FTSE INSIGHT //

NEWSLETTER
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BENCHMARKING A CHANGING AUSTRALIAN BOND MARKET

The Australian bond market has recently undergone substantial changes, increasing the need for accurate and comprehensive benchmarks.

According to Australia's central bank, the Reserve Bank of Australia (RBA), the Australian bond market has grown since the 2008/09 financial crisis, to nearly 100% of the country's GDP at the end of 2013[1]. Significant post crisis changes in the market's composition include a rise in the proportion of commonwealth and semi government debt, a pick-up in the issuance of lower-rated corporate bonds and a large drop in the market share of asset-backed securities.

On the demand side, a gradual ageing of the average participant in Australia's superannuation fund system, whose retirement schemes are major investors in the local bond market, is leading to growing demand for debt securities. Meanwhile non-resident participation in Australia's commonwealth and corporate bond markets remains substantial and close to historic highs.

Reflecting the growing importance of the Australian bond market, FTSE and the Association of Superannuation Funds of Australia (ASFA) launched the FTSE ASFA Australia Bond Index Series in October 2014. The index series answers the need for a representative set of indices to benchmark the performance of the various issuer, ratings and maturity segments of the market.

The series is designed to benchmark the Australian dollar denominated bond market according to transparent, publicly available rules and using an independent, third party source of bond market pricing.

1 *The Australian Bond Market*, Reserve Bank of Australia's speech to the Economic Society of Australia, 15 April 2014

SUPERANNUATION SCHEMES' RISING BOND MARKET ROLE

Australia's superannuation market is the fourth largest national pension fund system in the world, with **US$1.6 trillion** in assets at the end of 2013, according to Towers Watson[2].

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ABOUT ASFA
ASFA is the peak policy, research and advocacy body for Australia's superannuation industry. ASFA's purpose is to help achieve the best retirement outcomes for members of super funds through the development of good public policy and industry best practice.

The growth of the superannuation industry is due in large part to the introduction of a compulsory pension saving system by the Australian government in 1992. The new superannuation system, which replaced an earlier, voluntary system providing limited coverage, was supported by tax incentives for pension saving.

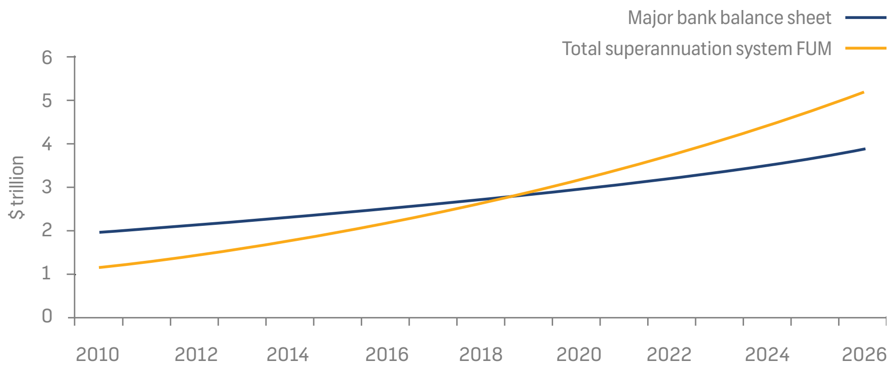
According to a 2012 discussion paper by ASFA[3], Australia's superannuation industry faces a rising demand for income producing investments as a result of the country's changing demographics, suggesting that pension plans will steadily increase their bond market allocations.

Other changes in the Australian financial system are also likely to lead to an increasingly prominent role for superannuation schemes in the local bond markets.

According to ASFA's 2012 discussion paper, funds under management in superannuation schemes are likely to overtake Australian banks' balance sheets in size during the current decade, partly as a result of regulatory constraints on bank balance sheet growth. This suggests that pension funds are likely to finance economic activity more directly in future, for example via participation in Australian companies' corporate debt issues.

Recognising this trend, the Australian government has in recent years hosted meetings between major superannuation funds, corporate treasurers and investment banks with the aim of developing a deep and liquid corporate bond market. This market could act as an alternative financing mechanism for smaller corporations, which have historically been reliant on bank funding.

Superannuation pool vs. banks' balance sheets



Source: *Developing Australia's Fixed Interest Markets*, ASFA, June 2012

2 *Global Pension Assets Study 2014, Towers Watson, January 2014*

3 *Developing Australia's Fixed Interest Markets, ASFA, June 2012*

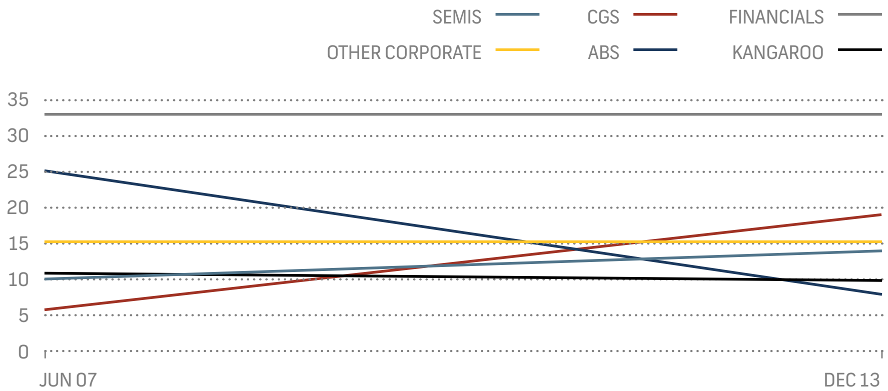
THE CHANGING STRUCTURE OF AUSTRALIA'S BOND MARKET

According to the RBA, Australia's bond market grew from 84% of the country's GDP in mid-2007 to 98% of GDP by the end of 2013.

This represents an increase in the notional value of Australian bonds from A$916 billion in June 2007 to A$1,522 billion in December 2013.

The Australian bond market has also undergone a substantial change in structure over the same period.

Market Share (%): Australia's Bond Market Segments



Source: *The Australian Bond Market*, Reserve Bank of Australia, April 2014

While the market share of financial, other corporate and Kangaroo bonds (bonds issued in Australia by foreign entities and denominated in Australian dollars) was almost unchanged, there was a substantial rise in the market share of commonwealth government securities (CGS) and semi government bonds, while the market share of asset-backed securities (ABS) fell from 25% to 8%.

According to the RBA's Assistant Governor, Guy Debelle, the increase in the Australian bond market's size and the shift in the relative importance of the bond markets' segments reflects debt issuance by the Commonwealth and state governments to finance their budget deficits as they sought to support economic growth throughout the financial crisis.

The Australian government bond market has witnessed substantial fluctuations in relative size since the 1990s. According to the RBA, the collective stock of CGS and semi-government bonds represented 40% of GDP in the first half of the 1990s, fell to under 15% of GDP by 2005 and is forecast to regain the 40% level by 2016/17.

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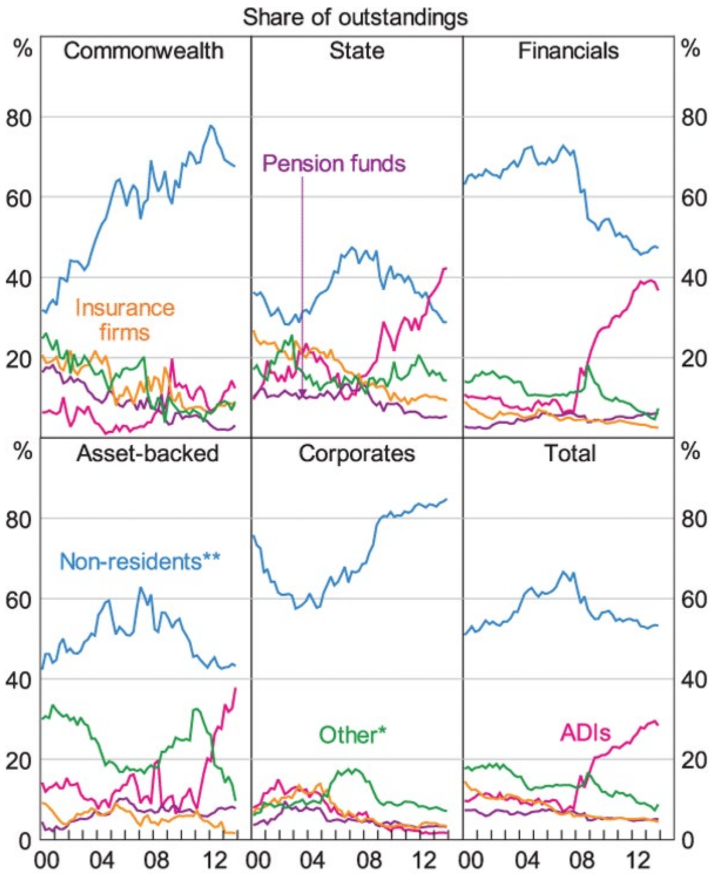
Despite the post-crisis decline in the relative size of the ABS sector, the market for residential mortgage-backed securities has shown signs of revival, the RBA noted in early 2014.

Meanwhile, non-resident investors continue to play a major role in certain segments of the Australian bond market, the RBA observes. Over 60% of the CGS market and over 80% of the Australian corporate bond market was in the hands of non-residents at the end of 2013.

Ownership of Australian Bonds



* Includes holdings by securitisers, households, non-pension investment funds, government, the RBA, and other
** Does not include self-securitised ABS
Sources: ABS; RBA

Source: *The Australian Bond Market*, Reserve Bank of Australia, April 2014

THE FTSE ASFA AUSTRALIA BOND INDEX SERIES

The **FTSE ASFA Australia Bond Index Series** is one of a number of regional indices calculated and maintained by FTSE.

FTSE applies global standards in index methodology to a range of domestic equity and fixed income markets, while taking into account local market characteristics.

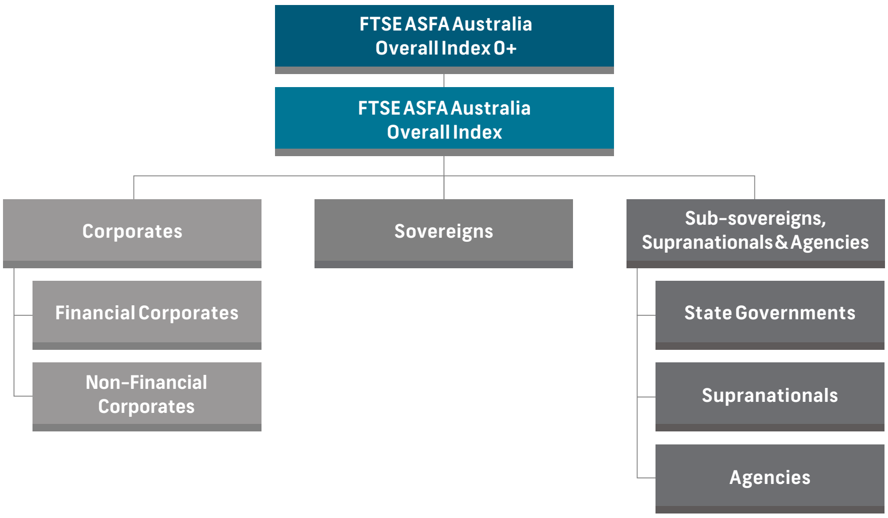
It seeks to implement a consistent approach when constructing indices. Within equity markets, for example, it uses a single industry classification framework and applies a common standard for measuring and reflecting index constituents' free float and shares in issue.

FTSE's approach involves regular discussions with its clients and index advisory committees to ensure that indices meet the requirements of end-users. Publicly available rules provide full transparency of index methodologies.

The FTSE ASFA Australia Bond Index Series is designed to measure the performance of the domestic Australian dollar-denominated bond market, including the government, semi government and corporate bond segments.

The series consists of the main index family, the FTSE ASFA Australia Overall Bond Index, which is broken down by sector, rating and maturity bands.

Index family structure



Additional indices include:

- FTSE ASFA Australia Government Index including national and state government bonds
- FTSE ASFA Australia Covered Bonds Index including covered bonds

Source: FTSE, November 2014

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The FTSE ASFA Australia Overall index 0+ includes bonds of all maturities, including those with an outstanding term to maturity of under one year, while the FTSE ASFA Australia Overall index includes only bonds with an outstanding term to maturity of one year or more. The FTSE ASFA Australia Overall index has three principal subcategories: corporate bonds (including financials and non-financials); sovereign bonds such as commonwealth government securities; and sub-sovereign, supranational and agency bonds, such as Australia's semi government bonds.

Bond eligibility and index review procedure

The index series excludes certain categories of bonds:

- Asset-backed securities
- Private placements or retail bonds
- Sinkable bonds
- Floating-rate notes
- Inflation-linked bonds
- Convertible bonds or bonds with contingent conversion features
- Perpetual bonds which are not callable

Eligible bonds must also have a minimum outstanding notional amount of A$100 million and must be of investment grade quality.

The index series is reviewed monthly with the objective of ensuring that index constituents remain up-to-date and compliant with the index rules. As part of such reviews, any new issues that pass the eligibility criteria are included in the index. Bonds that have become ineligible as a result of credit rating downgrades, or by a decline in the notional amount outstanding to below the minimum size threshold, are excluded.

The results of index reviews are announced five days before the last business day of the review month, while any resulting additions or deletions are implemented after the close of the last business day of the review month, taking effect from the first business day of the succeeding month.

Certain alterations to bond index constituents, such as an unscheduled redemption or repurchase (including puts or calls), interest coupons which step up or down, or the merging of one bond with another fungible bond, take place on the dates at which such changes become effective, rather than as part of regular index reviews.

Bond pricing

The indices within the FTSE ASFA Australia Bond Index Series are calculated based on evaluated bond prices from Interactive Data Corporation.

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Interactive Data's bond price evaluations are market-based measurements that represent its good faith opinion as to what a bond holder would receive in an orderly transaction for an institutional round lot position under prevailing market conditions. Interactive Data uses valuation techniques that reflect market participants' assumptions and maximise the use of relevant observable inputs, including quoted prices for similar assets, benchmark yield curves and market-corroborated inputs.

FTSE calculates parallel versions of each bond index within the series: one whose constituents are priced using the bid prices of the underlying bonds, and the other whose constituents are valued at mid prices. This allows the end-user to select the benchmark most suitable for them.

Meeting superannuation funds' requirements

The increasing demand from Australia's superannuation fund sector for income producing assets is likely to lead to steadily increasing bond allocations within funds' investment portfolios. This trend, together with frequent shifts in the local debt market's issuance patterns, have generated a requirement to measure accurately the return and risk characteristics of the market's different segments.

The FTSE ASFA Australia Bond Index Series meets this requirement by providing transparent, rules based coverage of the principal bond market categories and measures the returns of bonds meeting different ratings, sector and maturity specifications. The index universe can also be customised further, depending on individual client requirements.

FOR FURTHER INFORMATION ON THE INDEX, VISIT WWW.FTSE.COM/AUSTRALIAN-BOND