137 months to a December 1981 low of 61 months. A similar pattern would be evident for the semis. For too long the semi authorities have had little option but to accept whatever money that was available, even if it was all in the four year term. This has had the effect of aggravating what was already a difficult situation since the challenges of meeting the need for new funds is daunting enough on its own without the refinancing problems on top.

Every nerve and sinew of the semi-government sector in the 1980's therefore must be strained towards implementing arrangements whereby investors can be persuaded to invest for a longer term than the four year minimum, preferably out to ten years or longer. This will not be easy bearing in mind the terrible battering that ever-rising interest rates have inflicted on all fixed interest investors in the last few decades, particularly in the last couple of years. The scars from the most recent round of interest rate increases, over the last month or two, will not yet have healed. Consequently, the challenges in this environment of getting investors to go longer must not be under-rated.

The next few years will certainly not be the time for semi borrowers to start finessing by rejecting offers of longer-term funds on the grounds that interest rates may have peaked.

In the limited time for me to speak, it would be tempting for me to talk about the broad range of borrowing options available for the semis in the 80's. Important areas such as floating rate securities and terms of less than four years will not be canvassed. Nor the matter of breaking the nexus between Commonwealth and semi-government interest rates. This is not to suggest these areas are unimportant.

I am sure you will understand if I quickly skirt the subject of public loans vis-a-vis private loans. As a percentage of the approved Loan Council programmes, public loans in the last decade have risen from 15 per cent to 45 per cent with private loans a fast-shrinking 55 per cent. For most of the larger semi authorities, the amount of private loan funding is down to 20 to 30 per cent, a decline helped incidentally by the enormous gap which too often these days seems to exist between market rates and official rates.

The existence of this gap owes much to the disastrous tap system, a disaster which looks like being repeated in any switch to a tender system unless we can keep the politicians at bay.

I see public loans at least retaining their relative importance vis-a-vis private loans in the 80's due partly to the degree to which the institutional investor can at least obtain a return which is more sensitive to market levels than that available from private loans.

In any event, I would see the semis in the 80's funding an increasing portion of their needs by way of public rather than private loans. This is due not just to the greater rate sensitivity already mentioned. It is also due to the public loan rates which the semi authorities are paying today which are increasingly competitive in the market for household funds. Other borrowers in that market such as building societies and finance companies already feeling the effect of the cash management funds should prepare themselves for much stronger competition in terms of relative interest rates and otherwise from the semis in the 80's. this is not to suggest that the cash management funds will not at times present a challenge for semi-government public loans.

This expected higher public profile for semi borrowers reflects in part their realisation that conditions for them in the institutional market can only deteriorate. In the past, the 'captive' market was able to largely satisfy the needs of the semi and local government borrowers. Today, however, the increasing demands of this sector have significantly outstripped the diminishing supply of funds available from traditional sources such as 30:20 investors and savings banks. The following table shows that 30:20 support for the semis and locals is becoming increasingly insignificant. The figures for the semi-governments incidentally are considerably understated in that they ignore areas like promissory notes.

TABLE 3
SEMI-GOVERNMENTS AND THE VOLUME OF 30:20 FUNDS AVAILABLE
$M

Year Ended June 30	Approved Borrowings of Semis & Local Authorities	Increase in Assets of 30:20 Investors (Life offices, pension funds etc.)	Notional Amount of (2) Available for Semis and Locals (10%)
1978	1,843	2,437	244
1979	2,154	2,447	245
1980	2,481	2,936	294
1981	2,781	3,707	371

Source: — Commonwealth Budget Paper No. 7 — Various Issues
— Reserve Bank of Australia Bulletin Supplement — Financial Flows 1982

The immediate future prospects for funds from the 30:20 area is clouded while the Campbell Committee recommendations are deliberated on. The axe seems about to fall on funds for semis from the savings bank area, once a vital source of semi funds — the 1976 savings bank share of total semi and local government outstandings of 45 per cent had dropped to 33 per cent last year. Now following the changes proposed in the last month or so in savings bank regulations, those banks would be totally freed of any obligation whatsoever to support semi and local government securities in the future.

It is helpful to see the correlation between the cold official statistics in Table 3 and the experiences of Dominguez & Barry Partners operating as a semi-government underwriter, very much in the market-place. The following figures relate to the last financial year and show equally conclusively that 30:20 support is no longer fundamental for public sector funding.

TABLE 4
TRENDS IN SELECTED ISSUES 1980-81

Authority	MWSDB	SEC WA	ECNSW	MMBW	SEC WA	TELECOM
Loan Size	$45m	$26m	$165m	$50m	$17.3m	$97.6m
Date	Aug '80	Aug '80	Sept '80	Feb '81	Feb '81	Feb '81
Classification of Subscribers						
	%	%	%	%	%	%
Public	87.1	22.0	19.5	41.4	38.9	82.7
Captive 30:20	—	9.9	18.4	33.4	39.6	6.0
Other Institutions	12.9	68.1	62.1	25.2	21.5	11.3
	100.0	100.0	100.0	100.0	100.0	100.0

Source: Dominguez & Barry Partners Underwriting Department

Apart from the increase in reliance on public loans which I have already mentioned, I see the semi system in the absence of any official response increasing its dependence on avenues of fund raising outside of the present purview of Loan Council. These include the short term promissory note area. I estimate that about $1,100 million in short-dated promissory notes will be raised by semi-government authorities in 1982-83 which compares with $700m in the year just finishing and only $400m last year. I see promissory note raisings representing about 26 per cent of total semi-government authority raising next year estimated at $4,169m. The balance is likely to be split up as to $2,169m in Loan Council normal programmes (steady on last year), and $900m in approved infrastructure loans of which $600m could, with the Treasurer's approval, be raised offshore. In addition of course, there are maturing loans to be refinanced.

Let me sound a note of warning concerning these intensifying assaults on the market by the semi-government promissory note issues.

There is no doubt that increasingly as a hard core of promissory notes builds up, such funding will be used not just for working capital purposes. As a result a real dependence could build up to the point that it may be difficult for some semi-authorities to cope if the short-term market where the notes are sold suddenly dried up. A government backing is really no substitute, as far as the borrower is concerned, for adequate formal standby facilities. But how many issuers of such paper have such facilities?

There is another area of concern for the market in the proliferation of this short paper. Obviously if an investor is seriously concerned about the prospects of a rise in interest rates, he will not invest long. But there is no doubt that the ready availability of 30:20 ranking promissory notes is significantly eroding the market of support for semi-government programmes in the longer term area. Rumours currently circulating have it that promissory notes in the future may no longer enjoy 30:20 status. To the extent that this refocusses longer-term investors' attention in the four year and beyond area, it must be regarded as a very desirable move. However, this is obviously a controversial subject. Many think that since 30:20 support for public sector borrowers is increasingly irrelevant, its removal from the short-term market is a measure of realism. I agree.

Obviously, the area of 'off balance sheet' financing is also going to continue to develop in the same way as promissory note funding if only because it has not to date been drawn under the direct control of Loan Council. While precise official figures do not seem to be available, I understand that the increase in leasing transactions of various types has been from $100m in 1978-79 to a reported current total of around $5,000m including $1,453m in the 15 year take or pay arrangement for the Eraring Power Station. Not that the Federal Treasury is standing by casually watching the growth of these leasing outstandings. Telecom was refused permission to enter into leverage leasing on the grounds that it wasn't appropriate for a non-taxpaying Federal authority to enter a financial lease which would give the equity participants taxation benefits. However, it seems as though such a lease would not have incurred the displeasure of the gods if there had not been certain tax-saving aspects involved — in other words, Telecom was knocked back for fiscal and not Loan Council reasons. The size of the Eraring power deal led the Commonwealth to slow down the rush of the State authorities into leverage leasing by the rule of December 18, 1981 which put more teeth into legislation which was already in existence to prevent non-taxable State authorities from passing on the investment allowance. However, depreciation provisions still seem available for this use.

Infrastructure financing once loomed high on the semi-government budgets. At the height of the 'resources boom' infrasture spending was scheduled to increase, with what many State authorities then believed was the very positive encouragement of Federal Cabinet, from $1,123m for the two years to June 1980 to $8,355m in 1990 (measured in 1980 dollars). Of this total, 73 per cent was to be committed to electricity generation — ah well, alas poor Yorick...

However, any discussion of infrastructure spending — and the definition of some seems to be viewed very flexibly in some States — invariably raises the issue of offshore borrowing. The reluctance of Canberra to share the overseas capital markets with State authorities is well known and I don't propose to stir up that ants' nest.

However, there is no doubt that the present restricted access which the semi bodies have to overseas loan sources has the effect of exposing them to a currency exposure which particularly where it is longer term is almost impossible to be hedged. But it is possible for our semi borrowers to have access to one area of the offshore loan market where there is no foreign exchange loss potential. I refer to overseas borrowings in Australian dollars.

Unfortunately, a large portion of the potential overseas lenders is prohibited under present Australian exchange control regulations from providing Australian dollar denominated loan funds. The lenders shut out of this market include all foreign government and commercial (trading) banks.

As a result, the semi-governments are forced to take funds, in some cases from the same lenders, in a foreign currency which results in most cases in a most undesirable foreign exchange exposure. And if that risk is not bad enough, most foreign borrowings today involve floating interest rates. We have found, particularly over the last twelve months, that interest rate exposures could be almost as devastating as currency exposures.

Some authorities will seek to immunise currency exposure by drawing down funds in loans with a multi-currency option or with funds being taken in a basket of currencies hopefully matching as best as possible the Government's trade weighted basket of currencies. The clumsiness and administrative effort involved here are obvious. I wonder sometimes whether the zeal of the Government to protect the Australian dollar in this way from the alleged evils of the international currency market is justified. I also query whether Government policy in this area is very effective. Compelling our borrowers to saddle themselves with a foreign exchange risk is hardly going to do very much to prevent speculation against the Australian dollar. With combined foreign transactions (imports and exports) plus invisibles in the vicinity of an annual figure of $A46 billion, the scope for daily speculation against the Australian dollar merely by retarding or accelerating overseas currency transactions by a few weeks is enormous. When we compare the scope for speculation in the trade area against the speculation potential in foreign investment in Australian dollar securities, it is difficult to comprehend our Government's stance in substantially blocking the latter.

There is another reason why our authorities are off-beam in banning selectively foreign investment in our local fixed interest securities. Let us assume that having invested in say Commonwealth Loans one of these dreaded 'foreign devils', for currency reasons or otherwise, decided subsequently to withdraw his funds from Australia. Totally absent is the possibility of a sudden and substantial destabilising capital outflow. Why? Before any funds can be withdrawn, the investor has to run the gauntlet of our secondary market. Obviously the volume of stock that can be sold in the market at any one moment of time is finite, particularly if we are talking about medium to long-term securities.

One material source of finance for the State-controlled borrowers in the 1980's will be from internally generated profits. During the seventies, most State Governments took what seemed the soft option — they kept tariffs excessively low and financed the bulk of the capital expenditure programs by external borrowing. Well, it didn't take too long before the chickens came home to roost. As the earlier table demonstrated it has been the semi and local government borrowers which have set the pace, not the Commonwealth as far as increased demand for loan funds. In a dwindling market, a direct effect of the semi pressures has been an increase in interest rates. But ironically it has been certain State Governments which at Loan Council level have been the most strident in denouncing every official interest rate increase.

I think the lessons have now been learnt and we will see in the 1980's the users rather than the lenders funding the expansion of the public utilities. Around Australia we can expect to see a sustained rate of increase in tariffs. Since September last year, though domestic rates have been held down artificially to a modest rate of increase of 18 per cent p.a., industrial rates in N.S.W. have risen by 32 per cent. In Victoria, in the last financial year, domestic tariffs were up 34.4 per cent (industrial rates were up higher) and there are reports of a further rise of 26 per cent. In Queensland an average increase of 20 per cent will apply from July.

The trend towards greater self funding by the semis must be welcomed by all fixed interest investors although the effects on the industrial users of electricity must be rather calamitous.

During this address I have used 'semi-government' loosely and my references have generally embraced both semi and local government borrowers. Let me pause for a moment, specifically on the subject of the local governments and their funding in the 1980's. For an institutional investor conscious of the need for secondary market negotiability, the local government security is severely defective. In most cases it is barely transferable at all, there are onerous transfer duties and no transfer marking facilities. In addition some State Treasuries (not Queensland) short-sightedly withhold their Government guarantee. The effect of all this has been that the local government borrower, unable to offer any interest rate advantage under present Loan Council policy, experiences great difficulty in completing its annual borrowing program. These problems can be expected to increase now that it seems that the savings banks, probably the last of the major local government supporters, will no longer be required to provide any support whatsover for the semi and local government sectors. Mind you, the absence of a Government guarantee may be a very tacit recognition by the Treasuries of the need for government borrowers to present credentials which are adequate for the capital market generally, not just for the captive market.

One solution to the local government problem would be to permit a marginally higher interest rate, particularly for the smaller borrowers. Telecom admittedly in the public loan area has proved that it is possible to fine tune interest rates without affecting support.

Another solution which was recommended by the Campbell Committee and is likely to be implemented soon in at least one State, is to enable the smaller authorities to borrow in a pool under the aegis of State Central Borrowing Authorities.

Finally, looking to the 1980's the likely effects of the Campbell Committee's findings re public sector borrowings are worth mentioning. Consistent with the general theme of deregulation, Campbell urged that the more commercial authorities be made more accountable, to stand on their own merits, without Government guarantees, trustee status or 30:20 ranking. Such a recommendation to the extent that it takes authorities out of Loan Council control will be treated with some distrust by the State Governments who may view it as a potential erosion of their powers. But it certainly makes sense to have the authorities more open to the same market disciplines as all those non-government borrowers who have been subject to a crowding out by the up-to-now much cossetted public sector borrower. Forgetting the formidable difficulties in determining when a public authority should be commercial or not, the Campbell recommendations are a timely warning to the semi-government system and to the politicians. The sheer bulk of the semi-government paper being placed on the market in itself and even without any Campbell implementation makes these authorities more exposed to market disciplines. And this must be one of the main messages that I would like my paper to telegraph, the need for greater accountability.

Any exposure to market forces will not be either effective or practicable if the existing Loan Council limitations prevail, particularly in respect of public underwriting of issues. Most would concede that the underwriting of semi-government loans in Australia is extremely competitive — some would say excessively so. Accordingly the issuers are assured that their funds are raised as cheaply as possible. This competition between underwriters accordingly makes the present Loan Council interest rate and commission ceilings at best unnecessary. It was these ceilings that caused four prospective semi-government underwritings to abort in the last six months: the maximum underwriting offer in each case was still below the minimum required to make a loan possible. If there had to be any ceiling, it would best expressed in terms of amount. This in normal circumstances would certainly ensure that interest rates were contained. I think my point concerning the validity of certain of the Loan Council ceilings is made by the fact that most of those borrowers who were frustrated in their attempt to have a public loan were then forced to go offshore where, of course, there are no Loan Council ceilings.

In conclusion, if I had to identify the greatest single challenge which the public sector borrowers face in the 1980's it is that of lengthening their current maturity pattern. With institutional support vulnerable in a post-Campbell world, and in any event a demand for funds that outstrips that which is available from traditional captive sources the semi and local government borrowers are going to have more than enough challenges in raising new funds in the next decade without the distressing necessity of having to increasingly roll over bigger and bigger amounts of maturing debt. Nemo cautius est quid quisque vitet!