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16 July 2012

Mr Joe Dimasi
Commissioner
Australian Competition & Consumer
Commission
GPO Box 520
MELBOURNE VIC 3001

Dear Mr Dimasi

The Commonwealth Government Securities Market

I refer to your letter of 27 June 2012 seeking the Bank's views on certain aspects of the market for nominal Commonwealth Government Securities (CGS).

In recent years, changes in investors' risk preferences and/or their perceptions of risk have seen a significant increase in demand for risk-free assets, such as CGS, globally. Within the Australian market, one notable source of demand for risk-free assets has come from non-resident investors, whose holdings of CGS now comprise more than three-quarters of outstanding supply. As a result, there has been a widening in the spreads between CGS yields and those on other Australian dollar-denominated debt securities. This widening indeed confirms the market's assessment of the risk-free nature of CGS and reflects a general increase in risk premia on other assets.

The increased demand for CGS has not impaired the functioning of the CGS market. This is evident in the market for borrowing CGS where repurchase agreement rates on CGS do not indicate any degree of 'tightness'. Furthermore, the manner in which the Basel III framework is to be implemented within Australia is designed to ensure that the market for high quality liquid assets, such as CGS, is not distorted by the compliance of deposit-taking institutions with the liquidity standard. Specifically, the creation of a committed liquidity facility (CLF) by the Reserve Bank is intended to *prevent* a situation in which the liquidity in the CGS market is impaired or in which the premia attached to CGS are increased beyond reasonable levels.

Overall, our assessment is that the CGS market is liquid and is expected to remain so for the foreseeable future. Consistent with this, the Australian Government has affirmed its commitment to maintaining a liquid and efficient CGS market.

I therefore remain of the view that CGS yields are the most appropriate measure of a risk-free rate in Australia.

That said, market risk premia are unlikely to be stable through time. While it is a reasonably simple matter to infer changes in debt risk premia from market prices, it is less straightforward to do so for equity premia. In making use of a risk-free rate to estimate a cost of capital, it is important to be mindful of how the resulting relativity between the cost of debt and that of equity can change over time and whether that is reasonable.

Should you have any further questions, please feel free to contact me. I have copied my response to AOFM and Treasury.

Yours sincerely

Guy Debelle

Guy Debelle
Assistant Governor
(Financial Markets)