The Semi-Governmental Borrower, 
Competition for Long-Term Funds

By MAURICE NEWMAN

(b) Semi-Governmental borrowing allocations.  

The intense competition for available long-term funds from both the Government and Corporate sectors of the economy in recent times has brought to light the relatively weak position of the Semi-Governmental Borrower.

Almost without exception under current conditions, the attraction of Semi-Governmental Loan rates for the taxpaying investor is lost, once the Commonwealth Loan rate rises above 5 per cent.

This disability is likely to result in a number of Semi-Governmental instrumentalities failing to fill loan allocations in the current financial year. Should this occur, budgeted expenditure and development must be curtailed, having serious implications for the communities concerned.

If it is conceded the uninterrupt ed growth of services provided by the Semi-Governmental institutions is vital to the national interest—as surely it must be—it is clear amendments to existing arrangements are required to ensure loan raisings are competitive regardless of monetary conditions.

The Australian Loan Council

Annually, in June, the Australian Loan Council meets in Canberra, the primary function of the meeting being to discuss and determine for the coming financial year:

(a) Capital allocations from Commonwealth borrowings for State works and housing programmes, and

The Financial Agreement: Act 1928 by which the Loan Council was constituted in the Commonwealth states "on every question for decision by Loan Council, the member representing the Commonwealth shall have two votes and a casting vote, and each member representing a State shall have one vote".

No public Semi-Governmental Loan may remain open during or fourteen days before the period a Commonwealth Loan is open, although in New South Wales the Prospect County Council recently set a precedent in this regard.

Depending on the amount sought, a Semi-Governmental public loan will remain open from seven days to three weeks and for some larger Authorities an approach to the public may have to be repeated at least three or four times a year.

There is increasing evidence to suggest that with the growing number of Authorities using public loan financing together with the increasing funds being sought, satisfactory positioning in the public loan calendar is becoming a problem in itself.

Given the timing of a loan it is now common practice for borrowing Authorities to call for tenders from selected underwriting brokers, thus ensuring subscription of the underwritten amount. The successful tender must be submitted to the Loan Council for approval.

Public Loans

Directed by the Loan Council, an orderly public borrowing timetable is compiled annually, ensuring no two Semi-Governmental public loans are open simultaneously in the one State. Priority is given to Authorities with maturing series so that conversion arrangements will coincide with new raisings if required.

The private loan is undoubtedly the most significant source of Semi-Governmental financing, being in some instances the sole means of fund-raising.

Tailored to suit the needs of
large lenders (a minimum subscription of $20,000 is usually demanded by Loan Council) the private loan has certain advantages over the public loan particularly to institutional investors. Besides being offered a higher interest rate, the lender can choose the time of investment. In addition, the term and rate received is known immediately, whereas with a public loan sub-underwriting, the rate received is subject to public response.

Four private loan currencies are available and all borrowings must receive Loan Council approval.

Private loans may be accepted at any time up until the loan allocation has been filled.

**Interest Rates**

Interest rates paid on Semi-Governmental loan raisings are controlled by the Loan Council and governed to the ruling long-term bond rate. The maximum long-term rate payable on a public loan is \( \frac{2}{3} \% \) above the ruling long-term bond rate and that payable on a private loan is \( \frac{1}{3} \% \) above the ruling long-term bond rate.

As an incentive to sub-underwriters of public loans, the maximum fee of one per cent flat of the amount to be raised has recently been sanctioned by the Loan Council.

**Security**

The security offered with Semi-Governmental Loans is indubitable. Investors receive a charge over the revenue and assets of the undertaking concerned and Authorities are empowered to levy the communities served should insufficient funds be available to meet interest payments or redemption of loans. In addition, debt redemption or sinking funds are subscribed to annually and the loans carry an unconditional guarantee of the Government of the State in which the loan is raised.

There are, however, anomalies regarding “Government guarantee”. Until recently, for example, the public loans of electricity distributors, viz., The Sydney County Council and Prospect County Council, were secured solely upon the undertakings of the Authorities themselves and investors derived security from the ability of the Councils to raise levies. The private loans of both these Authorities still lack “Government guarantee” as to interest and principal, the reason being both Authorities are constituted under the Local Government Act. Although the addition to security of a “Government guarantee” may be academic, few institutional investors will spend the time to argue it out, as long as there are private loans available on the same terms with other Authorities offering “Government guarantees” on their borrowings.

**The Captive Market**

The “30/20 Legislation”

The establishment in March, 1961, of a captive market for Commonwealth and other public securities through the so-called “30/20 Legislation” was a major step forward in support of the Semi-Governmental borrower. Under this legislation institutional investors, such as Life Assurance Companies, Superannuation Funds and the like, were persuaded under the alternative of heavy tax liability to hold and invest certain minimum quantities of total and investable funds in public securities. Basically an investor complying with these requirements is obliged to hold a minimum of 20% of total and annual investable funds in Commonwealth Securities and the 10% balance in other public securities. Alternatively, so long as the level of other public securities held in March, 1961, is maintained, an investor may elect to invest 30% of annual investable funds in Commonwealth Loan stock.

Included in the definition of public securities are “securities issued in respect of a loan to a company the principal business of which is the supply and distribution of . . . water, gas or electricity”. Loan raisings by such companies are not controlled by the Australian Loan Council.

Although the “30/20 Legislation” has gone a long way in obtaining support for Semi-Governmental loan raisings, it is becoming patently obvious that under current conditions, alone it is not sufficiently effective.

**The Life Assurance Company**

As a result of the “30/20 Legislation”, apart from Savings Banks, the major supporters of public securities are undoubtedly the Life Assurance Companies. An examination of Life Office public security investments in recent years reveals a significant swing to Commonwealth Stock at the expense of Semi-Governmental stock. The reason for this is clear. The average Life Office pays tax at the rate of 37.5% and, with the 10c in the $1 interest rebate from Commonwealth Loan Stock is, under present conditions, assured of a return equivalent to 5.9 per cent per annum from any other security. With shortfalls of over 60% on public Semi-Governmental Loan raisings being far from exceptional and the maximum long-term Semi-Governmental Private Loan rate being 5.75% per annum, it is not surprising that the Life Office has chosen to invest a greater proportion of the 30% in Commonwealth Stock.

**The Superannuation and Pension Funds**

Collectively this class of investor is a major and growing force in the capital market. Historically, many of the Superannuation and Pension Funds have invested in public securities exclusively. Some have been and still are restricted in this way under the regulations governing their incorporation. Traditionally, therefore, “30/20 Legislation” aside, these investors have represented a considerable source of funds for Semi-Governmental borrowers. Being exempt from tax, the 10 per cent rebate on Commonwealth Loan interest does not apply. How-
ever, as time has progressed, the restrictions governing investment of funds have become less stringent. This has been particularly true of some of the large Commonwealth and State Funds. The net effect of the more flexible investment policies has been for more emphasis to be placed on such investments as mortgages, debenture stock and equities, while public security investments have assumed a closer “30/20” relationship. Similar changes in investment policies are being adopted by Health Funds as well as Charitable and Religious organisations.

Other “30/20” Securities

Of the securities, other than Commonwealth, being sought to meet “30/20” obligations, an increasing demand is arising for the debentures of the gas supply and distribution companies. Not being subject to the same controls as the Semi-Governmental borrowers, these companies have been raising funds from the public on more realistic terms. It may be argued the debentures of gas supply companies lack the security of Semi-Governmental stock. However, these companies are, in effect, quasi-government bodies, and it is hard to imagine a Government, State or Federal, allowing principal or interest to be lost through investment in them. The recent discoveries of natural gas in what seem to be commercial quantities in three States should ensure the financial success of these companies for the foreseeable future.

Whilst on the subject of other “30/20” securities, mention should be made of the Southern Electric Authority of Queensland, variable interest stock and loans to Local Government Authorities.

The variable interest or “V.I. Stock” issued by the Southern Electric Authority of Queensland is a unique “30/20” security.

Issued upon the conversion of the Southern Electric Authority from public company to public authority status, the stock is traded in $1 units on the equity boards of the Stock Exchanges and is freely marketable. Although interest is not Government guaranteed, payment of interest is not dependent on the profitability of the Authority. The rate of interest payable in any one year is 2 per cent greater than the long-term Commonwealth Loan rate of the previous year.

The Authority may make par issues to stockholders from time to time without renounceable rights.

On six months’ notice from 30th June, 1975, the Queensland State Government may convert the stock into fifteen and twenty-year Government guaranteed S.E.A.Q. inscribed stock. Interest will then be paid at the rate at which the secured inscribed stock of the Authority was last issued. If this rate is less than V.I. stockholders were receiving on the date of conversion, and subject to Loan Council approving the payment of a higher rate of interest, the Authority will issue additional stock to the extent that total annual interest received on the inscribed stock will equal that previously received on the V.I. stock. There is, however, no certainty the stock will ever be converted.

Although to all intents and purposes a Semi-Governmental Authority, as noted earlier, the borrowings of Local Government Authorities, which are invariably raised privately, do not carry a Government guarantee. As the terms offered are no more attractive, generally speaking, the Local Government bodies are at an even greater disadvantage than the Semi-Governmental Authorities.

The Public

It is clear from the alarming shortfalls being experienced on Semi-Governmental public issues, that the taxpaying investor not bound by “30/20” considerations, is providing less and less support. As the rate of return from Semi-Governmental stock compares inversely with Commonwealth Loan stock, the higher the rate of tax, this is not surprising. The “man in the street” as well as the company or professional investor is also being made aware of the relatively poor return from Semi-Governmental loans as a result of the numerous private and public debenture issues being floated by such companies as A.C.I., B.H.P., C.S.R., C.I.G. and I.C.I.A.N.Z. As each one of these companies offered at least 7% per annum with first-class security, little wonder that the Semi-Governmental 5½% public loan rate does not obtain satisfactory support.

Underwriting

Despite the loyalty of many sub-underwriters to the large underwriters, no yield-conscious investor whether “30/20” or not, can continue to suffer the shortfalls of recent Semi-Governmental public loans.

Under current conditions, Semi-Governmental “sub-underwriting” is in fact something of a misnomer. It is more the forward purchase of discounted stock calculated on an anticipated public response.

Working under the tender system, the borrower is bound to accept the tender for the largest loan underwritten for the lowest fee. This action may not be in the long-term interests of either the underwriter or the borrowing Authority. No sub-underwriter will thank an underwriter who leaves him with unexpectedly large holdings of low-yielding Semi-Governmental stock. The borrowing Authority will also have alienated the lender who will be loath to sub-underwrite further loans for that Authority. In addition, a further complication may arise if the sub-underwriter, embarrassed by the size of the sub-underwriting commitment, decides to sell all or part of it on a yield to the buyer far in excess of going loan rates. Such occurrences are becoming common and there is a growing tendency for many lenders to refuse sub-underwriting offers in the belief that large shortfall commitments will
become available at far more attractive yields. This "second-hand" market for Semi-Governmental securities is yet another force to be combated in the search for new funds.

**The Commonwealth v. The States**

As the prospects of the Commonwealth Loan rate falling below 5 per cent in the foreseeable future are not bright, permanent relief to the task of Semi-Governmental Loan raisings seems possible only through a change in the attitude of the Federal authorities and Loan Council policy. However, Federal-State financing is steeped in politics and, as is generally the rule, politics and economics make poor bedfellows. The careful "staging" of the May, 1966, Commonwealth Loan to produce an undersubscription result was, no doubt, aimed as a dampener to State aspirations for change at the 1966 Council meeting.

It is, however, a ludicrous situation where the Commonwealth sanctions, against opposition, Semi-Governmental Loan raising terms at Loan Council yet actively exploits the tax advantages available from Commonwealth securities in public advertisements aimed at the "Corporate" and "Private" investor.

It has been suggested the Federal authorities are opposed to change because they feel the matter is too contentious. A more likely explanation lies in the zeal with which the Commonwealth guards its privileged position as the nation’s prime borrower.

Even assuming effective Commonwealth and Semi-Governmental Loan rates were at parity, it is debatable whether Commonwealth Loan raisings would suffer greatly. Psychologically, Commonwealth Loans offer a more "secure" image and would be likely to attract greater public response than Semi-Governmental public loans. The Commonwealth would also be assured of a two to one advantage from those lenders captive under the "30/20" rule.

In addition, the Commonwealth holds captive another market for its securities in the Official Short-Term Money Market. Semi-Governmental Loan budgets must be prepared twelve months in advance and Authorities cannot accept advance subscriptions or over-subscriptions to any loan or loan allocation. The Commonwealth, on the other hand, can be somewhat flexible in its approach to loan raising budgets and may accept advance subscriptions or over-subscriptions to its loans. It must also be conceded the Commonwealth has wider access to both domestic and overseas capital markets.

The events of recent years have clearly demonstrated Commonwealth-State financial relations are reaching breaking point. It is not proposed to discuss this subject here, except to stress that the political and rather arbitrary handling of Commonwealth-State financing must quickly be replaced by a more reasoned and rational approach based on economic planning and co-operation. Failure to act promptly could result in a serious national crisis.

**Possible Solutions**

A number of possible solutions to the Semi-Governmental dilemma present themselves and a combination, rather than any one of these, may prove the ultimate.

Apart from the need to improve the terms offered by Semi-Governmental Authorities, it appears a widening of the existing market is necessary. An extension of the market available to Semi-Governmental securities could be achieved by—

(a) Providing more direct participation in Semi-Governmental Loans through certain forms of Savings Bank investment.

(b) The acceptance of Semi-Governmental securities in the dealings of the Official Short-Term Money Market.

(1) Direct Participation Through the Savings Banks

As mentioned earlier the Savings Banks have been major supporters of Semi-Governmental Loans. However, it appears, despite an ever-increasing level of Savings Bank deposits, that this source of Government finance could be exploited more effectively.

Apart from short-term call considerations, Savings Bank accounts can hardly be described as an attractive investment. A limit of $6,000 is placed on each account and allowing for tax and inflation the 3½ per cent per annum interest rate is likely to net depositors a real loss.

There seems merit, therefore, in exploring the feasibility in Australia of certain Savings Bank schemes now in operation in Great Britain and the Continent. The scheme devised in Great Britain allows Savings Bank depositors to derive a more direct benefit from the higher rates of interest offered on loans to municipal and Local Government authorities.

To be eligible to invest in this scheme, it is conditional that the depositor has a minimum of £50 (Stg.) in a general Savings Bank account. If this requirement is met, a minimum amount of £1 (Stg.) and a maximum amount of £5,000 (Stg.) may be lodged in a special "Investment Account". Funds invested in this account can only be withdrawn on one month's notice. The interest rate paid by the bank may vary also on one month's notice. The rate is currently believed to be 5½% per annum.

Although the scheme was only commenced in June, 1966, it has proved very popular, more than £15,000,000 (Stg.) having been invested in the first month.

The application of such a scheme...
in Australia is not without certain difficulties. In Great Britain, prior to the introduction of the “Special” accounts, the Post Office Savings Bank invested exclusively in the National Debt and paid depositors approximately 2 per cent per annum on general savings accounts. Thus, it created no real problem for the Bank to pass on to special account investors the benefits received from the wider range of securities held.

In Australia, however, the Savings Banks have already spread investments over Commonwealth stock, Semi-Governmental stock and Housing Loans and overall yields received would probably lie between 4½ and 5¼ per annum.

Should a similar scheme to that described above be introduced, Australian Savings Banks could expect a considerable percentage of existing general savings deposits to be switched across to the special accounts. The ability of the Savings Banks to pay an amount of approximately 5 per cent on the special accounts might, therefore, be in doubt. However, by reducing the rate of interest paid on general savings accounts to, say, about 2 per cent per annum a much higher rate than the present 3½ per cent could be paid on the special accounts. It has been said that if it were not for fragmentation of savings, Australia would be self-sufficient in its investment requirements. The introduction of a special savings account scheme therefore seems likely to serve the dual purpose of providing a source of additional funds for the needy Government sector and an attractive investment avenue for the public.

(b) The Official Short Term Money Market

It is estimated the official dealers of the Short-Term Money Market hold some $350 million in Commonwealth securities. A “grey” “buy-back” market also operates outside the official market using Semi-Governmental securities, but in absolute terms this is not considered substantial. It seems likely that Semi-Governmental borrowers would derive much benefit if their securities were approved for dealings in the official market—perhaps on a percentage basis with Commonwealth securities.

Improving the Public Image

Although not as important a source of financing as the private loan, public loans are a worthwhile supplement to overall financing. Unfortunately, for the reasons outlined above, this source of funds is steadily declining. Clearly, the degree of public response, all things being equal, will be influenced directly by the terms available from the Semi-Governmental borrower vis-à-vis other borrowers.

There are a number of ways in which Semi-Governmental loans could be made more attractive to public lenders.

1. Interest Rates

The time has come for the removal of the present arrangement whereby Semi-Governmental loan interest rates are directly governed to the ruling long-term Commonwealth Loan rate. As long as the 10 per cent rebate applies to Commonwealth Loan interest and the long-term Commonwealth Loan rate remains above 5 per cent, this arrangement is unrealistic. The higher the Commonwealth Loan rate climbs above 5 per cent, the less attractive Semi-Governmental loan rates become to the majority of taxpaying investors. Similarly, it is possible to conceive a situation whereby Semi-Governmental loan rates compare less and less favourably even though the Commonwealth Loan rate remains unaltered. Such a situation would occur given a general increase in the level of direct taxation. In the light of present circumstances, such a development is not unlikely.

The task of determining Semi-Governmental loan rates should still be undertaken by the Loan Council. However, the rates should be pitched according to ruling monetary conditions and Loan Council policy should be flexible enough to ensure even those Authorities with a poor or little-known image achieve loan targets. A maximum interest rate of 6 per cent under present conditions should result in a marked improvement in public response.

2. Terms

To many small investors, the term of seven years and over, available from Semi-Governmental public loans, is too long. The introduction of a three or five-year term is likely to prove attractive.

3. Negotiability

One of the greatest problems facing the public investor and the Semi-Governmental Authorities alike, is the lack of official open market support such as is carried out by the Federal Treasury with Commonwealth Loan stock. Lack of this support invariably means a sharp reduction in the market value of Semi-Governmental loan stock the moment it is listed on the Stock Exchanges. This capital loss element is a source of great concern to small investors as well as large, particularly when circumstances dictate the disposal of the stock held. This factor has influenced many smaller super-annuation funds faced with resignation and retirement problems to forgo the higher return on Semi-Governmental loans for the greater negotiability of Commonwealth stock. It is also a cause of concern to the borrowing authority, because, as mentioned earlier, the greater the availability of discounted stock, returning redemption yields substantially in excess of the going loan rates, the more difficult the task
of obtaining support for loan programmes.

It was to be part of the function of each Authority's Sinking Fund to provide open market support. However, with the decline in public response, many Authorities have looked to their Sinking Funds as a source of private loan money and purchases of stock on the open market have become so limited as to be ineffectual. The problem is a cumulative one in that the less public response, the greater the underwriting shortfall, the more discounted stock available and the less relative open market support that can be provided.

The Government agency that would be responsible for open market support is difficult to ascertain. Few, if any, of the State Treasuries would have sufficient funds available for such transactions. However, some method of controlling the yields available on the open market is required and it is possible, given higher interest rates and greater public participation, the individual sinking funds will be in a position to bring about this situation.

In any event, some provision could be introduced for the prior redemption at par of loans in amounts up to say a maximum of $10,000 where extenuating circumstances are involved.

**The Future of Underwriting**

Assuming action is taken to raise Semi-Governmental loan rates to more realistic levels, Authorities must seriously reconsider the merits of underwritten public loans.

Although it is possible, even under current conditions, to achieve a return in excess of 6 per cent from sub-underwriting Semi-Governmental public loans, this result has rarely been achieved. In fact, the current crop of disastrous shortfalls is resulting in sub-underwriters receiving stock on returns far less than are available from private loans, after allowing for the maximum underwriting commission.

It seems probable that sub-underwriters, who invariably come from the ranks of the "30/20" lenders, would be more satisfied with a guaranteed realistic return on Semi-Governmental stock (let us assume 6 per cent per annum under current conditions) than the vagaries of the present underwriting system or the better though still not competitive private loan rates.

Such a move should also benefit the borrowing authority. The present system of public loan underwriting is, in many instances, involving the borrowing Authority in costs, which in relation to the amount raised, are out of all proportion. Taking into account costs of underwriting, printing and promotion and amortising this amount over the average period of the loan raised, the net cost per annum to the borrowing Authority must, in many cases, exceed 7 per cent per annum.

Given the more attractive rates of interest it should be possible for the borrowing Authorities to make public loans without resorting to external underwriting arrangements. The results are likely to be satisfactory and the cost cheaper.

The problems associated with the disposal of heavily discounted shortfall commitments should largely be overcome if the present system of underwriting is abandoned.

**Conclusion**

The solutions mentioned are by no means exhaustive and explore only some of the avenues open to ease the present Semi-Governmental financial problems.

In some instances, such as a revision of the regulations relating to trustee investments and the removal of stamp duty on the transfer of Semi-Governmental stock, the States can assist themselves. However, as explained, only with the co-operation of the Federal authorities can any real benefit be achieved.

The financing of national works is vital to the economic structure of the country at the present time and by design or default it is the responsibility of certain State authorities to perform part of this work.

The arrangements under which the necessary finance is being raised are inadequate and outdated.

It is time for a change.

**Fixed Interest Investor—from p. 1**

concerned, much more information is needed in relation to each of the various assets in the balance sheet. The investor should be given some idea of the realizable value of these assets and trust deed limitations should be related to what these assets might realize in depressed conditions,

I do not believe that the suggestions that I have offered are in themselves an answer to the questions I have discussed. I think there will come a time when management will have both the resources and the expertise to make the calculations proposed by Donaldson, and it will be possible to allow security analysts and investors the opportunity to judge the calculations before making their decisions as to the soundness of fixed interest securities. Perhaps Donaldson's technique will be more readily used when its application has been made more practicable by refinement and modification.

**Disclosure—from p. 3**

that might be occurring in sections of the group.

Finally, there is in my view a great need for more accurate information on the causes of company "failures" in the past. "Failures" in this instance covers "declines" as well as actual bankruptcy. Those cases which have received considerable press publicity in recent years have usually had a flavour of over-borrowing. It would be of great value if members who have had the opportunity of making post-mortems could submit their findings in writing for the Society's library, even if the companies concerned remain anonymous.