

NEW ZEALAND: THE
BIG PICTURE ON
DEBT AND ECONOMY

JAPANESE INVESTORS:
VIEWS ON AUSTRALIAN
RATES AND CREDIT

SOCIAL IMPACT: IS AN
INSTITUTIONAL BOND
MARKET POSSIBLE?

KangaNews

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AUSTRALASIAN FIXED INCOME: GLOBAL REACH, LOCAL EXPERTISE

SEASON CHANGE FOR BANK FUNDING

MARKET CONDITIONS ARE PUTTING SECTOR
STRATEGY IN FLUX ONCE MORE





Thank you

TCorp would like to congratulate and thank our 14 Dealer Panel banks for their support during the 2017/18 financial year.

Top 5 Dealers

Total Benchmark Bond Turnover

1. UBS AG, Australia Branch
2. National Australia Bank
3. Commonwealth Bank of Australia
4. Australia & New Zealand Banking Group Ltd
5. Deutsche Bank AG, Sydney Branch

Top 3 Dealers

Total Inflation Linked Bond Turnover

1. Citigroup Global Markets Australia Pty Ltd
2. UBS AG, Australia Branch
3. Westpac Banking Corporation

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BIG-FOUR FUNDERS TALK STRATEGY AS THE SEASON CHANGES

KangaNews and RBC Capital Markets hosted their annual roundtable for heads of funding at Australia's big-four banks in Melbourne on 13 August. After an almost unprecedented period of benign market conditions, 2018 has posed new challenges and seen execution risk back on the table. The issuers acknowledge the revived headwinds but say they are well-placed to navigate them.

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COPUBLISHED ROUNDTABLE

SUN NOT SETTING FOR JAPANESE INVESTORS IN AUSTRALIAN DOLLAR PRODUCT

In 2017, *KangaNews* and **Mizuho Securities** hosted their first-ever

roundtable discussion in Tokyo for Japanese investors in Australian dollar debt. A year later, a larger group of buy-side participants explained that, while the headwinds facing international participants in the Australian market are real, they are if anything engaged with a wider range of product than ever before.

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COPUBLISHED Q+A

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NEW ZEALAND'S GOVERNMENT RESETS THE PLATFORM

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EVENT REPORT

VIEW FROM THE LAND OF THE LONG WHITE CLOUD

Discussion at the **KangaNews New Zealand Debt Capital Markets Summit 2018**, held in Auckland on 8 August, captured all the talking points in the New Zealand capital market including macroeconomics, the business environment and trade updates.

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KangaNews is a one-stop information source on anything relevant to **Australian and New Zealand debt markets** – including in- and outbound issuance.

Each issue provides all the information market participants need to keep up to date with the deals and trends making headlines in the markets, in-depth issuer and investor insights, and deal and league tables.

KangaNews is published six times a year, with regular reports and yearbooks adding to the suite of printed offerings. Subscribers also have access to email updates on breaking deals and news from the **KangaNewsAlert service**, as well as priority invitations to **KangaNews events** and full access to the www.kanganews.com website.

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Our climate has a way of generating solutions



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ISSUER INSIGHTS

SAFA says lack of supply worked in its favour in July syndication

South Australian Government Financing Authority

(SAFA) executed Australia's largest deal in nearly two months on 4 July, printing A\$1 billion (US\$740.1 million) of new 10-year notes. **Andrew Kennedy**, Adelaide-based director, treasury services at SAFA, discusses a deal that came in the wake of one of the quietest Australian issuance months in recent years (see facing page).

What was your read on market conditions around your deal?

There was some volatility – including tension around trade wars and US monetary-policy tightening among other factors – but low new issuance meant conditions were reasonably stable. The Australian market has been relatively orderly, certainly. We haven't seen significant widening in spreads, though there hasn't been the issuance to test conditions.

We heard anecdotally that there was reasonable global demand for paper but that it has been hard to come by. Early July looked like a good time to come to market, with the

not want to be seen as opportunistic in the way we go about issuing. Given the tightening global liquidity conditions, leaving a small concession in a transaction to ensure investor confidence makes sense.

We don't want investors turning away from deals, particularly the global investors which now have a different view on Australia given we are sub-US in the government curves. A negative interest-rate differential to the US means we need to be more discerning in how we approach markets.

It has been suggested that some offshore investors are finding

"Global investors won't be as aggressive in books as they have been in recent years. We still had decent Asian participation in our transaction, but it wasn't as broad or deep as we have seen in the past."

ANDREW KENNEDY SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY



supply-demand dynamic creating an opportunity for us to meet our own liquidity guidelines and client funding requirements with this deal.

To what extent did you have to 'meet the market' on pricing?

When we come to the market we are always very cognisant of the fact that we are a small issuer and a price taker. Our primary concern is therefore that we have access to markets.

We always look to bring transactions that have value and we do

better relative value away from Australian dollars. What has been your experience in this regard?

We were in Asia in late April and the feedback we received from the investor community was in line with what you suggest. They are being more cautious in their approach to investing in Australia due to rates being sub-US. However, the same investors remain a significant participant in the Australian market across all sectors.

At the margin, global investors won't be as aggressive in books as

they have been in recent years. We still had decent Asian participation in our transaction, but it wasn't as broad or deep as we have seen in the past.

How did overall demand compare with the last deal you executed?

Considerations such as timing, volume, maturity and market conditions locally and globally all have an impact, so we try not to look at transactions side-by-side because it doesn't give a consistent view of a book. We just hope domestic and offshore investors are sufficiently engaged to make an informed decision as to whether they can participate.

We always hope to achieve broad global distribution and we have noted in recent years that longer-dated deals attract a more diverse global investor base. This deal was consistent with that theme. Roughly a quarter of the book was distributed offshore with the balance going to Australian investors.

The blend of investors was different from what we have seen in previous transactions. Roughly half the book was allocated to domestic and offshore balance-sheet investors. A large proportion was allocated to asset and insurance managers and there was good support from institutions locally and offshore.

Was there ever any consideration to postpone the deal given market conditions?

Definitely not. SAFA is very aware of how important it is to be consistent with messaging and activity in the market. It is critical that we follow through on our promises.

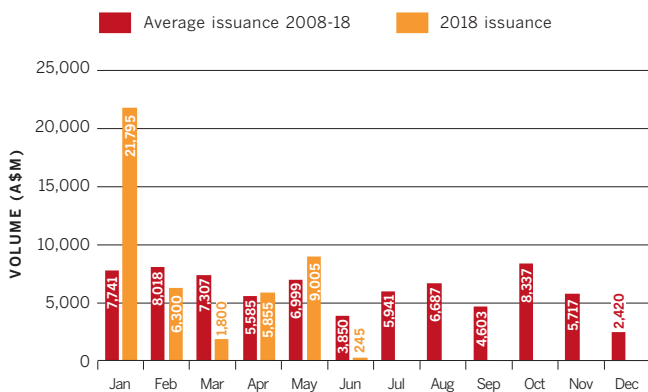
The timing of our transactions is reasonably transparent because it is based around our liquidity profile and our requirement to be prefunded. For this particular deal, some agencies wanted to roll their debt out over a longer term. We have known this for a while and were able to let the market know that this is where the next point on our curve would be.

Market adjustments drop Australian June supply near record low

Deal flow in the Australian market, particularly for domestic senior transactions, virtually ground to a halt in June. A confluence of factors contributed to the lack of supply, dealers say, including issuers having prefunded ahead of expected turbulence, relative value and geopolitical tension. But intermediaries insist the market remains open for business.

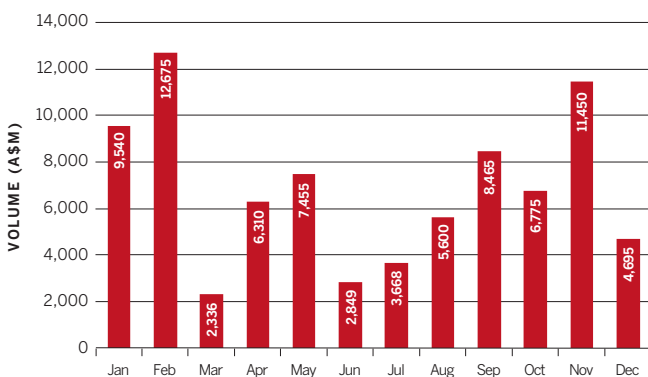
It is not uncommon for issuance to tail off in the mid-part of the year as most sectors tend to front-load new issuance at the start of the calendar year or following results announcements. But 2018 has provided an extreme example, as more than A\$21 billion (US\$15.5 billion) of syndicated deal flow priced from Australian issuers in January – albeit buoyed by a jumbo sovereign-bond syndication – and only A\$245 million in June (see chart 1).

CHART 1. AUSTRALIAN DOMESTIC SYNDICATED ISSUANCE BY MONTH



SOURCE: KANGANEWS 2 JULY 2018

CHART 2. AUSTRALIAN REDEMPTION VOLUME 2018 (ALL ISSUERS)



SOURCE: KANGANEWS 2 JULY 2018

According to KangaNews data, June 2018 also saw the second-lowest monthly domestic issuance total in Australia since the financial crisis – with the record set in the traditionally quietest market month of December (see table).

A range of factors is at play. Mark Abrahams, head of debt syndicate at National Australia Bank in Sydney, points in particular to mean reversion after a very busy start to the year in the primary market and the low level of domestic maturities in the middle of the year (see chart 2).

Global volatility has also played a role in the lack of supply in Australia, says Rod Everitt, Sydney-based head of Australian dollar syndicate at Deutsche Bank. “Factors such as escalating trade tensions have caused volatility in markets globally,” he comments. “The Australian market has taken its lead from offshore. There has been stronger deal flow in the US, but even there the numbers look better than they really are as some large volume was driven by M&A activity.”

However, even during May dealers were confident that the supply hiatus should be temporary. For instance, Daniel Chandler, director, debt capital markets, Asia Pacific at RBC Capital Markets in Sydney, says issuer and investor expectations needed to realign to support primary issuance.

Intermediaries confirm that credit spreads have reset wider, though not spectacularly so. Yieldbroker ratesheets show five-year major-bank paper trading 10-15 basis points wide of levels from the start of the year, and *KangaNews* understands credit-default swaps widened by around 20 basis points between May and late June.

MONTHS WITH LESS THAN A\$1 BILLION OF AUSTRALIAN DOMESTIC PRIMARY ISSUANCE, 2008-2018

MONTH	ISSUANCE VOLUME (A\$M)
Sep 08	0
Nov 08	0
Dec 16	140
Jun 18	245
May 10	450
Dec 12	550
Jun 15	900
Jan 12	930

SOURCE: KANGANEWS 2 JULY 2018

TRANSACTION ANALYSIS

FI issuance returns to Australian market with three years the focus

Benchmark financial-institution (FI) issuance returned to the Australian domestic market in July, with a total of A\$3.9 billion (US\$2.9 billion) printed across a trio of public three-year deals. With market volatility limiting FI issuance in preceding weeks, deal sources say a build up in investor cash as well as issuer willingness to execute at investors' preferred tenor drove the transactions.

Issuer: **ANZ Banking Group**

Issuer rating: **AA-/Aa3/AA-**

Pricing date: **10 July 2018**

Maturity date: **16 July 2021**

Volume: **A\$2 billion**

Tranches: **A\$1.6 billion floating, A\$400 million fixed**

Margin: **75bp/swap**

Indicative margin: **77bp/3m BBSW & mid-swap**

Geographic distribution: **see chart**

Lead manager: **ANZ**



Issuer: **United Overseas Bank (UOB) Sydney Branch**

Issuer rating: **AA-/Aa1/AA-**

Pricing date: **17 July 2018**

Maturity date: **24 July 2021**

Volume: **A\$600 million**

Margin: **81bp/3m BBSW**

Indicative margin: **83bp/3m BBSW**

Geographic distribution: **see chart**

Lead managers: **ANZ, National Australia Bank (NAB), UBS, UOB**

Issuer: **Royal Bank of Canada Sydney Branch**

Issuer rating: **AA-/Aa2/AA-**

Pricing date: **18 July 2018**

Maturity date: **26 July 2021**

Volume: **A\$1.3 billion**

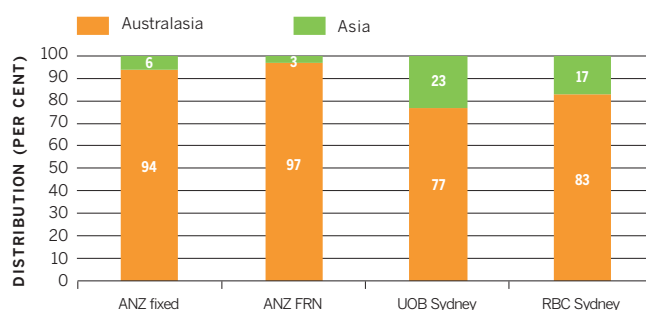
Margin: **75bp/3m BBSW**

Indicative margin: **77bp/3m BBSW**

Geographic distribution: **see chart**

Lead managers: **ANZ, Commonwealth Bank of Australia, NAB, RBC Capital Markets, Westpac Institutional Bank**

JULY FI DEALS IN AUSTRALIA GEOGRAPHIC DISTRIBUTION



SOURCE: ANZ, NATIONAL AUSTRALIA BANK, UNITED OVERSEAS BANK 23 JULY 2018

TRANSACTION INSIGHTS



GERARD PERRIGNON
MANAGING DIRECTOR,
DEBT CAPITAL MARKETS
RBC CAPITAL MARKETS

“The bills-Libor curve is being driven by front-end funding pressures and it widened again ahead of deal execution for RBC Sydney.

This has been evident for some time across repo, bank bills and foreign-exchange forwards markets as the demand for Australian dollar funding remains high.”



PAUL WHITE
GLOBAL HEAD OF CAPITAL MARKETS
ANZ

“In the current, more volatile, environment investors have become more defensive: they have shortened their duration appetite and are looking for high-quality assets. ANZ, RBC and UOB are all highly rated and well-regarded credits so they were able to attract significant demand with their respective three-year deals.”

TRANSACTION ANALYSIS

Tenor focus drives Port of Melbourne's choice for capital-market debut

The US private placement (USPP) market provided insulation from global volatility as well as the mix of tenors and volume Port of Melbourne desired for its capital-markets debut, according to the issuer and its agents. With a large portion of its acquisition finance now termed out, the issuer says it has scope to consider public markets for future transactions.

Port of Melbourne priced a USPP transaction on 27 June, across 10-, 12- and 15-year tenors for equivalent total volume of US\$1.3 billion (see table). The Bank of America Merrill Lynch (BAML)-Westpac Institutional Bank joint venture and Commonwealth Bank of Australia (CommBank) led.

Acquisition, via a 50-year lease to Lonsdale Finance, in September 2016 left Port of Melbourne with A\$4.2 billion (US\$3.1 billion) in acquisition finance across three tenors. The first, worth A\$1.75 billion, was due to mature in October 2019 and has now been entirely refinanced.

Tenor was a particularly important consideration for Port of Melbourne given the status of its 50-year lease from the government of Victoria. The issuer and its arrangers say they doubt the volume and tenors would be possible in any other public market in what has become a more challenging environment for new corporate issuance.

PORT OF MELBOURNE USPP DEAL STRUCTURE

TENOR	VOLUME	COUPON/MARGIN TO BBSW	SPREAD (BP)
10 years	US\$340m	4.19%	135/UST
10 years	A\$85m	4.42%	145/mid-swap
12 years	US\$360m	4.27%	143/UST
12 years	A\$90m	4.58%	153/mid-swap
15 years	US\$380m	4.34%	150/UST
15 years	A\$115m	4.74%	160/mid-swap
15 years	A\$45m	3m BBSW +180bp	180/3m BBSW

SOURCE: COMMONWEALTH BANK OF AUSTRALIA 5 JULY 2018

TRANSACTION INSIGHTS



DARRYL MUTZELBURG
CHIEF FINANCIAL OFFICER
PORT OF MELBOURNE

"We looked at public markets for this transaction, but with the large initial maturity we wanted

to pick an option that would allow us to refinance the A\$1.75 billion quickly and with certainty. The USPP market offers the ability to raise a large volume and tranche it across multiple tenors, which likely would have been much more difficult in a public market."

"We can take a steady approach to refinancing the rest of our bank debt. We have time on our side and can be selective with the markets we would like to be active in."



TABITHA CHANG
DIRECTOR, DEBT CAPITAL
MARKETS ORIGINATION
COMMONWEALTH BANK
OF AUSTRALIA

"Pricing between the Australian domestic and USPP markets was aligned at the

beginning of the year. This has swung in favour of the USPP market recently, although the Australian market always makes sense for a local issuer with this quantum of debt. In general, Australia has performed very well in the last 18 months and it should remain a conducive market for domestic corporate issuers."



GARY BLIX
HEAD OF CORPORATE
ORIGINATION
WESTPAC INSTITUTIONAL BANK

"Port of Melbourne's debut demonstrates why USPP has become the preferred destination for privatised infrastructure

assets wanting to establish themselves in capital markets."

TRANSACTION ANALYSIS

Zurich cashes in as 20-year Australian dollar corporate demand flickers

Demand for long-dated Australian dollar product, predominantly from a specific cohort of investors in Asia, helped Zurich Finance Australia (Zurich) to execute a rare 20-year, benchmark-sized senior deal in July. Deal sources suggest demand is narrow enough that private placements remain a more likely outcome at this tenor – as Dexu Finance demonstrated with a small trade of its own in early August.



Issuer name: **Zurich Finance Australia**
 Issuer rating: **A+/A1**
 Pricing date: **18 July 2018**
 Maturity date: **26 July 2038**
 Volume: **A\$250 million**
 Launch volume: **A\$150 million**
 Coupon: **4.5%**
 Lead managers: **ANZ, Mizuho Securities**



Issuer name: **Dexu Finance**
 Issuer rating: **A-/A3**
 Pricing date: **3 August 2018**
 Maturity date: **10 August 2038**
 Volume: **A\$30 million**
 Coupon: **4.7%**
 Lead manager: **SMBC Nikko**

TRANSACTION INSIGHTS



MATHIAS MEISEL
 HEAD OF CAPITAL MARKETS
 ZURICH INSURANCE GROUP

“Following our inaugural issue in May, we received many reverse enquiries from Australian dollar investors seeking to invest in our credit at longer

tenors. The strength of the investor appetite made us very confident our 20-year senior transaction, despite being the first of its kind for a financial name, would be a huge success.”

“When we came to the market in May we told investors that, if possible, we would like to build a curve over time. Now we have gone a long way towards delivering this aspiration, by establishing five- and 20-year Australian dollar benchmark lines.”

“Having access to a broad range of tenors is essential for any well-functioning debt market.

We hope our transaction helps the Australian dollar debt market to evolve further along the maturity spectrum.”



DANIEL LEONG
 DIRECTOR, DEBT SYNDICATION
 MIZUHO SECURITIES

“The small group of life insurers in Korea and Taiwan that supported Zurich’s transaction has ongoing demand for very long-dated credit, but it only tends to

trigger Australian dollar transactions when hedging costs offer relatively superior economics to euro or US dollar investment.”

“It is hard to find issuers that want 20-30 year funding. In Australia, the names that could benefit from issuance of this duration often only want to go out to 10-12 years. I’d say, though, that it is the utility and education sectors that have the most natural fit.”



Sustainable lending in focus as ING rolls out wholesale expansion in Australia

Sustainable lending is a key pillar of ING Bank (ING)'s plans to "significantly grow its wholesale lending business in Australia", which will also focus on the bank's strengths by sector and network capabilities. A local debt-capital-markets presence is not on the radar at present.

Gerrit Stoelinga, ING's Singapore-based chief executive, Asia, says the bank has identified Australia as one of the main growth opportunities in the region. It has been building a client list in priority sectors for the past five years – initially focusing on the utility-and-power, infrastructure and, more recently, real-estate sectors – but is now targeting growth sufficient to reshape the local balance sheet.

ING has more than A\$52 billion (US\$38.5 billion) of loans in Australia, the majority of which are retail mortgages – the bank says its book makes it the fifth-largest lender in the sector locally.

Uday Sareen, chief executive, Australia at ING in Sydney, says the bank hopes to increase the nonmortgage component of the local balance sheet to 20 per cent by 2020, from 10 per cent in 2015 – without losing mortgage market share. Some of the growth will come in other consumer assets like personal loans and credit cards, but a larger wholesale lending book is a clear target.

ING hopes that having a large and well-established Australian balance sheet offers it a differentiating factor in what it acknowledges is a competitive local wholesale-lending environment. "ING covers a wide range of sectors globally, and we felt bringing an expanded presence to Australia was something we could achieve because we have something to leverage off in the form of the retail balance sheet," Stoelinga says.

Charles Ho, head of wholesale banking, Australia at ING in Sydney, adds: "Having a large retail bank in Australia means access to a broad balance sheet and economies of scale operationally – both of which can support wholesale banking. It's not a

silver bullet but we believe these will help us grow in a competitive market."

The offering is likely to be relatively concentrated by product and service even as ING looks to grow its client base and sectoral coverage. Stoelinga says there is no intention to compete with Australia's major banks in areas like cash management and transaction banking, while ING's debt-capital-markets (DCM) presence is likely to remain low-key for the foreseeable future.

"Historically, ING has been a lending bank in the wholesale space and relatively

"We see lots of firms positioning themselves in the green-bond market but we want to be a market leader in green loans," Stoelinga reveals. "We worked with the Asia-Pacific Loan Market Association to establish the green-loan principles and were pleased to be involved in the first such transaction in Australia."

In future, ING's sustainable-finance offering in Australia may include "sustainability-performance loans", which tie the interest rate to both the borrower's rating and its sustainability performance. The first such loan was a €1 billion



"ING covers a wide range of sectors globally, and we felt bringing an expanded presence to Australia was something we could achieve because we have something to leverage off in the form of the retail balance sheet."

GERRIT STOELINGA ING BANK

underweight in DCM presence," Stoelinga adds. "This said, we have been building a presence in recent years and increased our mandates in the Asian region threefold in 2017. We don't expect to have a presence in local debt capital markets any time soon but we like to think we will be able to help in offshore markets as we build our client base."

SUSTAINABLE FINANCE

One area of focus for ING is sustainable lending, including the nascent green-loan sector in which it has already made its presence felt in Australia. ING was one of two green structuring advisers and a joint bookrunner on a £2 billion (US\$2.6 billion) loan facility issued by Macquarie Group (Macquarie) in June this year, which included £500 million of green-loan tranches.

(US\$1.2 billion) facility written for Philips in April 2017.

According to ING, the Philips loan is specifically tied to improvements in the borrower's Sustainalytics rating, meaning social and governance elements are as important as the environmental aspect. Unlike conventional green loans, pricing is linked to specific green covenants.

In November last year, ING converted a US\$150 million bilateral revolving loan facility for Singapore-based agribusiness company Wilmar International into the first sustainability performance loan in the Asian region. Ho says the bank has also had early-stage discussions with a client in Australia about the concept – though he adds that economics will only be one of many factors attracting corporate clients to sustainable borrowing.

TRANSACTION ANALYSIS

Retail-led sub supply boosts New Zealand corporate issuance

A trio of subordinated corporate debt deals priced in New Zealand between late May and early July, in what intermediaries say is a sign that local retail investors are supportive of issuance despite challenges in other funding markets. Scarcity of debt securities with the attractive headline yield offered by sub debt drove demand, they add. Meanwhile, market sources argue that the spread of issuers suggests the retail market is willing to engage with familiar and new names.



Issuer: **NZX**

Issuer rating: **NR**

Pricing date: **25 May 2018**

Maturity date: **20 June 2033**

Coupon: **5.4%**

Lead managers: **Forsyth Barr (ForBarr),
Commonwealth Bank,
First NZ Capital**



Issuer: **Genesis Energy**

Issuer rating: **BBB+ (S&P)**

Issue rating: **BB+**

Pricing date: **26 June 2018**

Maturity date: **16 July 2048**

Coupon: **4.65%**

Margin: **201bp/mid-swap**

Lead managers: **BNZ,
Deutsche Craigs, ForBarr**



Issuer: **WEL Networks**

Issuer rating: **NR**

Pricing date: **9 July 2018**

Maturity date: **2 August 2023**

Coupon: **4.9%**

Lead managers: **ANZ, Deutsche Craigs,
ForBarr, First NZ Capital**

TRANSACTION INSIGHTS

GARTH DIBLEY
CHIEF EXECUTIVE
WEL NETWORKS

“There is strong population growth in the region in which we operate, and we have already experienced growth in our business through investment in our fibre network. Investors, particularly those in our region, were able to identify this.”



DAVID MCCALLUM
DIRECTOR, DEBT CAPITAL
MARKETS
DEUTSCHE CRAIGS

“WEL Networks is a debut issuer, but investors understand the electricity-

distribution business and that the company has robust cash flows. There are also similar companies which are listed and which investors can look to.”

“There is a reasonable amount of cash in the market at the moment. Investors generally are more confident with senior debt, but subordinated debt offers good execution for the right names.”

MIKE FAVILLE
HEAD OF DEBT CAPITAL MARKETS
BNZ



“Retail investors are more concerned with the relative value of the yield being offered than they are with the potential for spread volatility, which is what a lot

of institutional investors focus on.”

“Pricing comes down to looking at secondary levels and extrapolating from them. We also look at the yield sensitivity, and where these factors intersect gives a good indication of where pricing should be.”

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15 November Westpac, Britomart **Auckland**

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LAURENCE DAVISON
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The will of the people

Capital markets seem to have come to an uneasy détente with the apparently unstoppable rise of populism in politics. But any interrogation of what populism really means should leave market participants worried about the effect its unchecked progress will have on the norms on which their livelihoods depend.

Populism is easy to identify in practice but actually somewhat tricky to define in abstract. *The Economist* describes the definition offered by political scientist Cas Mudde in 2004 as “increasingly influential”, so I will use it as the basis for my discussion. Mudde calls populism a “thin ideology” that establishes a framework of a “pure people” in opposition to a “corrupt elite”.

This thin ideology can be stapled to a more complex belief system as a means of explaining the world and justifying an agenda. Nationalism, socialism, anti-imperialism and racism are examples of the type of “thick ideology” to which populism adds appeal, and therefore power.

This definition chimes with two aspects of contemporary populism that have been playing on my mind for several years. Taken together, these two elements point to a worrying future in a populist environment for an industry, like financial markets, that relies on inherently complex systems that lie beyond the comprehension – and, to be fair, interest – of most people.

ASSUMED UNDERDOG-ISM

The first factor is the pervasive desire of many people to cast themselves in the role of underdog. This seems to be a fundamental human characteristic, whether or not the world is in the throes

of a populist paroxysm. It explains why, for instance, it is hard to find a fan of a sports team who doesn’t think their preferred outfit routinely gets the rough end of the stick from referees or unfavourable treatment from administrators.

This apparently innate human need to self-identify as oppressed or ill-favoured is

“ ONLY IN AN ENVIRONMENT OF CATASTROPHICALLY DUMBED-DOWN PUBLIC DISCOURSE COULD SOMEONE WHO HELD THE HIGHEST OFFICE IN THE LAND SAY ‘IT’S A BASIC LAW OF ECONOMICS THAT INCREASING THE SUPPLY OF LABOUR DEPRESSES WAGES’ AND PRETEND IT HAS SOME VALIDITY AS AN ARGUMENT AGAINST IMMIGRATION. ”

grist to the mill for populist leaders, who can tell a cohort of potential supporters that, yes, the ref has been blowing penalties for the opposition far too easily all day long.

It is for this reason that the purported anti-elitism of populist politics scores. It also explains why populism demands elites to rail against instead of – or at least as well as – more generic enemies. For a nationalist, foreigners will suffice as the opponent – only populism demands the existence of elites as ‘advocates of unrestricted immigration’.

What a populist overlay adds to the volatile mix is the irresistible element of an elite that, in some nebulous way, benefits from the presence of the foreigners the underlying nationalism seeks to vilify. Hence the thin ideology

attaches itself to the thick one and gifts it a thesis to present to the populace as a lure for its support.

This is why one side of the climate-change ‘debate’ focuses on the liberal media and intelligentsia. It seeks to fabricate a situation in which two sides not only have equal validity in theory but where one – not coincidentally the objectively wrong one – also has the moral authority. Pro-Brexit voters, meanwhile, will swear blind that their opposition to the EU was nothing to do with immigration but entirely based on a desire to “take back control” from a shadowy elite “in Brussels”.

THE DEATH OF COMPLEXITY

The second critical factor inherent to populism is its embrace of a rejection of complexity that has already taken a firm hold on contemporary politics. There is a lot of talk nowadays about what one can and can’t say, but it seems to me that in the public realm the only thing a politician or chief executive absolutely, definitively couldn’t get away with saying is anything to the effect of: “This is a very complex issue with no simple solutions, and there is a decent chance that most of you don’t have the time, inclination or intellect to grasp it.”

Instead, politicians of all stripes are locked in a death spiral of simplification, assuring voters that hugely complex problems can be solved with three-

word slogans – or just ignoring them completely.

Let's take as an example Tony Abbott, a man who clearly sees himself as Australia's answer to Donald Trump – and probably isn't entirely wrong to do so, albeit perhaps not in the way he thinks.

Only in an environment of catastrophically dumbed-down public discourse could someone who held the highest office in the land say "it's a basic law of economics that increasing the supply of labour depresses wages" and pretend it has any validity as an argument against immigration. But in a world where "jobs and growth" counts as an economic policy, objections to the facile nature of this pronouncement are restricted to the realm of, inevitably, the liberal elite.

The natural conclusion of this rejection of complexity is an increasing prevalence of false equivalence. Here, the fact that – for instance – economic projections are not 100 per cent accurate is sufficient grounds to assign them no greater credibility than the ravings of the ill-informed and venal. After all, in the words of the egregious Michael Gove: "People in this country have had enough of experts."

TRUBLE AHEAD

So far, so obvious. What I am concerned about is the tendency in financial markets to seek to normalise the political realm's most worrying trends. I have lost count of the times I have heard or read a market participant arguing that the practical consequences of Donald Trump's US presidency have been limited or even positive, and in fact most of the noise is no more than the predictable effluent belching forth from the sewer of 21st century discourse, Twitter.

I will allow that this is strictly market commentary, and some or all of the

normalisers are putting aside personal views on the streak of ethno-nationalism that accompanies the Trump project. But seeing Trump's policy outcomes as conventionally successful economic liberalism even in the narrowest terms seems bizarre to me. The Trump administration's signature legislative achievement is to pump a vast stimulus into a growing economy – a move with terrifying long-term implications under any economic orthodoxy one cares to name.

This rush to normalise speaks of a degree of complacency among market professionals, and one which is already showing signs of running into jarring reality. It would be unwise to assume that capital markets – with their inherent complexity and apparent status as a

would see anti-bank policy go the way of the mining tax. Again, the early signs are not good for the banks.

TIDE OF HISTORY

At the moment, the message of populist leaders appears to be mainly one of punching down – of identifying areas where the marginally comfortable feel hard done by, and blaming the less comfortable.

We live in a world where Trump supporters can bay "drain the swamp" at campaign rallies and not flinch in their support when he packs his administration with ex-Goldman Sachs bankers. So perhaps capital markets will manage to get by in their position as an elite, but not the type of elite that draws fire from the strongmen.

But the signs are not good. In Australia, the royal commission has helped focus the vague anti-bank sentiment that sprang to the surface a decade ago. Like the UK's place in the EU, there has been no public discussion about the purpose or value of the financial sector;

nothing to counter the easy points to be scored by knocking strips off the banks.

Even if the status quo survives the current wave of predominantly right-leaning populism, there is nothing to say that an economically disenfranchised electorate won't tire of Trumpian hot air and turn to a different set of easy answers – those provided by a Bernie Sanders, Jeremy Corbyn or another voice with much less inclination to allow the market establishment a free pass.

In a column about the danger of promoting simple solutions to complex problems it would be nonsensical to suggest there is a straightforward way out of the populist mire. But the path has to involve an end to normalisation and a fight for the broad acknowledgment that easy answers are rarely the right ones. •

“IT WOULD BE UNWISE TO ASSUME THAT CAPITAL MARKETS – WITH THEIR INHERENT COMPLEXITY AND APPARENT STATUS AS A STAMPING GROUND OF THE ELITE – WILL FOREVER BE SPARED FROM THE POPULIST INQUISITION BY MISDIRECTION OF PUBLIC IRÉ TOWARDS THE LESS ADVANTAGED AND THE CULTURE WARS.”

stamping ground of the elite – will be spared from the populist inquisition thanks to misdirection of public ire towards the less advantaged and the culture wars.

Brexit provides a useful analogue. After 40 years of doing little to counter a negative media and public narrative about the EU, a hubristic British political class attempted to convince its electorate over a six-week referendum campaign that the European project was not, in fact, its implacable foe. They failed, of course.

I got a similar sense of complacency about the Australian banking sector ahead of the royal commission. Even when the government introduced its banking levy, the sector appeared to think that the combination of a broadly on-side government and a decent PR campaign

SDG integration and the impact-investment landscape

The relatively nascent state of Australia's impact-investment market is demonstrated by the ongoing development of impact-measurement standards according to recent work by Responsible Investment Association Australasia (RIAA). However, the UN sustainable development goals (SDGs) may be emerging as an assessment framework in a sector dominated by green bonds.

BY LAURENCE DAVISON AND MATT ZAUNMAYR

A report published by RIAA in July suggests that a final state for impact measurement remains some way off. However, the report and speakers at a market forum hosted by RIAA in the same month suggest engagement with the SDGs is growing.

The report says: "This year's data set shows that while there is more consistency in the 2018 data set to 2016 apex metrics than not, there are particular outcome areas that do not match neatly to what was being measured two-and-a-half years ago. One explanation is that impact management and measurement is bespoke to the individual investments and impact strategies associated with each investment."

The report notes that impact measurement continues to be a "relatively young and emerging" field with "healthy debate about the protocols, best practice and reasons for measuring impact". Interest may be coalescing around the SDGs, though.

Six institutions that provided input to the RIAA study say they have engaged with the SDGs as a measurement or reporting framework – out of 24 that participated in total. No more than two institutions mentioned any other specific framework for impact assessment.

Simon O'Connor, RIAA's Melbourne-based chief executive, adds: "Investors are increasingly reporting on how their investments are contributing to delivering on the UN SDGs, an area that we are seeing again influence the portfolios of investors well beyond the impact-investment market."

MARKET VIEWS

Debt-market-relevant institutions say they are increasingly integrating the SDGs into their sustainability agendas, with potential consequences for green and social funding. The critical role of the SDGs is to provide a common language for capital-markets participants to assess impact.

Large companies can legitimately claim to have some interaction with all 17 SDGs. However, the consensus appears to be that the optimal strategy is to focus on the goals with which an organisation can have the most meaningful impact, according to market users participating in RIAA's July webinar.

Eliza Mathews, Sydney-based associate director, sustainable finance at ANZ, says the SDGs broadly correlate with the bank's purpose and corporate-sustainability framework. This led to the identification and selection of nine SDG goals which ANZ used as the basis for the first-ever Australian-issuer SDG bond.

Of these nine goals, funds from the bank's €750 million (US\$868.7 million), five-year deal are currently addressing six. "Importantly, it is not only the goals we are looking at addressing but the specific targets and indicators that fit within those goals," says Mathews.

One of the most commonly expressed criticisms of the green-bond asset class is that it directs financing exclusively to existing qualifying assets – in effect, that it allows issuers and investors to label their 'good' assets but does not facilitate funding of more complex, but potentially more meaningful, environmental transition. Some market users believe the SDGs provide solid foundations for a more dynamic sustainable capital market.

With a business model based on the use of toll roads, Matthew Brennan, head of sustainability at Transurban in Sydney, acknowledges that a certain level of carbon intensity is currently unavoidable for the company. At the same time, when the company studied the individual SDGs Brennan says it discovered consistent alignment with Transurban's established sustainability aspirations.

The company has launched initiatives based around specific SDGs in areas in which Transurban believes it can have a significant impact, such as helping customers facing financial hardship, encouraging carpooling to decrease emissions, increasing road safety, and designing and operating roads in ways that reduce emissions and congestion.

On the investor side, asset managers say identifying goals they can address through their investment choices is helping move the conversation about responsible investment to a focus on positive impact rather than risk management.

Piet Klop, senior adviser, responsible investment at PGGM in Zeist, who participated in the RIAA webinar, says the pension fund has chosen four areas in which it wants to have impact: climate, water, food and health. “We wanted to map the solutions we could think of to each of the targeted SDGs. Once this was done we could establish rules and criteria by which investments qualify as sustainable-development investments,” he comments.

Closer to home, Nicole Bradford, Melbourne-based portfolio head, responsible investment at Cbus Super, says the fund has integrated the SDGs into its process. “Our investment committee has approved new responsible-investment policies, which is how we formally brought the SDGs into our investment process. This not only guides how we invest but also how we engage with companies and our external fund managers,” says Bradford.

Identifying SDGs that are a natural fit with a company’s sustainability agenda or an investor’s goals is one thing. The next step is quantifying impact. Proving that a company’s commitment to certain SDGs is having real-world effects is the critical piece in assessing the impact of corporate SDG alignment.

Market participants broadly acknowledge that reporting on the impact of company decisions is one of the most important and challenging aspects of SDG integration. Klop says some funds in Europe have established what proportion of their portfolios is SDG-compliant and have thus been able to assign a euro value to compliance.

This is impressive at face value, but Klop argues it that it is probably not the end game for SDG integration on the buy side. “We are more focused on the measurement of tangible impact. Ultimately the purpose of aligning with the SDGs is to demonstrate and measure real difference rather than the euro value,” he says.

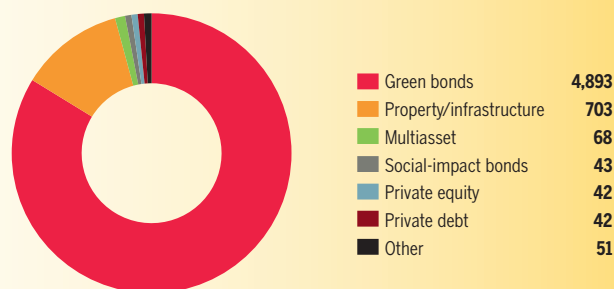
BOND PROMINENCE

How the bond market chooses to act could be critical for the role of SDGs in Australian impact investment, because green bonds make up more than three-quarters of the sector by dollar volume according to RIAA’s study. It suggests that, at A\$5.8 billion (US\$4.3 billion) of committed funds, impact investment remains a niche market in Australia – but one that has experienced exponential growth.

The RIAA report draws on data from 1 July 2015 to 31 December 2017. It finds that impact-investment volume in Australia grew from A\$1.2 billion in this period with green bonds accounting for the majority of growth. Green bonds make up A\$4.9 billion of the total in the new report (see chart), growth of around A\$4 billion from 2015.

“When compared with the broader financial market, some may argue that the size of impact investments remains small, and as a result, inconsequential. However, this would be to miss the

AUSTRALIAN IMPACT-INVESTMENT COMMITMENTS BY ASSET CLASS (\$M)



SOURCE: RESPONSIBLE INVESTMENT ASSOCIATION AUSTRALASIA JULY 2018

much greater market influence of impact investing, which goes to the very nature of how investing is considered,” says O’Connor.

The pace of overall growth in Australian impact investment picked up significantly in 2017, the RIAA report finds. Green-bond issuance so far this year has maintained the pace of 2017, and with no maturities in the asset class locally until 2019 this will continue to drive impact-investment growth.

KangaNews data show more than A\$2.5 billion of green and renewable-energy bonds printed in Australia last year – a substantial component of the A\$3.4 billion of overall impact-investment asset growth in the RIAA report – and issuance in 2018 was nearing A\$2 billion by early August.

As an emerging asset class, defining impact investment remains a central theme of the RIAA report. To be included, investment products had to demonstrate that they had committed capital in a manner that is intentionally seeking positive social or environmental benefits, that they are measuring both these benefits and financial performance, and that they are seeking financial return – in other words, are not “grant making”.

The inclusion of green bonds appears to have been a subject of some debate. The report says they were included “as they meet the study criteria for inclusion by intentionally targeting positive environmental impacts, deliberately seeking positive financial returns, and measuring both”.

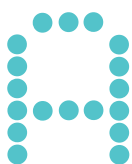
However, it adds that study consultation suggested green bonds potentially be treated differently in part because of their “clearly differentiated impact strategies”. The report does not have a blanket inclusion for all socially themed bond products, and RIAA notes “unclear or insufficient intentionality or measurement of social or environmental outcomes” in some cases.

“An interesting example is Australia’s first gender-equality bond, issued by National Australia Bank in 2017 to provide financing to organisations certified by the Workplace Gender Equality Agency as employers of choice for gender equality,” the report states. “Although examined, this bond was not considered to meet the criteria for the study because the organisations receiving the finance do not have limitations on what they do with the capital, ie the capital does not have to be used to generate positive social impact.” •

INSTITUTIONALISING THE SIB MARKET

The use of social-impact bonds (SIBs) by governments, around the world and in Australia, is continuing to expand as stakeholders seek to mobilise private-sector capital for social gain. However, the problem of replicating what has already been achieved at scale and in a format that works for institutional investors is proving difficult to overcome.

BY MATT ZAUNMAYR



As the sustainable-debt market progresses its thinking about applying more rigour to defining, assessing and reporting impact, so the challenges of social investment loom more into view. Where the green-bond space is in theory relatively straightforward – because carbon mitigation lends itself to quantification – the social realm is harder.

At present, the most investable product for the institutional market – social bonds – can struggle to tick all the boxes on impact measurement. For instance, the “social bond (gender equality)” issued by National Australia Bank (NAB) in 2017 was excluded from Responsible Investment Association Australia (RIAA)’s total of Australian impact-investment securities because the proceeds could not be directly ascribed to specific positive impact.

Meanwhile, the debt product with the clearest link to positive social outcome – SIBs – presents significant challenges to institutional investors. In fact, takeup in Australia has largely been limited to the likes of charitable trusts, philanthropic foundations and family offices with radically different investment mandates from mainstream funds.

The question is whether the two worlds of social projects and capital markets can be united by a common language. The answer is as yet unknown.

SIBs allow a government entity to incentivise private investment in an organisation or project targeting a specific social outcome by offering a higher rate of return when outcome hurdles are met by the organisation. A typical project might target rehabilitation of prisoners, where the government commits to paying a higher rate of return if recidivism is reduced by at least a target rate.

Successful projects can be mutually beneficial. Governments are able to save money because even a higher rate of direct funding is more than offset by the savings generated by the success of the project – in the example case, this would be less future incarceration. Meanwhile, investors receive a higher return when the desired outcome of the SIB is achieved.

BUILDING A MARKET

According to UK-based non-profit organisation, Social Finance, the equivalent of US\$392 million has been raised across 108 SIBs globally. The majority of these have been in the UK and US. In Australia, there are currently 12 SIBs in various stages of development from four jurisdictions, with the New South Wales (NSW) Office for Social Impact Investment (OSII) recently beginning the process of taking proposals for two more.

Ben Gales, Sydney-based executive director, economic strategy at NSW Treasury, says: “It is a challenge for governments to find the right solutions on issues like homelessness and recidivism. We think social-impact investment provides a good alternative to traditional government policies by leveraging the expertise of non-profit organisations and providing reward for outcomes.”

Christine Crain, Brisbane-based director of Queensland Treasury’s Social Benefit Bonds Pilot Programme, tells *KangaNews*: “The cost of interventions is considerable. On the other hand, the long-term cost of not having interventions that make an impact is the continued consumption of acute services – which is of course even higher over long periods.”

There are signs that some institutional investors are at least trying to engage with the concept. QBE Insurance (QBE) was one of the earliest institutional movers in the space, announcing in 2014 a plan to invest US\$100 million in SIBs globally. James Pearson, manager, responsible investments at QBE in Sydney, says in committing these funds the firm wanted to stimulate the market and bring attention to the space, which it hopes will in turn lead to more institutional interest.

But deal sizes remain relatively small, even in the jurisdictions where the product is most developed and has most scale. Some of the critical features of a SIB structure are inherently difficult for institutional investors to address.

First and foremost, risk assessment in SIBs takes a completely different form from a standard bond. Daniel Madhavan, chief

executive at Impact Investment Group in Melbourne, says: “Institutional investors are used to taking on balance-sheet risk in fixed-income investments. Effectively, SIB investors are taking on contract risk: the ability of the organisation to deliver the outcomes mandated in its contract with government.”

The credit work an institutional investor would usually apply to a bond investment is therefore inapplicable to the assessment of a SIB. Most institutions have neither the experience nor the mandate to undertake the type of work Madhavan describes, particularly when the volume on offer is less than the threshold of participation for these investors.

KangaNews understands some Australian superannuation funds have looked at investing in SIBs. But the cost associated with evaluating the transactions is too high for most.

Nor do SIBs feature the quick path to market of benchmark bonds. Market users say the typical timeframe for a SIB to go from first conversations with an organisation to the beginning of service delivery is two years. It may be another two years before the programme begins to deliver results, with income flow in the interim likely to be below market rate and question marks lingering about exactly how success should be measured (see box on p18).

David Carrington, London-based consultant and adviser to Giving Architects, suggests the complex and time-absorbing process to go from proposal to implementation and outcomes means it is unlikely the majority of institutional investors will be able to justify devoting the appropriate time to SIBs in their current form and volume.

PROJECT SCALE

This introduces the issue of scale. In theory, simply having larger and more frequent transactions might incentivise institutional managers to devote resources to the SIB product – even more so given the growing trend, especially at superannuation fund level, for environmental, social and governance factors to be made integral to the investment process.

Building track record, and proving results, will clearly be crucial in achieving scaled-up SIB deals. Market users agree that as more SIBs come to market it can be expected that a common approach to things like impact measurement will start to emerge – paving the way for wider investor engagement.

The problem is that SIBs as currently construed tend to be built around highly targeted projects with relatively small subject cohorts. This may be required given the complex world of

long-term impact measurement, but it is hardly ideal for building institutional scale.

James Waddell, director, capital markets origination at NAB in Sydney, highlights the On TRACC SIB, which addresses recidivism in NSW – currently for 600 parolees per year. This will shortly increase to 900, but Waddell says this is close to a reasonable limit for such a programme in NSW. “If you scale up an intervention in recidivism you eventually need more people to be in prison. This is clearly not ideal as a societal outcome,” he says.

Specific sponsor circumstances only exacerbate the challenge. For instance, Crain says scaled-up deals may be even harder to deliver given the focus of some of Queensland’s SIBs falls outside the populous south-east of the state.

The long-term horizons of many social interventions also make it hard to predict that governments will massively ramp up their support of SIBs. Governments typically want results to fall within near-term budget and election cycles, while the results of a wide-scale intervention in an area such as housing may not be fully realised for years or even decades.

Ideology and political forces also play a part. Indeed, the very first SIB – designed to reduce the rate of recidivism at Peterborough Prison in the UK – was ultimately cut short. Market sources say the SIB succeeded in reducing recidivism and saw investors repaid in full, but it was abandoned early as the UK government implemented a new national programme.

Carrington says the Peterborough Prison deal taught all involved a lot about how to structure and execute this sort of transaction. However, he believes it would have been even more successful were it allowed to run to completion.

The fate of the UK project also hints at a further risk for investors. “The possibility of a government changing policy direction before the maturity of an intervention certainly doesn’t encourage long-term, patient investors to participate in these deals,” Carrington adds.

In New Zealand, the former National government was eager to use SIBs to tackle issues such as mental health and youth unemployment. However, the new Labour-led government has announced that it is not planning any SIBs.

The door has been left ajar for other types of social investment in New Zealand, though. Clive Pedley, Auckland-based director and chief executive at Giving Architects, says a recent social-impact-investment transaction has many of the characteristics of a SIB but without the payment-for-success piece – which he says provides more certainty for investors.

“Institutional investors are used to taking on balance-sheet risk in fixed-income investments. Effectively, SIB investors are taking on contract risk: the ability of the organisation to deliver the outcomes mandated in its contract with government.”

DANIEL MADHAVAN | IMPACT INVESTMENT GROUP



THE MEASUREMENT PIECE

Social-impact bonds (SIBs) are designed to produce measurable impact thanks to the payment-for-outcomes structure most feature. Actually delivering an outcome that is quantifiable to capital-market investors is perhaps the most important and complex piece of the puzzle.

How social outcomes are measured tends to vary between SIBs, and for many the true outcomes will not be seen for many years or be highly complicated to measure definitively. With return dependent on positive outcome, anything less than the most rigorous standards for impact measurement makes it difficult for investors rationally to assess the risk involved in investing in SIBs.

David Carrington, consultant and adviser to Giving Architects, says the natural way in which an institutional investor that is interested

in a SIB would measure an outcome might be simply to count the number of people that have participated in a project and take that number as a measurement of success or failure.

This is likely simply not good enough. "The measurement of success has to be whether it made a difference to those people's lives, not just how many people went through the process," Carrington explains.

More nuance is required. James Waddell, director, capital markets origination at National Australia Bank, uses the

example of an intervention in homelessness. "The immediate cost of an intervention, which would involve getting a person registered for government welfare programmes, is easy to measure. However, future cost saving from that person's decreased use of emergency services and justice services is more difficult to quantify," he says.

Ben Gales, executive director, economic strategy at New South Wales Treasury, says proxy measures can allow for easier measurement and help accelerate the timeframe involved.

"The true cost saving to government in providing stable housing comes from the decreased use of emergency services and welfare in the long term. This is difficult to quantify, but as a proxy if someone is in stable housing for two years the government would be happy to pay for that outcome because it is a fraction of the long-term cost of the alternative," he says.

SIBs are less than a decade old as an asset class and market users say it is natural that impact assessment is still being ironed out. In the end, investor expectations will likely set the path.

James Pearson, manager, responsible investment at QBE Insurance, says his firm's process for investing in SIBs has evolved over time. "Our investment process has been informed by our experience as a SIB investor across multiple markets, including early-stage involvement in US SIB transactions. We consider many factors, including the programme intervention and the alignment of successful programme performance with financial risk and return."



"The measurement of success has to be whether it made a difference to those people's lives, not just how many people went through the process."

DAVID CARRINGTON GIVING ARCHITECTS

PROGRESS AND POSSIBILITIES

To date, the context in which a SIB is developed arguably has more influence on its format than considerations of investability. Carrington says: "There are now 18 countries with national advisory boards for social-impact investing. Each is developing at a different pace and in different ways, as you would expect, though there are a lot of similar themes between them."

Carrington says the Global Steering Group for Impact Investment is allowing stakeholders in the space to pool their learning.

Despite some false starts, there appears to be relatively consistent desire from governments, intermediaries and some progressive institutional investors to bring SIBs into the institutional light. Madhavan reveals that some institutional investors have already participated in SIBs as a market-building exercise.

Social Finance's London-based chief executive, David Hutchison, says institutions are tracking the market and, in this

context, the positive returns of the first SIBs is reassuring. He says some transactions have been structured to attract institutional investment, for example through principal guarantees, though this may not be a long-term fix. "The net effect of this has been to offer unsustainably generous returns on the proportion of capital at risk," Hutchison explains.

While this initiative may not be the answer, limited institutional-investor participation in the SIB market should not be taken as a failure, market participants insist. For one thing, no-one involved in the sector expected institutional funds to be early adopters.

Furthermore, the ramifications for economic and social policy would be immense if governments successfully mobilise mainstream private investment funds for SIBs and other debt-based impact-investment models in the volume that a regular government bond deal might achieve.

Pedley says: "The idea of government de-risking, rewarding or incentivising private wealth to participate in social and environmental purpose is essential. SIBs provide a model to

“The cost of interventions is considerable. On the other hand, the long-term cost of not having interventions that make an impact is the continued consumption of acute services – which is of course even higher over long periods.”

CHRISTINE CRAIN QUEENSLAND TREASURY



do this, but the model doesn't fit very well at the moment for institutional money. There needs to be innovation from all parties for this to work at scale.”

AGGREGATED ACCESS

One way of removing some of the due diligence and time cost for potential institutional investors is to create an aggregated fund. The first of these have already been established abroad, with QBE providing the cornerstone for the first US-based SIB fund in 2017.

Pearson tells *KangaNews*: “Aggregation of SIBs into a fund vehicle mitigates some of the risks and transfers a lot of the time-intensive factors that are difficult for institutional investors onto a fund manager, who is likely to be closer to the service provider and more experienced with the social-impact area.”

Whether there is enough SIB scale in Australia to establish a fund is debatable. But Pearson believes this innovation would be more than welcome in the market as a signal of intent and commitment to the product from investors.

Hutchison says another route to scale that has been observed in the UK is for an intervention with a track record of success to be commissioned by multiple local partners. He highlights a successful intervention to support the families of adolescents at risk of entering the care system in Essex, launched in 2012 and terminating this year.

“This has established a value-for-money case that has encouraged five London boroughs to commission the same service off the same platform on identical terms. It required the raising of £5 million [US\$6.5 million] of risk capital with the prospect of at least the same required again to support the expansion of the intervention across the Greater London area,” Hutchison says.

Innovation in the way SIBs are structured to deal with risk is evolving to enable greater participation from institutional

investors – and Australia is playing a role in the sector's development (see box on p20).

It may also be possible to engage institutional investors in a way that allows scale to come into the market without requiring the mainstream funds sector to familiarise itself with the most challenging aspects of social-project funding. Most non-profit organisations and NGOs have backing from philanthropic supporters, and Waddell says these can provide leverage as guarantors to the working-capital provider should the programme not deliver the contracted results.

SIBs could effectively take on a guise similar to the securitisation market, where the investors providing the higher-risk but smaller-volume capital at the mezzanine and equity level are often completely different from those contributing the bulk of funds in the top tranches.

Pearson says a structure has been used in the US with layering of capital in junior and senior tranches. “As an insurer that is focused on capital preservation and lower volatility, being invested in a senior tranche – where the junior tranche would be exposed to the first loss – would be very attractive,” he adds.

When it comes to political risk, Madhavan suggests a possible way to mitigate policy change would be for institutions at least one step removed from the political realm to become the issuers of SIBs. Development impact bonds – where institutions such as aid agencies or NGOs are the outcomes payer – are becoming popular in emerging markets.

The concept has yet to be taken up by the private sector, according to SIB market participants, but how it might work is clear at least in theory. For instance, in the health sector a SIB might be used to fund prevention of diabetes or heart disease, where there are well-known steps that can be taken to reduce the risk of the disease developing. Pearson says this could present tremendous cost savings not only for government but also for health-insurance companies.

“The idea of government de-risking, rewarding or incentivising private wealth to participate in social and environmental purpose is essential. SIBs provide a model to do this but for institutional money the model doesn't fit very well at the moment. There needs to be innovation from all parties.”

CLIVE PEDLEY GIVING ARCHITECTS



AUSTRALIAN EXPERIENCE AN INNOVATION

Australia may not have been the first country to adopt social-benefit bonds (SIBs) but it is among the market leaders in the number of projects, drive for wider investment and willingness to innovate and share knowledge.

Having invested in nine SIBs globally, four of which are in Australia, QBE Insurance (QBE) has perhaps the best view on the state of play locally. James Pearson, manager, responsible investments at QBE, tells *KangaNews* the SIBs his firm has been involved with in Australia tend to be in a more familiar format to institutional investors than those it has seen offshore.

Being based in Australia helps with due diligence, but Pearson also says Australian SIBs benefit from greater collaboration among the various parties.

New South Wales (NSW) might have the most developed SIB programme in Australia. The state's Office of Social Impact Investing (OSII) has

six transactions ongoing, two new deals it has begun taking proposals for and another in development. Ben Gales, executive director, economic strategy at NSW Treasury, says OSII is developing track record with these deals and has built a standard legal template to boost investor familiarity.

Furthermore, the two new programmes for which OSII is now taking proposals incorporate innovations Gales believes will help make allocation decisions easier for institutional investors.

One such innovation is the use of an outcomes rate card, which OSII is implementing for its SIB to address homelessness. Outcomes rate cards, which were first developed in the UK, provide a

list of outcomes a government wishes to achieve through a SIB and the monetary value it is willing to pay for the achievement of each one.

Gales says the rate card is designed to streamline the transaction process. "Bringing simplicity to the process will hopefully encourage more institutional interest and should also help speed up transactions," he says.

Meanwhile, James Waddell, director, capital markets origination at National Australia Bank, says the bank has used a structure which minimises the risk for the working-capital provider by involving philanthropic capital. "Rather than packaging up the working-capital requirement and the risk of failure together,

we have broken the risks out by looking at who is best placed to take on that risk," he says.

By using this format, Waddell says the transaction cost of a SIB can be decreased dramatically. Working capital can be provided by a reliable low-cost provider with the risk of failure taken by the philanthropic fund.

Collaboration between jurisdictions is often crucial for markets during the early stages of development. This is also in evidence in Australia, despite the states all referring to their programmes by different names.

Christine Crain, director of Queensland Treasury's Social Benefit Bonds Pilot Programme, says: "There has been a lot of sharing between the states that have executed these transactions. Each iteration sees replication and improvement which helps reduce transaction development time and cost, and also shows investors in the market that there is a similar look and feel as well as common language to these transactions."



"Bringing simplicity to the process will hopefully encourage more institutional interest and should also help to speed up transactions."

BEN GALES NEW SOUTH WALES TREASURY

SIB issuance by institutions other than governments could potentially serve as the springboard needed to introduce more scale and entice institutional money. The long-term prospects of projects run by private-sector entities, and therefore the SIBs they issue, could be less contingent on the whims of government policy. With more actors able to participate, the quantity of transactions could also be greater.

Madhavan also identifies SIBs as theoretically tempting to institutional investors as a diversification tool. If transaction risk can be successfully mitigated, the returns SIBs offer for successful interventions should be very attractive to investors as they increasingly look for assets that provide an uncorrelated opportunity.

SIBs are a unique asset class, and Pearson agrees that they would offer portfolio diversity. However, he stresses that at their

current size SIBs are relatively immaterial in diversifying an overall institutional-size portfolio.

SIBS IN CONTEXT

At this stage, any realistic assessment of the state of the SIB market has to acknowledge that it is not yet close to being an institutional product – and that the majority of mainstream fund managers are not close to allocating.

SIBs are a small segment of the overall impact-investing space. According to a report by RIAA, there was a total of A\$5.8 billion in committed funds in Australian impact investing by the end of 2017. Of this, the report states SIBs account for A\$43 million (see p14).

Part of the challenge lies in identifying sectors where scale might be available. Areas like health and housing, where

“If you scale up an intervention in recidivism you eventually need more people to be in prison. This is clearly not ideal as a societal outcome.”

JAMES WADDELL NATIONAL AUSTRALIA BANK



governments spend billions of dollars on solutions, are perhaps the most readily applicable to a scaled-up SIB.

Both sectors have had vanilla bond issuance in various jurisdictions. Housing New Zealand's recent capital-markets return and International Finance Facility for Immunisation's "Gavi bonds" are examples of large, institutional investor-backed deals which produce positive social outcomes.

Even so, a SIB product with returns directly linked to positive outcomes could have a substantial impact in critical service provision if the institutional investor base can be attracted to the asset class. The question is whether this direct link is absolutely critical to mobilising institutional funds for social benefit, and indeed whether the two sectors can ever realistically interact in scale.

Gales says OSII will be working closely with NSW Treasury Corporation for its proposed sustainability bond, which was announced in June 2018. The transaction will not include payment for outcomes, however.

But Carrington says: "It is fine for an institutional investor to want their money to be going towards positive outcomes without being as involved in the process as they would be in a SIB. The most important step for these investors is wanting their money to be used in this way, and many are beginning to take it."

Waddell points out that not all societal problems should be looked at in relation to SIBs, and in fact it would not be appropriate for governments to do so. Australia's federal government announced in its 2017 budget plans to establish the Australian Housing Finance Corporation (AHFC), a bond aggregator which will raise low-cost debt and provide loans to not-for-profit community housing providers.

With any bonds issued by AHFC guaranteed by the government, and volume likely to be substantial, institutional investors would likely be more immediately interested in this transaction than they would in a SIB addressing a similar issue.

Even so, the existence of other government plans to bring a greater quantum of institutional funding into social-policy prerogatives does not necessarily mean SIBs will inevitably only ever be a niche component of the social-impact-investment scene. It is evident, however, that the choice of projects to which SIBs are applied is critically important, even more so if it is to be done at scale.

The reality for now is that SIBs, despite their potential for higher returns when outcome hurdles are met, simply cannot provide the scale of return necessary to attract widespread take-up from mainstream investors. However, the funds being dedicated to impact investing continue to grow and so too does the desire from many investors to see real impact outcomes from their allocation decisions.

Pedley tells *KangaNews*: "The fundamental driver of this is that money is being looked after on behalf of conscious consumers who are now becoming conscious investors. Fund managers and institutions are having to behave differently to respond to this."

The forces driving these types of investments, as well as those prompting governments to seek private investments in the provision of social services, are likely to continue.

This is evident in QBE's Premiums4Good offer, which has committed an additional A\$100 million to impact investing in 2018. The funds are available to the full spectrum of impact investing, from SIBs to green bonds, with the scale expected to increase in future years.

Pearson says: "We knew coming into these deals that they would be small. We look at the transactions for social and financial returns. But it is also about showing our credibility to the impact-investment market and offering our policyholders, through our Premiums4Good offering, the chance to align their beliefs around community and the environment with their purchase of insurance." •

“As an insurer that is focused on capital preservation and lower volatility, being invested in a senior tranche – where the junior tranche would be exposed to the first loss – would be very attractive.”

JAMES PEARSON QBE INSURANCE





BIG-FOUR FUNDERS TALK STRATEGY AS THE SEASON CHANGES

KangaNews and **RBC Capital Markets** hosted their annual roundtable for heads of funding at Australia's big-four banks in Melbourne on 13 August. After an almost unprecedented period of benign market conditions, 2018 has posed new challenges and seen execution risk back on the table. The issuers acknowledge the revived headwinds but say they are well-placed to navigate them.

PARTICIPANTS

- **Alex Bischoff** Executive Director and Head of Global Funding WESTPAC BANKING CORPORATION
- **Mostyn Kau** Head of Group Funding ANZ BANKING GROUP ■ **Kylie Robb** Head of Group Funding COMMONWEALTH BANK OF AUSTRALIA
- **Eva Zileli** Head of Group Funding NATIONAL AUSTRALIA BANK

MODERATORS

- **Laurence Davison** Managing Editor KANGANEWS ■ **Gerard Perrignon** Managing Director, Debt Capital Markets RBC CAPITAL MARKETS

EXECUTION CONDITIONS

Perrignon Conditions were clearly stronger when we had this discussion last year than they are now, including spreads near record tight levels and a broad base of investors engaged across a range of asset classes. In your minds, what are the most notable changes from an execution perspective?

■ **KAU** Conditions aren't the slam dunk they were as recently as January this year. But underlying fundamentals are still pretty good – it's mainly technical factors and risk around geopolitics and trade wars that are causing challenges.

We are seeing equity markets testing new highs and credit periodically rallying, but it feels like we are at one of those inflection points during which something fairly innocuous can set off markets and unwind a lot of what I'd call 'goodwill'. That's a gut-feel call on my part, but I have a sense that a more serious correction is not out of the question.

■ **ZILELI** The real change from my perspective is investor participation – in volume and in number. Comparing our January and June US dollar trades, there was a difference in the granularity of the books. Issuers have to do a lot more due diligence ahead of trades now, and even then we can't be certain of success in the same way we could be in 2015 and 2016. Liquidity was really phenomenal in those years, and navigating the deal process is trickier now. As Mostyn Kau says, it's no longer a slam dunk.

Investors are more wary about geopolitical concerns and are looking for higher new-issue concessions. They don't want to invest in a bond and see it widen in the secondary market straight after issuance. This is a change, and I don't see conditions reverting to what they were in 2015-16.

■ **PERRIGNON** In those years my sense was that the top 15-20 per cent of deal books often comprised 'momentum'-type investors that participated because credit spreads were tightening and conditions felt very good. That portion of the order book seems to have been stripped away, with the result that a multi-tranche, US dollar book from a major bank is less likely to generate US\$6-7 billion of demand. It's more like US\$4-5 billion nowadays.

■ **ZILELI** I think that's right, but we've also seen fewer of the mid-range investors – by which I mean US\$25-50 million

tickets – active in our books. If anything, we can be more reliant on a few of the bigger accounts. These accounts tend to be quite price-sensitive, and at times we have seen some of them drop out of books on the back of a 1-2 basis point tightening.

■ **KAU** I agree that investors have a lot more pricing power than has been the case. Until recently, market momentum and investor inflows meant they had to come into deals. The pricing power has definitely shifted to investors from issuers.

■ **BISCHOFF** This is all true, but I'd also say that where we are now is more of a normal state of affairs than what we experienced over the past couple of years. Volatility isn't abnormal. The way I'd describe the change is to say that a year or two ago any of the Australian majors could have executed more or less any trade on more or less any day, whereas execution risk has now returned.

We are already seeing the majors change their execution strategies in response – for instance both Westpac Banking Corporation (Westpac) and Commonwealth Bank of Australia (CommBank) have issued dual-tranche deals in recent weeks, to minimise execution risk. Westpac and National Australia Bank (NAB) have both issued yen bonds recently, as we seek funding diversity – and we are seeing issuance of securitisation and covered bonds for the same reason.

The market has evolved, but as funders we will evolve along with it. I don't think execution risk across the programme has materially changed, but it is more in evidence on a market-by-market basis.

■ **ZILELI** That's a good point. The conditions we are experiencing now are definitely closer to long-run normality, and it is in conditions like these where we – hopefully – show our skill as funders.

■ **BISCHOFF** You don't have to use all the tools available when you can issue US\$4-5 billion in a single transaction. That's a significant chunk of our annual funding requirement done in one deal, and it means a lot of alternative currencies and products simply weren't required.

Davison Changes in the deal process – around things like deal disclosure – emerged during the period of benign funding conditions when presumably their impact was easily manageable. Are those changes

“Investors have certainly been pleased with macroprudential measures and it has been good to be able to report slowing growth in the areas that have been targeted. Housing is still an investor focus, though.”

EVA ZILELI NATIONAL AUSTRALIA BANK



HOLDING POSITION ON CAPITAL

Funding markets may be experiencing renewed volatility but the Australian banking system is enjoying an unusual period of calm when it comes to capital evolution. There is more to come, but there is also confidence that the heavy lifting is complete.

■ **PERRIGNON** Investors know the Australian banks have very conservative settings on the net stable-funding ratio and liquidity coverage ratio. Going forward, what should they expect as a regulatory focus on capital?

ZILELI We have all made submissions on the future of risk weights and we are waiting on the outcome. I believe this is going to be rolled up in a forthcoming paper covering the nature of “unquestionably strong” capitalisation. That is due at the end of this year – though it has already been pushed back.

We are also awaiting a discussion paper on total loss-absorbing capacity (TLAC), but again this seems to have been delayed. No doubt this will emerge at some point.

KAU The risk-weight issue is in train, and it will have a flow-on impact on the attractiveness of capital-relief residential

mortgage-backed securities. This could potentially be quite an important development.

PERRIGNON Recalibration of risk weights should be a good story for investors. It suggests the Australian regulator is seeking better to align asset risk with capital in banks’ portfolios – which should be a message of further strength in the balance sheet.

BISCHOFF Yes, but the Australian Prudential Regulation Authority (APRA) has already made it clear that notional value of capital is done at 10.5 per cent. I don’t think investors will assume that a higher calibration makes us structurally stronger.

■ **PERRIGNON** Would that still be the case if the capital is assigned more efficiently across the underlying portfolio, for instance by reassigning risk weights?

ROBB The allocation approach might be tidier, but if the

absolute number is no bigger investors won’t attribute much change to the credit profile.

KAU APRA has already stated that it is not changing the absolute capital number we need to hold.

■ **DAVISON** Also on the subject of capital, new issuance of tier-two securities seems to have been quite low for a while. Is this just a refinancing story or is there a structural shift by the majors away from this type of additional capital?

KAU Risk weights aren’t growing particularly fast and our tier-two need is a function of risk weights. Investors are asking the same question about tier-two supply, and on a regular basis. But with balance sheets not growing particularly fast it’s really a refinancing story. In our case, we issue about A\$1-2 billion (US\$740.1 million – US\$1.5 billion) a year and we don’t see this changing in the near future.

BISCHOFF What we saw in 2014-16 was a period in which a lot of old Basel II instruments rolled off and the refinancing need was consequently quite high. The need is lower now given reduced maturities, and while APRA’s calibration of the capital framework could prompt a slight increase in issuance we don’t expect it will be significant.

ROBB We have done two tier-two transactions in the past year: a euro 12-year non-call seven and 30-year US dollars. At this stage we are well positioned for tier-two. While we also get a lot of questions from investors about tier-two issuance expectations, we don’t have any near-term needs.

KAU I was in Sydney in early August where I met a dozen investors, and after mortgages and the royal commission the next most popular question was about tier-two.

ROBB It continues to be a positive sign that investors move very quickly from talking about the big risk factors to asking for sub-debt issuance.

ZILELI They want the yield. If investors are happy with a bank’s credit they tend to be happy with its tier-two issuance.



“RECALIBRATION OF RISK WEIGHTS SHOULD BE A GOOD STORY FOR INVESTORS. IT SUGGESTS THE AUSTRALIAN REGULATOR IS SEEKING BETTER TO ALIGN ASSET RISK WITH CAPITAL IN BANKS’ PORTFOLIOS – WHICH SHOULD BE A MESSAGE OF FURTHER STRENGTH IN THE BALANCE SHEET.”

GERARD PERRIGNON RBC CAPITAL MARKETS

having a greater impact in a more challenging execution environment?

■ **ROBB** I think Alex Bischoff’s point is also important here – that we shouldn’t overstate the challenge current markets present. For example, CommBank printed A\$3.5 billion on 10 August in what was the largest domestic MTN we have ever issued. There are still good deals to be done in every market, we just have to be more careful to align issuance to periods of

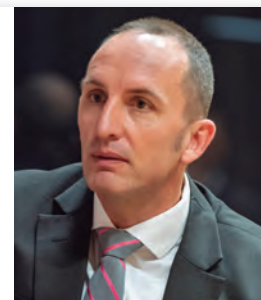
strength. It’s a more dynamic market, and we can’t assume we will be able to execute on any day we want.

■ **BISCHOFF** I agree – I don’t think CommBank would have had the same result had it issued in June. The domestic market has recovered in July and into August, and CommBank used a window of good execution conditions to issue.

■ **ROBB** It is also true that there are more issues to navigate including around disclosure and engagement with investors.

“If the movement in the base rate is prolonged the banks will clearly have to work through it. But it’s absolutely critical to reiterate that this is not an issue of funding pressure and it will not affect how we go about funding.”

MOSTYN KAU ANZ BANKING GROUP



■ **BISCHOFF** We have been dealing with similar considerations in other markets, though – including in Europe, where new execution processes have been in place for a while. We solve the execution-risk issues in various ways, including via price and dual-tranching.

We have seen the domestic investor base shifting in recent years, specifically to a place where new-issue premia are more relevant. Not every deal will go well, but I think we have reached a place where deals are appropriately tranching and where price discovery generates the appropriate size outcome.

Perrignon We are witnessing some key structural changes in the market backdrop. Rising US rates, moderation of QE elsewhere in the world and taxation reform are front of mind. How are these embedding themselves in markets and to what extent do they require changes to funding strategy?

■ **KAU** I think we are facing a much bigger challenge in the next couple of years, because of the sheer volume of liquidity that is going to be drained from the system.

I believe G4 central-bank balance sheets alone have contributed something like US\$12 trillion to global liquidity. While that won’t be unwound in one fell swoop – and it can be adjusted if markets weaken significantly – I can’t envisage a scenario in which the unwind won’t have a significant impact on all markets, including credit.

The volume of liquidity in the system has covered up all manner of cracks in the past 3-5 years, and its withdrawal is clearly the largest single challenge facing us.

■ **BISCHOFF** I agree. This structural element drives our longer-term funding strategy, for instance the fact that we have significantly shifted duration longer in each of the past four years to take advantage of structurally flatter credit curves. Technical factors will always drive our near-term thinking, but everyone needs to be able to think with both perspectives in mind.

■ **ROBB** Issuing a variety of products in a range of currencies and managing timing carefully is increasingly important in response to this backdrop. It is

amazing how quickly sentiment changes given these structural concerns – literally on a week-to-week basis.

It’s not just that there are a lot of events that make the market nervous – which there are – but market participants often differ in how they interpret events. It’s more important than ever to stay plugged in to investor sentiment.

Earlier in 2018 we issued senior sterling bonds and US dollar covered bonds, both for the first time in more than three years, to capture pockets of investor demand at attractive pricing.

Davison One specific area where there has been commentary around the retreat of liquidity has been US tax reform taking away funds held offshore by US companies – a component of which was being invested in global credit. How much impact has this had on Australian major-bank deal books?

■ **BISCHOFF** I think it’s important not to get too caught up in comparing liquidity conditions to 2016. If you go back to 2012, say, issuing US\$1 billion was a good outcome, and both Westpac’s most recent US dollar trades have printed more than US\$1.5 billion in the five-year tranches. There are still good pockets of liquidity to be found and a larger investor base than there used to be.

Losing a group of investors as a result of something like tax reform just adds to the atmosphere of caution we have been discussing. There is still good liquidity to be found if you are careful around timing and execution.

■ **ROBB** I think tax reform is a good example of the market jumping at a headline without fully understanding the implications. What’s going on as a result of US tax reform is nuanced and complicated, and in fact I think the impact to flow of funds in the short end is more significant than the corporate cash investment story on which a lot of people initially focused.

“We would certainly be conscious of increasing our exposure to wholesale markets given renewed volatility. There is a system-wide funding gap, but we are yet to see it flow through to our balance sheets.”

EVA ZILELI NATIONAL AUSTRALIA BANK

STRUCTURED ISSUANCE SUFFERS AT THE MARGIN

The Australian majors say covered bonds and securitisation remain an important component of the funding tool kit. Issuance of both has been subdued of late, though the rationale is not the same for both asset classes.

■ **PERRIGNON** Covered-bond issuance was slightly down in outright volume in 2017 but it probably forms about the same proportion of wholesale funding as it has in recent years. What is the outlook from here?

BISCHOFF The original concept of covered bonds was as a triple-A contingent funding tool. If the next 12-18 months features more volatility and significant periods of spread widening, having a triple-A instrument available should allow access to certain offshore markets when senior is volatile.

If these conditions don't eventuate we will likely continue to focus our covered-bond issuance on duration

and investor diversity in core markets.

ROBB The double counting of covered bonds under the bank levy detracts from the relative economics and the asset class gets unfavourable net stable-funding ratio (NSFR) treatment.

Therefore it's less appealing now than it was historically as a funding tool. Though the two transactions we recently completed – €1 billion (US\$1.2 billion) and US\$1.25 billion, both for five years – received incredibly strong investor response.

They came during choppy periods for senior debt, so we were very pleased with

the outcome. But, all things considered, we mainly focus on covered bonds as a long-dated private-placement tool.

KAU The economics Kylie Robb mentions make it very hard for covered bonds to stack up with other funding options – and I'd add the liquidity-coverage ratio (LCR) impact as another headwind. It's hard to justify covered bonds on an economic basis in positive senior-unsecured funding conditions like those we have had for the past couple of years.

I agree with Alex Bischoff, though, that it's a very important option to have on a rainy day – and it has proved itself in this respect to some

extent already. We haven't issued for about two years, but we are going to the European Central Bank covered-bond conference for the first time in about five years in 2018, because we think it's vital to stay in touch with investors.

■ **DAVISON** The economic appeal of residential mortgage-backed securities (RMBS) and asset-backed securities (ABS) also seems to have been lower for the majors of late. It's interesting that they were only marginal contributors to a very healthy issuance year in 2017, for instance. Where do the banks see securitisation at the moment?

ROBB We continue to be a strong supporter of our Medallion RMBS programme and we have around A\$14 billion (US\$1.2 billion) outstanding. It makes up about 5 per cent of our term-funding portfolio. Investors also tell us they are keen to continue to see issuance from this programme.



"IT'S NOTABLE THAT CURRENT RMBS PRICING IS CLOSE TO FIVE-YEAR DOMESTIC SENIOR-UNSECURED, WHICH SUGGESTS SENIOR IS STILL THE MORE FAVOURABLE ISSUANCE OPTION. TRADITIONALLY WE SAW THIS SPREAD CLOSER TO THE MIDPOINT OF 3-5 YEAR SENIOR LEVELS."

ALEX BISCHOFF WESTPAC BANKING CORPORATION

■ **ZILELI** There was a lot of selling when the news broke and this had a widening impact on credit spreads. But this settled down when the market fully absorbed the news.

What we are left with is the withdrawal of two larger investors – one that isn't playing at all and another that is only active in much smaller volume. Some of the smaller corporate accounts are still active. But it's true that some orders have been lost, and we either have to make this up elsewhere or have smaller order books.

■ **KAU** What's interesting is that the selling was probably less pronounced from the accounts directly affected by US tax reform than it was from Asian investors that were more driven by what they expected to happen elsewhere and with basis-swap movement. Their activity certainly had a greater impact on price.

Our experience with corporate investors is the same as NAB's: there are two big accounts that have largely gone missing, but there is another group – albeit with smaller tickets – that hasn't changed its behaviour at all.

■ **PERRIGNON** There was a period earlier in the year when consequential volume of US dollar investment-grade product came back into the system from some sell-side programmes, but while it certainly affected the market one could argue that dealer balance sheets soaked it up in a fairly efficient manner.

■ **BISCHOFF** There has also been a supply-side counterbalance in the sense that issuers have been coming to market less frequently.

Overall, we can't say that everything has been rosy with these tax changes and there has certainly been an incremental

We sought and received capital relief in both our two most recent RMBS transactions, which makes it much more appealing economically. I expect this will be the format we use going forward.

ZILELI We also see value in the product and we issued a A\$2 billion RMBS transaction earlier this year. We have also moved to capital-relief format, which makes it an efficient product from an NSFR perspective as well as for the LCR. This is because it's match-funded instead of having large maturity blocks.

We also see strong investor engagement both domestically and offshore. So it is definitely a product we will continue to support going forward.

ROBB On the investor side, it has also been really pleasing to see the level of demand for junior tranches – this has been tremendous, in breadth and depth. One of the early concerns about securitisation was placement of these tranches, but in fact we have had allocation challenges.

■ DAVISON Westpac Banking Corporation has been more active as an ABS issuer from its auto-loans programme than it has in the mortgage-backed sector. What is the bank's outlook on securitisation?

BISCHOFF We continue to see securitisation as a core part of our funding platform. However, given the liquidity environment we have experienced over the last few years there have been other options available to us as an issuer.

It's also notable that current RMBS pricing is close to five-year domestic senior-unsecured, which suggests senior is still the more favourable issuance option. Traditionally we saw this spread closer to the midpoint of 3-5 year senior levels.

Looking forward, we continue to see a diverse pool of demand for RMBS that we haven't tapped into for some time – and this could become more relevant. At the same time, we have been using our auto programme consistently as a funding diversification tool. We compare ABS and RMBS, so we can afford to offer something to securitisation investors in a format which offers appropriate value to both sides.

KAU I've mentioned already that changes to mortgage risk weights could be a game-changer for RMBS. As a funding-only tool, given all the cost inhibitors, it is probably off the table for the foreseeable future. Capital relief – and the quantum of capital relief – is the main driver.

impact on demand. I don't think any of us would say we think liquidity is going to get easier over the next 12-18 months, either. But it's marginal, and it's taking us back to a point that's still better than it was 5-6 years ago.

■ PERRIGNON I'd also suggest that timing has worked well for the banks – not just in Australia but globally – when it comes to preparation for the liquidity-coverage ratio and net stable-funding ratio. That would be a much tougher task in the more difficult conditions we are experiencing now, whereas a lot of the heavy lifting – around issues like extending duration – has already been done and housing lending is moderating.

It's probably a good time for the Australian banking sector as a whole to be funding around A\$110 billion (US\$81.4 billion) in term markets annually rather than A\$140-150 billion.

■ BISCHOFF I don't think this gets talked about enough, much as we say quite clearly that the real inflection in funding volume was around 2016. Including New Zealand, as a system we were funding close to A\$160 billion – and it's a pretty dramatic shift to roughly A\$110 billion this year and next. I suspect most of us have reduced the amount of short-term funding we are doing as well.

Davison Putting aside credit growth, is that number – roughly A\$110 billion – the baseline for total big-four funding expectations going forward? Presumably duration extension reduces refinancing velocity.

■ ROBB We certainly have a pretty material drop in term-funding requirement, to A\$33 billion last year and around A\$25 billion this year from A\$43 billion in 2016/17. This is driven by regulatory requirements, a changing balance-sheet gap and a significant short-to-long funding switch.

As you say, a core driver of tenor extension is reducing refinancing risk. Given the macro environment we've discussed, I don't think any of us would want to face the sort of term-funding requirement we navigated a few years ago.

The reduction in term-funding requirement makes it possible to be well supported by the pockets of demand we've found and not to need every single investor to be active.

■ ZILELI We issued A\$32 billion for NAB's Australian entity last year and this year it will be in the low A\$20s billion. This is primarily driven by refinancing, and while this increases in subsequent years we are very mindful of how the additional funding we put on will affect maturities in subsequent years.

■ KAU It's also worth remembering that the Australian dollar is a great stabiliser. When we had to do a collective A\$160 billion in 2016 one of the drivers was the Australian dollar being up by 10 per cent. Generally speaking, when the currency appreciates the world is in a pretty good place. This is when we have to do more funding offshore.

Conversely, when the Australian dollar is weak – certainly if it was close to US\$0.60 – we would have to do a lot less offshore funding because what we issue would be returning more Australian dollars. This is a really good 'right-way risk' for the system.

Davison There have been several references to the value of funding diversity. Does this mean the banks are, at the margin, more willing to pay a premium for currency and asset-class diversity or is diversity coming because the economics of a wider range of issuance options have improved?

■ BISCHOFF It's always a mix of the volume we need to issue and what we can get out of core markets – which tend to price most competitively. It's not all about price, either – a specific market might offer something appealing on duration or product, for instance.

SUSTAINABILITY AND BLOCKCHAIN FEATURE IN FUNDING INNOVATION

Green and sustainable debt should become even more prominent in the major-bank funding mix, the big four say. This is not the only funding innovation catching the eye, either.

■ **DAVISON** Sustainable-debt issuance is an evolving market and all the majors seem to have taken slightly different strategies to date. Perhaps the banks could give an update on their specific approaches and issuance strategies, and how firmly they are established?

ROBB Commonwealth Bank of Australia has a strong commitment to respond to the challenge of climate change and is active in low-carbon financing to support our transition to zero emissions by 2050. In the sustainable-issuance market, we are focused on a rigorous approach to socially responsible investment asset classification. The transaction we did last year was, at A\$650 million

(US\$481.1 million), the largest green bank deal in Australia and was accredited by Climate Bonds Initiative.

We have communicated to investors that we want a robust, sustainable green asset class. The management task around assets is not inconsiderable as a result. In addition to identifying eligible assets, this involves ongoing monitoring and reporting as well as validating and separately auditing those assets. The feedback we have received, especially from the international investor community, is that this approach has long-term value.

■ **KAU** It's right to describe this as a developing space, and as market participants become

more aware of environmental and social concerns it will get bigger both from an asset perspective and on the bond-market inflow side. We will meet the demand from investors, because it naturally makes sense to match the two sides of the balance sheet.

What would be really positive is if the liability side becomes significant enough that investors start to take an absolute economic interest in the assets – for instance via securitisation or covered bonds. There is some way to go, but it would make a real difference.

We have to listen to what investors want and not have preconceived ideas about things like issuance formats.

But at the end of the day, as we add assets to the balance sheet it makes sense for the liability side also to have a voice.

■ **ZILELI** We support financing the transition to a low-carbon economy, we have issued a significant volume of green bonds and we will continue to do so. We have also developed a social-bond framework and have issued once from this platform. We would like to develop this framework further.

We recently updated our green-bond framework to a UN sustainable-development goals (SDG) green-bond framework. This means we will diverge somewhat in the sense of having an SDG green and an SDG social framework.



“I’M SURE WE ALL SHARE SOME OF THE FRUSTRATIONS WITH THE STATUS QUO WHEN IT COMES TO EXECUTION, SO IT’S ENCOURAGING TO HEAR THAT BLOCKCHAIN IS GRADUALLY DELIVERING ON SOME OF ITS POTENTIAL AND STARTING TO BE APPLIED IN REAL MONEY MARKETS.”

KYLIE ROBB COMMONWEALTH BANK OF AUSTRALIA

There’s no single driver, but if one or more markets are offering clearly better value it’s pretty difficult, in the context of a smaller funding programme, to justify issuing elsewhere. We hadn’t issued in the yen market for two or three years, for instance, purely because the basis swap had made it uncompetitive.

■ **ROBB** It tends to be market opportunity in a currency or product that drives us to issue, with diversification being a nice added benefit rather than a primary driver.

When we issued €500 million (US\$579 million) of floating-rate notes in May we saw a very different investor book from our typical fixed-rate euro deals. But we decided to launch as it was an appealing price. The investor diversity was a bonus.

■ **ZILELI** It depends on the funding task, so this year – with a smaller task overall – we wouldn’t have issued a Samurai bond if the economics weren’t appealing. In fact, the yen basis had

improved and we priced yen five- and 10-year notes pretty much in line with what we would have done in euros when swapped back to Australian dollars.

There wasn’t any consideration of a diversity premium for us, because the pricing was there. Actually we would have been more inclined to contemplate a diversity premium in previous years, when the funding task was larger.

■ **BISCHOFF** We still do annual roadshows to a range of jurisdictions, whether or not we have been issuing – to ensure we stay in front of the larger investors. What’s encouraging for us is that we had the largest range of investors we have ever seen in a Samurai deal when we priced this year, even though we hadn’t issued for two-and-a-half years. It wasn’t just big banks, either – we had involvement from a number of smaller and regional accounts. They hadn’t let their mandates lapse even though we hadn’t issued for some time.

We have issued in euros, Australian and US dollars, and in securitised formats. We are driven by the assets the bank writes and we are also looking at what else we can use as reference assets. It's an ongoing process, especially on the reporting side.

BISCHOFF Westpac Banking Corporation initially focused its efforts on green bonds, which related to some of the points that have already been made – specifically that the industry is developing and we wanted to make sure the product we were putting in front of the market was in line with accepted formats, with robust reporting and assessment standards.

We have made commitments as an organisation to meeting a range of targets by 2020, and these cover both the lending and issuance sides. We have recently made a new hire in treasury, who will be responsible for the sustainable-issuance programme on a full-time basis.

Like National Australia Bank, we are currently working on developing our framework to give additional flexibility around social and SDGs as well as green. This is a path followed by a number of our international peers, too.

As banks, we have a responsibility to drive this market but also to be conscious of how quickly it is evolving. Things are changing all the time, and we don't want to commit ourselves to something that will become redundant in future.

■ DAVISON Changing the subject but staying with the theme of funding innovation, we were interested to see Commonwealth Bank of Australia being mandated to lead the first bond to be issued via blockchain – for World Bank. Do the funders have any early thoughts on this development?

ROBB This is a broader project from our institutional banking and markets unit, rather than an issuer project, but certainly something we are watching with interest.

I'm sure we all share some of the frustrations with the status quo when it comes to execution, so it's encouraging to hear that blockchain is gradually delivering on some of its potential and starting to be applied in real money markets.

I'm sure it's something we will all be interested in. It's early days of course, but I think it's an exciting development.

BASE RATE

Davison The Australian base rate has continued to trend upwards through 2018. How has this affected funding strategy?

■ KAU It's potentially a significant development. The relationship between US dollar Libor and overnight indexed swap (OIS) has clearly broken apart with significant divergence on the Australian side in recent times.

This is due to a number of – sometimes conflicting – reasons, but it's important to note that these are mainly

technical in nature. They certainly do not relate in any way to funding pressure. It's obvious that we are not experiencing funding pressure, but it's also a message we are making clear to investors.

Our sense is that the cause is a combination of lots of small things, mainly technical factors, including elevated repo demand and basis swaps.

The impact is not insignificant. I think CommBank's most recent results said that each 5 basis points of movement in the base rate means 1 basis point of net interest margin. ANZ Banking Group has a smaller household balance sheet so the impact is not as great, but it's still material.

How the banks deal with this is yet to be seen. But if the movement in the base rate is prolonged they will clearly have to work through it. The environment makes it much more difficult to do so than it would have been five years ago – from both a funding and a political perspective. But it's absolutely critical to reiterate that this is not an issue of funding pressure and it will not affect how we go about funding.

■ ROBB The market is still trying to determine how much of the move is technical versus structural in nature. A number of different reasons have been 'blamed' for the move, but until we can pin down the fundamental driver or drivers I think it's hard to know whether it is transient and where base rates might stabilise.

There is good evidence to support the relevance of international-bank Australian dollar funding requirements and the flow-on impacts to FX and the bank-bill swap rate.

As for the term-funding impact, I agree with Mostyn Kau in saying I don't think it materially alters the way we think about markets. We haven't seen investors particularly concerned about this issue, though they are interested and want to understand what's happening.

Davison Has the protracted nature of the base-rate run-up come as a surprise? Our sense is that a lot of market participants initially thought it would reverse earlier in the year – especially as the initial increase matched a similar move in US Libor that did unwind much sooner.

■ KAU It's a difficult question. What happened initially was wholly attributable to international developments, so it has really only been the past two or three months in which the

“The market has evolved, but as funders we will evolve along with it. I don't think execution risk across the programme has materially changed, but it is more in evidence on a market-by-market basis.”

ALEX BISCHOFF WESTPAC BANKING CORPORATION



Australian system has broken away from the US. It was very well correlated prior to that.

We're not talking about a long time, in other words – but there's no way of knowing for how long it will last. I suspect it will moderate, but that's not a conclusive view.

■ **ROBB** Market participants will certainly be watching the September- and December-period ends for a guide on where the cyclical peaks and troughs might land.

■ **BISCHOFF** At the end of the day, our funding decisions will be driven much more by credit growth and refinancing. We are no longer seeing double-digit deposit growth and the ability to shift that deposit balance materially is restricted, although credit growth is also moderating.

Perrignon The national savings rate in Australia has been in decline for some time but we haven't yet seen this translate into challenged deposit growth. What is banks' read on deposits?

■ **ROBB** In our recent results we highlighted transaction-account growth as a highlight of the past financial year. The gap between new lending and deposits only grew by A\$2 billion – at A\$11 billion versus A\$9 billion – so, for us, deposits are still largely funding asset growth.

■ **BISCHOFF** The test is whether any of the banks are confronting a bigger wholesale funding task than 12 months ago, and the reality is that we are all likely to land at smaller or similar numbers to last year.

■ **ZILELI** We would certainly be conscious of increasing our exposure to wholesale markets given renewed volatility. Deposit growth has been lower than credit growth, but system-wide credit growth has been moderate – and quite a lot of it has gone to regional banks and nonbanks anyway. There is a system-wide funding gap, but we are yet to see it flow through to our balance sheets.

INVESTOR RELATIONS

Perrignon What is investor feedback on the Australian housing market at present? Do investors seem comfortable with macroprudential controls and with the soft landing that so far seems to be developing?

■ **ZILELI** Investors have certainly been pleased with macroprudential measures and it has been good to be able to report slowing growth in the areas that have been targeted. Housing is still an investor focus, though, simply because it is such a significant component of our gross loans and acceptances – 58 per cent for NAB.

The questions we get asked are about our arrears in particular, and they also tend to match the headlines. This year, for instance, we have had a lot of questions about underwriting and borrower expenses – because there was an article on the topic written by one of the research houses.

In many respects, when we go offshore our job is around education. We'll explain, for instance, that our approval process doesn't just accept the income a potential borrower declares and we do look at payslips and deposits, and that we have changed the granularity of the process we use on the expenses side.

Really, what investors are asking is whether what they read is true. They want to see how our practices align with the headlines.

■ **BISCHOFF** Offshore investors fundamentally view the credit profile of our mortgage books as strong. Delinquencies of more than 90 days have ticked up but not materially, and if anything the message we were giving investors 12 months ago was that they should be more concerned if they saw another year of double-digit house-price growth after strong growth over the preceding five years.

Davison Has the nature of dialogue with investors on housing changed since the introduction of macroprudential measures in the second half of 2016?

■ **ROBB** There is generally a good level of comfort in the investor community around recent house-price moves. If the strong growth trajectory had continued it's likely it would

have been a problem, and in this context the measures the Australian Prudential Regulation Authority (APRA) introduced have played out as they were designed to do.

In particular, investors are seeing APRA's removal of the 10 per cent investor-only growth limit as evidence the market has responded as intended.

■ **KAU** The macroprudential measures have brought to the fore some questions around interest-only lending that happened in recent years and that is now coming up for resetting. This is because there have been headlines about something like A\$120 billion of such loans each year for the next couple of years.

The Reserve Bank of Australia gave a speech a few months ago about some of the mitigating factors around this debt, but it's not surprising that offshore investors are interested in the topic given what happened with resetting loans in the US.

We emphasise that the mortgage market in Australia is very different structurally from the US. Where lending standards in the US were loosening at the time, ours are tightening. It's a very different set of circumstances here too, for instance, than in some European countries – where banks were lending up to 125 per cent loan-to-value ratio – or in the US, where they were lending significant volumes of subprime.

Davison China has traditionally been a focus of offshore investors and it is back in the headlines around global trade. What is the feedback from investors on China at the moment?

■ **BISCHOFF** Going back to 2012, I expect all the majors would have had investor presentations addressing China in some detail, such as the interest in exports and commodity prices. Nowadays, we might have one table in a presentation speaking to this.

My sense is that investors are more comfortable with the way in which China has managed its slowdown and the tools it has available to do so – and therefore also with the impact this has had on Australia.

Having said all this, we haven't roadshowed since May and it is in the period since that rhetoric around trade has really picked up. Certainly

our experience is that global investors have been much more interested in the housing market and the royal commission.

■ **KAU** It's certainly all about the mortgage market in our experience. We go through investor meetings in which China isn't mentioned at all.

“It's not just that there are a lot of events that make the market nervous – which there are – but market participants often differ in how they interpret events. It's more important than ever to stay plugged in to investor sentiment.”

KYLIE ROBB COMMONWEALTH BANK OF AUSTRALIA

■ **ZILELI** I actually think things are changing. Our experience was the same as that just mentioned – China had gone away completely from investor agendas. But we were in Europe in June, and there were questions specifically about the China-US trade war, tariffs and potential impacts on Australia.

Davison What are global investors asking about the royal commission?

■ **BISCHOFF** They want to understand how it will affect the underlying quality of our credit and whether there are potential tail-risk scenarios that could affect them as credit investors. They want to understand the degree of government intervention they can expect and how it will affect their investment decisions.

To be fair, it's hard for us to give a definitive response to these questions – other than to say, at a very high level, that it would be naïve to assume there will be less regulation in future than there is today. How that will affect credit is unknown at this stage.

■ **ROBB** Investors are, quite rightly, asking a lot of questions. But for the most part they are also taking a wait-and-see approach. There is a long way to go in this process: the commission needs to review all the evidence and make recommendations, then the government has to decide how to respond to those recommendations.

■ **ZILELI** We were asked about the royal commission in most of the investor meetings we had in Europe. They are expecting some changes and they want to know what they will be – which we don't know. My suspicion is that investors are concerned about some of the cases they will have seen offshore, with large fines coming out of reviews into bank conduct.

■ **KAU** That's exactly what I was going to say. Without being flippant, this is nothing compared with what investors will have seen offshore. •

“I think we are facing a much bigger challenge in the next couple of years, because of the sheer volume of liquidity that is going to be drained from the system.”

MOSTYN KAU ANZ BANKING GROUP

UNANSWERED QUESTIONS

The Australian base rate has been on a trend incline throughout 2018, driving up banks' cost of funds and some lending rates. Debate is raging about whether the trend is structural or cyclical, for how long it will last, how far it could go and the wider consequences.

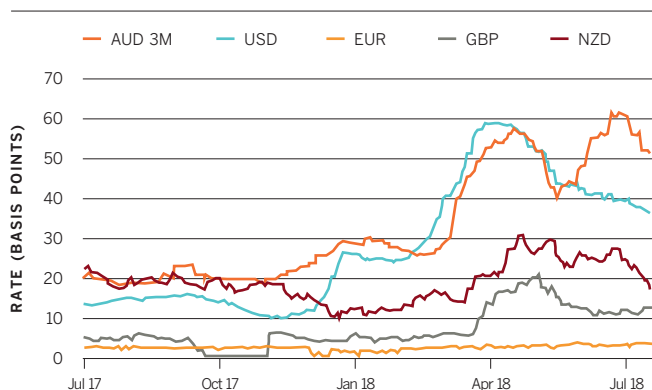
BY LAURENCE DAVISON

Higher Australian base rates have not exactly crept up on the local market – there has been commentary about spikes in the bank bill swap rate (BBSW) and repo rate since at least the final quarter of last year. BBSW has moved in waves, but through 2018 it has been 20-40 basis points higher, relative to overnight indexed swap (OIS), than its very stable level from the entirety of 2017.

However, the way in which the trend developed made it easy, until recently, to write it off as a temporary phenomenon. In its early stages the accelerating Australian base rate matched a similar move in US Libor, to which it is historically fairly well correlated. It also fell back from new highs after quarter ends in late 2017 and early 2018, which likely caused it to become a relatively lesser focus for market participants in the near term.

By August, however, it appears that Australia is grappling with a unique set of circumstances. US Libor has fallen progressively since April. After initially following this easing trend BBSW rose again into the end of the first half, hitting a new high in June. Market participants expect a further spike into the end of the September quarter, possibly setting another high-water mark for BBSW. As a result, serious discussion is taking place about whether this is a structural shift for the Australian market.

CHART 1. SHORT-TERM INTERBANK FUNDING RATES



SOURCE: BLOOMBERG, COMMONWEALTH BANK OF AUSTRALIA 19 JULY 2018

The consequences could be significant. While bank borrowers are quick to make it clear that there is absolutely no suggestion of a wider liquidity squeeze or funding pressure, a higher base rate will inevitably have an impact on financial institutions' cost of funds and net-interest margins (NIMs).

The transmission mechanism is not identical across the funding book, and relatively stable pricing in the deposit market has so far helped mitigate the overall major cost-of-funds impact for most banks. But the capacity of the deposit market to flex to the banking system's needs is also under question in an environment of falling household savings. Issuers say they are undoubtedly feeling the pinch of the elevated base rate.

A raft of Australian authorised deposit-taking institutions (ADIs) have executed out-of-cycle increases to their mortgage rates with higher funding costs universally blamed for the moves. While the major banks had not followed suit by mid-August, most market users believe the only thing that has stayed their hand is public-relations pressure driven by the ongoing banking royal commission.

The interplay of funding costs, the royal commission and desire for competition in the banking sector could have even wider implications. Some lenders, especially in the nonbank sector, are exploring ways to weaken the link between front-end funding cost and household lending.

Meanwhile, at least some market participants are watching closely for any sign that the norms on which the Australian banking system has been built – broadly, the prioritisation of stability ahead of price competition – might be re-examined by regulators and government.

BROKEN CORRELATION

After a protracted period of stability, BBSW started to climb appreciably in Q4 last year. At the time, however, this appeared to be no more than the Australian rate mirroring action in US Libor (see chart 1).

"The usual explanations at the time were changes to US tax arrangements resulting in US corporations repatriating their cash, US fiscal deficits increasing with issuance favouring the short

end and of course the tapering of the Federal Reserve balance sheet,” says David Goodman, head of macro strategy at Westpac Institutional Bank (Westpac) in Sydney.

Both BBSW and US Libor eased in the early months of the new year before spiking again, much more dramatically, around the end of the first quarter. The start of Q2 was the final period of correlated behaviour as both short-end rates fell once more, before BBSW’s most recent elevation in the lead up to the end of the June quarter. For the first time, this most recent run-up was not in lock step with US Libor.

Market participants tend to believe the spiking phenomenon – Australian base-rate elevation into quarter end followed by partial correction in the first half of each new quarter – is likely a technical factor (see box on p34). Nonetheless, this pattern combined with the initial correlation with US Libor made many slow to react to what now appears to be a prolonged and idiosyncratic rise in Australian base rates.

The course of events also means that, while BBSW has been on a climbing trend for more than nine months, there are only a few months of price action unique to the Australian market on which to base conclusions.

Speaking at the annual *KangaNews*-RBC Capital Markets major-bank funding roundtable on 13 August (see p22), ANZ Banking Group’s Melbourne-based head of group funding, Mostyn Kau, said: “What happened initially was wholly attributable to international developments, so it has really only been the past two or three months in which the Australian system has broken away from the US. We’re not talking about a long time, in other words – but there’s no way of knowing how long it will last.”

In its August statement on monetary policy (SMP), the Reserve Bank Australia (RBA) appears to concur with Kau’s view that the initial move in Australian base rates was indeed the result of US market action – in other words, that the more recent, independent continuation of the Australian trend marks a new phase of market behaviour.

The SMP says: “The increase and subsequent, smaller, decline in money-market rates through March and early April coincided with similar movements in rates on a range of short-term US dollar instruments relative to US dollar OIS. These movements in the US markets had a knock-on effect in other markets including Australia, since Australian...banks fund a share of their domestic balance sheets in US markets; so, in part the increase in BBSW rates relative to 2017 has reflected a spill-over from higher US Libor spreads.”

CHART 2. AUSTRALIAN MANAGED FUNDS’ ALLOCATION TO CASH AND DEPOSITS



SOURCE: MACROBOND, NATIONAL AUSTRALIA BANK, RESERVE BANK OF AUSTRALIA
13 JULY 2018

BBSW GOES IT ALONE

It is, therefore, only since the most recent run-up in BBSW that market users have been looking for causes unique to Australia. “All the US-related factors remain, yet US Libor has retreated,” says Goodman. “Unlike the moves earlier in March this year, the current BBSW widening has not been accompanied by similar moves in US Libor. Thus the global theories seem less valid and the latest moves appear local in nature.”

Analysts and bank funders have identified several characteristics unique to Australia that could be to blame, and a consensus appears to be forming that there is no single cause. The fact that several drivers are at play makes it harder to unwind whether the market is confronting a temporary phenomenon or a new normal.

Unsurprisingly, the issue fundamentally comes down to supply and demand. There appears to be a structural reduction in the volume of short-term funds major banks and investment funds are providing to the market. At the same time, while domestic banks’ reliance on short-term wholesale funds has fallen international banks are widely thought to have become more active front-end borrowers.

In the background, a declining household savings rate is making it harder at the margin for borrowers to reallocate their front-end needs into the deposit market. Using offshore markets to fill the loan-deposit gap has also become less appealing as, in particular, US dollar funding costs have increased.

John Caelli, ME Bank’s Melbourne-based treasurer, tells *KangaNews*: “The key factor that has caught people unaware is the

“The increasing need for short-term wholesale funding has met a market with depleted liquidity. The result is the trend widening in BBSW we have seen and the pressure in FX substitutes for short-term funding.”

PHILIP BROWN COMMONWEALTH BANK OF AUSTRALIA



DON'T BELIEVE *THE SPIKE*

To some extent, the trend increase in Australian base rates was harder to isolate because of the new pattern of behaviour in the short-end market around quarter ends. The story of spike and retreat may be here to stay.

Separating the emergence of quarter-end spikes in the bank bill swap rate (BBSW) from the ongoing upward trend is not easy to do. But analysts believe a single key factor is driving the pattern of BBSW rising into quarter ends then reversing in the early weeks of a new quarter – and, as a result, they say the spikes may continue.

The theory is that BBSW spikes are not being driven by action in the bank-bill market itself but rather by a structural reduction in major banks' willingness to run repo exposures over quarter ends.

As banks have worked through the myriad consequences of new capital regulation in detail, they have come to more

granular conclusions about how their own capital can be deployed most efficiently. One of these, analysts suggest, has led them to reduce their willingness to have repo transactions open during reporting periods.

"Australian repo has a very clear quarter-end effect," says Philip Brown, senior fixed-income strategist at Commonwealth Bank of Australia. "There is quite clearly a motivation for some players not to hold repos over quarter end."

Since April, Brown says, repo data have shown a 10-20 basis point cost increment for repos crossing a quarter end relative to those conducted entirely within quarter. Repo

duration explains the way the cost spikes develop and recede gradually, as the proportion of transactions that straddle a quarter end gradually increases in line with proximity to such a date.

Repo and BBSW are alternatives to each other as sources of short-end funds, and their economics are therefore correlated. Equivalent price action in BBSW is close to inevitable in the case of an idiosyncratic increase in repo cost.

"Repo is a secured short-term loan and BBSW is an unsecured short-term loan, and there is no reason for a secured loan to have a higher yield than an unsecured loan," Brown says.

He continues: "If you are an investor with money to lend, you could lend it to a bank for three months in return for a bank bill which would be eligible for BBSW, or you could do a repo where you take a government security as collateral. You are in a much better position if you take the government security."

It may take regulatory change to resolve this situation, as without it there seems little prospect of banks reviving their willingness to conduct cross-quarter repos. However, Brown argues that the change required is a relatively minor one.

He tells *KangaNews*: "Some ratios and regulatory systems still use the quarter-end number rather than quarter averages. It wouldn't be tearing down the system if this changed – in fact it is a small tweak – but it might have a large impact."

increase in issuance in the short end combined with a complete lack of demand in that part of the curve."

FRONT-END DEMAND

Banks' reduced willingness to provide short-term liquidity may be a structural development. The RBA's SMP says banks' reluctance to supply liquidity in money markets is "likely to be partly the consequence of changes in banking regulation following the global financial crisis – which were intended to encourage market participants to price the risk involved in market making appropriately".

It also cites "the greater focus on bank conduct in money markets" as a potential cause of lower bank-provided liquidity. Either way, there is now less capacity to buy or sell at short notice without significantly affecting the price of short-term funds – and thus the base rate.

Westpac research highlights low growth of "broad money" supply, which had fallen to 2.5 per cent in early 2018 from nearly 10 per cent in 2012, as an illustration of this phenomenon. Damien McColough, head of rates strategy at Westpac in Sydney, says broad-money growth fell to its lowest level since September 1992 in early 2018. "The pace of decline is analogous to previous recessionary or financial-crisis-type levels," he comments.

The supply of institutional-investor money to the short end also appears to have fallen. While this may be a cyclical rather

than a fundamental shift its scale is readily apparent, as managed funds' cash allocations have dropped to a level as low as they were immediately before the financial crisis (see chart 2).

"One channel by which a banking system can lose deposits has been domestic fund managers allocating away from cash and deposits to other asset classes – particularly overseas assets," says Peter Jolly, global head of research at National Australia Bank (NAB) in Sydney. "This happened in the second half of 2017 as funds allocated into foreign assets. Cash and deposit holdings by asset managers are near an all-time low."

The phenomenon has been noted by borrowers, too. Speaking at the KangaNews-NAB Fixed Income Beyond the Institutional Sector Summit on 2 August, NAB's Melbourne-based group treasurer, Shaun Dooley, said: "There has been a changing bias around placement of money in the local investor base, towards less allocation to cash and more to offshore equity."

INTERNATIONAL BANK SUPPLY

At the same time as a cyclical and structural reduction in front-end demand, some market participants say the call on Australia's short-term market has increased – at least in relative terms. The main driver of this supply is not domestic banks, however.

There is universal acknowledgement that regulatory change has made short-term funding a highly unappealing option for Australian banks, and as such it is generally assumed that issuers

will only use this market to the least possible extent.

Jolly argues that higher offshore funding costs have likely brought some issuance home, as Australian banks facing less appealing cost of funds in US dollar money markets have repatriated part of their front-end issuance. However, the focus of most attention is on the behaviour of international banks in the Australian market – especially those active in the institutional space.

McColough comments: “When I have discussions with liability managers, asset managers and other market participants such as issuers and other funders, a lot of the conversation ends up covering the fact that there is a lot more competition in the Australian loans business including a lot of competition from offshore banks.”

The suggestion is that these international lenders, as a group, have a greater marginal inclination to use the local front-end market to fund their lending activity. Data from the Australian Prudential Regulation Authority and RBA cited in a TD Securities research note back this impression up. While Australian domestic banks as a whole fund barely 10 per cent of their balance sheets in the short-term market, foreign banks in Australia use short-term debt for more than 40 per cent of their funding.

The short-term proportion of foreign banks’ funding has grown by around 10 per cent since 2015 and surpassed the deposit component in 2017 for the first time this decade. This pattern mirrors the withdrawal of offshore bank balance sheets from Australia in the wake of the financial crisis and the rise in international liquidity coming into the market in more recent years.

Philip Brown, senior fixed-income strategist at Commonwealth Bank of Australia (CommBank) in Melbourne, concludes: “The influx of foreign investment into Australia of late has caused the Australian branches of foreign banks to take an increasing share of some lending markets. But that lending needs to be funded and foreign banks are much more likely to be forced to use short-term wholesale markets, or FX markets, to source Australian dollar funding.”

The consequence for front-end pricing is clear. “The increasing need for short-term wholesale funding has met a market with depleted liquidity. The result is the trend widening in BBSW we have seen and the pressure in FX substitutes for short-term funding,” Brown continues.

“The key factor that has caught people unaware is the increase in issuance in the short end combined with a complete lack of demand in that part of the curve.”

JOHN CAELLI ME BANK



FUNDING IMPACT

Financial-institution funders of all stripes are quick to point out that price action in the Australian short end does not reflect a liquidity crunch across funding markets. Long-term wholesale funding cost has also increased and execution conditions are more challenging in 2018, but there is no suggestion that liquidity is not available.

“The fact is major Australian banks have had no difficulty issuing large amounts of long-term paper,” Brown tells *KangalNews*. “This is not a credit squeeze where there is actual risk of not obtaining credit. Investors are happy to lend to banks at five and 10 years, which they wouldn’t do if they were worried about a real problem with a bank.”

Even so, there are funding consequences of an elevated base rate though they vary by instrument and market used. Short-term funding is of course directly affected, as is wholesale debt priced off BBSW – floating-rate notes and, especially, securitisation.

ME Bank’s Caelli explains: “It has been an almost instantaneous price shock for lenders that fund primarily through securitisation because all this funding prices off one-month bank bills. There is 100 per cent transmission through securitisation funding.”

This poses a particular challenge to nonbank financial institutions, which are in most cases heavily reliant on securitised funding via warehouse or public term-debt markets. For instance, Andrew Marsden, Sydney-based general manager, treasury and securitisation at Resimac, confirms that his firm is almost exclusively funded off the one-month BBSW rate apart from some legacy debt priced off three-month bills.

Focusing on short-term markets in isolation also ignores the cost impact of an elevated BBSW on all wholesale funding. Brown points out that Australian banks’ foreign-currency deals will set their swap back to Australian dollars against BBSW while local-currency FRNs directly reference to BBSW.

“To date, banks have been able to extract a margin that covers credit cost through a cycle pretty satisfactorily. But we can see from what happened in the UK in the mid-90s that this can change. Everything was about competition, to the extent that consumers got a ‘good deal’ which clearly wasn’t sustainable.”

PATRICK WINSBURY MOODY’S INVESTORS SERVICE



DEPOSITS: THE PIECE OF THE PUZZLE THAT DOES NOT FIT

When wholesale funding costs – short and long term – are rising and deposit growth is low, one might expect deposit cost to be rising too. So far, this does not appear to be the case.

Getting a holistic read on deposit funding cost is hard to do, given the bewildering array of providers, products, terms and specials on offer. But anecdotal evidence and the best data available suggest

the cost of deposits had by mid-August yet to follow wholesale markets upwards.

Reserve Bank of Australia data for blended deposit cost show the rate holding steady

during the period in which wholesale-market base rates, including bank bill swap rate (BBSW), have increased significantly (see chart 3).

Westpac Institutional Bank's head of rates strategy, Damien McColough, adds: "Outside of specials, term deposits and savings are the cheaper form of funding. Anecdotally we have been hearing that competition for deposits is increasing, but this is very difficult to prove. If deposits remain competitively priced it may take some pressure off BBSW."

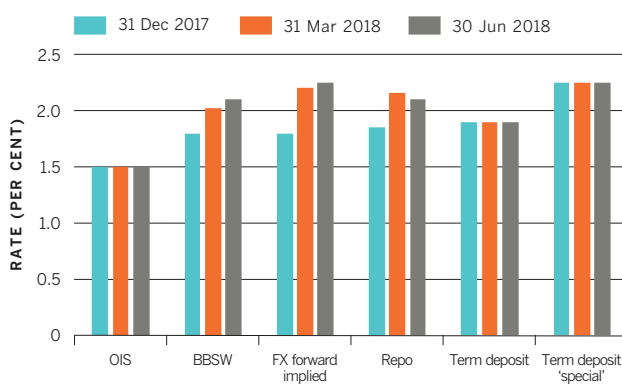
Confidence that deposit-funding economics will stay competitive is not high, however. Even in the absence of challenges in wholesale markets, all the signs are that a lower rate of household savings in Australia is making

it harder for banks to increase the deposit portion of their overall funding mix.

"We are no longer seeing double-digit deposit growth and our ability to shift that is pretty low, so it is an open question whether we will be able to fund credit growth through deposits going forward," acknowledged Alex Bischoff, Sydney-based executive director and head of global funding at Westpac Banking Corporation, at the *KangaNews*-RBC Capital Markets bank funding roundtable on 13 August.

With deposit system growth constrained, funders say enhanced competition for deposits could be expected to have a significant price impact. "We have seen this to some degree and there is the potential for elevated wholesale funding cost to flow through to retail markets further. This would be a substitution effect whereby banks are chasing retail deposits as wholesale funding becomes more expensive," explains John Caelli, treasurer at ME Bank.

CHART 3. THREE-MONTH MONEY-MARKET INTEREST RATES



SOURCE: BLOOMBERG, RESERVE BANK OF AUSTRALIA, WESTPAC INSTITUTIONAL BANK
4 JULY 2018

"It isn't actually the fact that short-term bank-bill borrowing is now more expensive that is driving overall funding costs higher," Brown tells *KangaNews*.

The bulk of Australian dollar demand for financial institutions is in floating-rate format, which is not in issuers' power to change. "In theory we could do more fixed-rate transactions, but there is much less demand," Caelli says. "In any event, balance sheets are benchmarked to bank bills so the BBSW effect will still be there through the swap market."

The most recent round of bank results reporting demonstrates that the impact of a higher base rate is material even for banks with diversified funding bases. In its results for the year ending 30 June 2018, CommBank disclosed that every 5 basis point increment in BBSW has an approximately 1 basis point impact on the bank's NIM.

This ratio appears to hold true at the other end of the Australian bank spectrum. Reporting its annual results on 17 August, MyState attributed a 4 basis point decline in NIM across the year to the "significant increase in BBSW". Based on the CommBank estimate, MyState's NIM hit would represent a 20 basis point increase in BBSW – suggesting that if the elevation is prolonged there will be more NIM pain to come.

The story gets even more complex when the deposit sector is factored in. Australia's household savings rate – and thus deposit growth – is down. At the same time, elevated wholesale funding costs might be expected to cause banks to flex their marginal funding need into the deposit sector and thus increase competition for – and cost of – deposits. But, so far, there has been little sign of deposit rates being driven up (see box on this page).

LENDING COST

Contained deposit cost is likely mitigating some of the pain of a higher BBSW for ADI borrowers. Even so, many of Australia's smaller banks have moved to protect NIMs by increasing home-loan rates outside the RBA cash-rate cycle.

Institutions that have increased their standard variable mortgage rate – generally by around 10 basis points – include AMP Bank, Auswide Bank, Bank of Queensland, Bendigo and Adelaide Bank, ING Bank Australia, MyState and Teachers Mutual Bank.

"Most of the smaller players have done some loan-book repricing, as we did in early May, as a consequence of the substantial increase in BBSW we have seen since last November – and in particular since February," confirms Melos Sulicich,

“I suspect the market will move away from pricing consumer credit portfolios off inferred rates. We are working on a genuinely floating-rate mortgage product based on a more frequent reset between borrower and lender.”

ANDREW MARSDEN RESIMAC



managing director and chief executive at MyState in Hobart. “We don’t expect any near-term relief in BBSW or funding cost, so in my view NIMs will continue to fall.”

There is undoubtedly some pain involved in repricing the lending book in an environment of low credit growth. The smaller banks have, in effect, been asked to choose between preserving NIM – and, therefore, profitability – at the risk of losing market share or competing for market share by sacrificing NIM. The risk is particularly acute as the big four – which typically lead any repricing move – had not altered their own home-loan pricing by mid-August.

There is a strong consensus among market users that the only thing staying the majors’ hands when it comes to mortgage-rate hikes is the negative publicity surrounding the ongoing banking royal commission. One source sums up this view by stating an expectation that the big four will raise their own lending rates “as soon as their PR departments let them”.

BIG CHANGES

Moody’s Investors Service (Moody’s) published a report on 30 July arguing that smaller banks’ willingness to increase mortgage rates is “credit-positive evidence that they retain pricing power independent of the current challenges confronting the majors”. It also suggests that the norms of the Australian banking system – specifically the default to system stability above competitive forces – remain in place.

“What we see now is the small players looking to preserve margins rather than use it as an opportunity to gain market share,” Patrick Winsbury, Sydney-based associate managing director, corporate finance and financial institutions groups at Moody’s, tells *KangaNews*. “This suggests that at system level there is still an emphasis on preserving stability and maintaining margin, although there seems to be a reverse order at the moment in who is leading with rate changes.”

The next question is how palatable a straight cost pass-through will be to government, regulators and bank customers in the anti-bank environment the royal commission reflects. If the base-rate run-up is a structural shift, it will add another straw to the camel’s back of system-security prioritisation over price competition.

Winsbury explains that the story of the Australian banking sector is one of regulation that favours financial stability and has sufficiently high barriers to entry that incumbents can focus on making low-risk loans at reasonable margins.

He adds: “If something challenges this story of risk versus reward it is a significant issue. To date, banks have been able to extract a margin that covers credit costs through a cycle pretty satisfactorily. But we can see from what happened in the UK in the mid-90s that this can change. Everything was about competition, to the extent that consumers got a ‘good deal’ which clearly wasn’t sustainable.”

At least some Australian lenders are examining the nature of a lending margin that functions through the cycle in light of a potential long-run rise in funding costs. Resimac’s Marsden tells *KangaNews*: “I suspect the market will move away from pricing consumer credit portfolios off inferred rates. We are working on a genuinely floating-rate mortgage product based on a more frequent reset between borrower and lender.”

The major consequences will only occur if the elevated base rate is a new structural norm, or indeed if it continues to ratchet higher. Most market participants believe at least some structural elements are at play, but none are willing to predict that elevation will be protracted at its current extent.

Kylie Robb, head of group funding at CommBank in Sydney, told the *KangaNews*-RBCCM roundtable: “The market is still trying to determine how much of the move is technical versus structural in nature. Until we can pin down the fundamental driver or drivers I think it’s hard to know whether it is transient and where base rates might stabilise.” •

“Unlike the moves earlier in March this year the current BBSW widening has not been accompanied by similar moves in US Libor. Thus the global theories seem less valid and the latest moves appear local in nature.”

DAVID GOODMAN WESTPAC INSTITUTIONAL BANK





Fixed income for the mainstream

The third **Fixed Income Beyond the Institutional Sector Summit**, hosted by KangaNews and **National Australia Bank (NAB)**, took place in Sydney on 2 August. This unique conference attracted another record number of delegates in 2018, as NAB continues to champion the importance of fixed income to the noninstitutional investor base.



DREW BRADFORD NATIONAL AUSTRALIA BANK

“Australians as a whole are getting richer together. But their asset allocation is still far from ideal: they have property, equity and cash with a very limited allocation to fixed income – less than 1 per cent in self-managed superannuation funds. This is changing, and with the ageing population we are starting to see more and more demand for fixed income from our clients.”

“Three-quarters of private-sector credit in Australia is provided by bank balance sheets. The global average is about 55 per cent, and the US is only 20 per cent. Australia’s corporate bond market has traditionally only been open to big names, but we see a lot of demand for term debt from smaller corporates.”





TODD SAMPSON

"Entering corporate life is like getting hit by a freight train of conservatism. We are born with incredible intellectual flexibility and there is no reason for us to lose it – other than lack of use. There is no such thing as creative and uncreative people; if you are born, you are creative."

"Multitasking should be called 'suboptimal tasking'. Your brain cannot do two high-attention tasks at the same time without degrading your performance of both."



MARK TODD NATIONAL AUSTRALIA BANK

"Sovereign risk hasn't been talked about in political circles for years, but it is there and has potential ramifications for investors."

"The US presents an enormous opportunity for infrastructure investment at the moment. But there are a lot of dynamics to come to terms with, such as fiscal and trade policy."





CHRIS BLACK
ALEXANDER FUNDS MANAGEMENT

“Traditional credit funds are and should be ‘wired to worry’. We overlay protection on our portfolio and we increased this late last year because we anticipated volatility. This hasn’t come through yet but we are maintaining protection: if US Treasuries hit 3.5-4 per cent or even more, the stock-market impact could be extreme.”



RICHARD BRANDWEINER PENDAL GROUP

“When rates were at their lowest point the consensus was that the situation was going to last more or less forever. Two and half years later, we are seeing normalisation. There is plenty of economic strength about, though our concern is the extent to which the equity market is priced for perfection.”



CHRISTOPHER JOYE SMARTER MONEY INVESTMENTS

“We think we are still in the mid cycle, not late cycle. We continue to expect a major inflation break-out but it could be 2-5 years before it happens. We typically only hold assets for relatively modest periods – where we can capitalise on opportunities – and we believe the current economic environment is constructive for credit over the next 6-12 months.”





ASHLEY BURTENSHAW GRYPHON CAPITAL INVESTMENTS

“Central bankers knew the consequence of QE was asset-value inflation. The market is familiar with QE but not with the transition out of it. It will be a bumpy road out, and we need to build this into our scenario analysis.”

JASON HULJICH CENTURIA CAPITAL

“There is a lot of opportunity on the development side of real-estate lending. Banks are focusing on large-scale clients, meaning smaller developers which have great track records are finding it difficult to get debt funding. We started lending to these clients in the mezzanine space, but we are now seeing more senior-debt opportunities.”



CHRIS ANDREWS LA TROBE FINANCIAL

“What we see in the Australian property market is playing out across advanced economies globally. We aren’t seeing property prices collapsing, but some of the unsustainable growth that Sydney and Melbourne were experiencing is starting to be retraced in an orderly way.”

“Increasing capital requirements, macroprudential regulation and the royal commission mean high-quality borrowers are increasingly coming to alternative lenders, because we can deliver superior service and certainty around the decision-making process.”



DAVID HANCOCK AFTERPAY TOUCH GROUP

"We went to the US not just because it is big but because merchants there were asking us to come. Our model is very much about working with merchants while remaining focused on being the payment method of choice in fashion."

CATHRYN CARVER NATIONAL AUSTRALIA BANK

"Growing businesses have a very strong focus on management from a conduct perspective. This is what the community expects, in discipline and operational excellence. This leads to quality people in the organisation and quality assets to invest in."



MILES GEORGE BRIGHT ACRE ENERGY

"In the past year, more than A\$10 billion has been invested in large-scale renewable-energy assets in Australia. It has been estimated that renewable energy's contribution will more than double, to 34 per cent, of Australian energy generation over the next decade."

"Australian generation capacity is very old and expensive to replace. It's simple economics that it will be replaced by cheaper renewables."





JONATHAN ARMITAGE MLC

“Private equity is becoming a much more important part of a diversified high-net-worth portfolio. There are more opportunities emerging and we are seeing increased appetite for this area, driven by the ability to access investments that aren't available in public markets.”



NICK BISHOP ABERDEEN
STANDARD INVESTMENTS

“In the last two years in Australia there has been more activity than ever before in banks and arrangers approaching investors directly with lending opportunities. There is a long way to go though, as only 10-12 per cent of debt is raised in capital markets in Australia.”

CHRISTINE YATES
NATIONAL AUSTRALIA BANK

“Property and equities are significant asset classes for private-bank clients. High-net-worth Australia has also tended to have a big slab of cash and only a tiny sliver of fixed income in their portfolios. It has always been my intention to work out how to bring more of a fixed-income understanding to our clients. As we build out this opportunity, we will also serve corporate Australia.”



STEVE GOLDMAN KAPSTREAM CAPITAL

“Australia is a very small bond market compared with the rest of the world, which has positives and negatives. One positive is the slightly higher yield for comparable credits relative to offshore. However, this is paid for in a lack of liquidity.”



JOHN PEARCE UNISUPER

"China is an obvious risk factor but if anything I am more focused on the US – it is looking like a potential train wreck in a couple of years' time. The US has introduced huge stimulus late in the cycle that its economy simply does not need. It could be looking at a massive deficit when it should be generating surplus, with very limited firepower to counter cycle change."



SHAUN DOOLEY NATIONAL AUSTRALIA BANK

"We are working through consultation with APRA about the nature of unquestionably strong, with new capital standards to come next year – including the future of non-common-equity capital. APRA has been quite clear it will monitor international developments around TLAC and the consequences for Australia, and it is appropriate to synchronise work around capital and sub debt before following with TLAC."





DAMIAN GRAHAM FIRST STATE SUPER

"We are trying to lift the engagement of the average super member. But our data show that members' investment choices don't tend to lead to better outcomes – they are generally better staying off in a balanced option. It's more about building trust, because trust is probably lower now than it has ever been."

"Superannuation is going to be two or three times GDP in Australia in the foreseeable future, and I think this is going to change the nature of our capital markets. It is important that we make members feel engaged – that they know this is their money."



"Increasingly, our business needs to be connected with the challenges the nation is facing. The days where government, business, the charitable sector and so forth are disconnected are over, and what we can bring to issues like climate change and affordable housing is phenomenal."

MIKE BAIRD NATIONAL AUSTRALIA BANK

"Having recently met a number of senior US political strategists on Capitol Hill, there is a growing sense that it is not just likely that Donald Trump will win re-election in 2020 but that it is inevitable. The sense is that he is winning people over outside his base because he is getting things done, most clearly on the tax side – where everyone is getting lower taxes."



DAVID WHITELEY INDUSTRY SUPER AUSTRALIA

"The vast majority of people don't have either the time or expertise to invest for their retirement – which is a 50-60 year strategy. We are trying to inform and engage our members about how trustees invest, but the reality is it would be in most people's interest to be in a balanced fund and stay there for decades."

"Every stock market fall is now reported through the medium of the impact on superannuation savings, and every time this happens our phones run hot the next day with people wanting to switch to the cash option."





DAN EAST FUTURE SUPER

"There is a lot of work being done behind the scenes to develop product, but the universe of ethical investment opportunities is still small. We have taken a different approach and provided debt directly to infrastructure projects. These long-term assets suit our portfolio, providing long-duration assets which match our investment themes."

ANNE MOAL PERPETUAL INVESTMENTS

"Demand for high-yield bonds in Australia is strong at the moment. In a low interest-rate environment, and with many investors being overweight in equities, high-yield products are attractive and offer diversification in portfolios."



MATT WILLIAMS AIRLIE FUNDS MANAGEMENT

"The reason Australia doesn't have a more active fixed-income allocation is because equities have been so good to Australians, and franking has made them even better. We have been in one of the longest-running bull markets, but we are at a turning point – and now is the time for equity investors to start adding protection by looking in a more formal sense for quality fixed income."



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SUN NOT SETTING FOR JAPANESE INVESTORS IN AUSTRALIAN DOLLAR PRODUCT

In 2017, *KangaNews* and **Mizuho Securities** hosted their first-ever roundtable discussion in Tokyo for Japanese investors in Australian dollar debt. A year later, a larger group of buy-side participants explain that, while the headwinds facing international participants in the Australian market are real, they are if anything engaged with a wider range of product than ever before.

PARTICIPANTS

■ **Hiroshi Domoto** General Manager, Investment and Treasury Department SBI SUMISHIN NET BANK ■ **Takehisa Ikeda** Head of Credit and Structured Investment SUMITOMO MITSUI TRUST BANK ■ **Yoshisada Ishide** Senior Fund Manager, Fixed Income Investment DAIWA SB INVESTMENTS ■ **Hirohito Sakurai** Senior Manager, Treasury and Investment SONY BANK ■ **Keiji Yamada** Associate Manager, Fixed Income Investment MITSUI LIFE INSURANCE COMPANY ■ **Motohiro Yamagishi** Head of Institutional Fixed-Income Sales and Head of Non-Yen Fixed Income MIZUHO SECURITIES

NOTE: Three investors asked to appear on an anonymous basis. They are identified in this discussion as 'asset manager', 'bank investor' and 'life-insurance investor'.

MODERATORS

■ **Laurence Davison** Managing Editor KANGANEWS ■ **Julie Edinburgh** Managing Director, Primary Debt Markets MIZUHO SECURITIES ■ **Daniel Leong** Director, Debt Syndication MIZUHO SECURITIES ■ **Samantha Swiss** Chief Executive KANGANEWS



■ **YAMAGISHI** The Mizuho Group as a whole has a big focus on Asia. For Mizuho Securities, the fact that the Australian market is a significant component of the Asian region means we have been focusing our attention on Australia as a key market for the past three years.

Here, we are working in the supranational, sovereign and agency (SSA), credit and structured-finance markets, in both primary and secondary. These are the key focus areas when it comes to expanding our business in future.

Our first roundtable with *KangaNews* last year met with a very positive response, and have we decided to expand the content in 2018. This year we are looking at all the interest-rate, credit and structured-finance markets, so it is good to see such a large turnout of investors and range of interests. I hope we can have a broad-based exchange of opinions and information and that this will be beneficial for the participants. We will continue our unwavering commitment to Australia.

INVESTOR SPECIFICS

Swiss Can the investors explain the types of funds they manage and the broad outline of the assets they are mandated to own – whether it be by rating, issuer type, geography or other factors? Where do Australian dollars fit in?

■ **ISHIDE** I'm pleased to be participating in this second roundtable discussion in Tokyo. I feel that *KangaNews* is paying strong attention to Japan, while at the same time Australia is now becoming a very close market for us.

I work mainly for retail investors, on whose behalf we run publicly offered investment trusts. Unfortunately, since 2013 Australian dollar funds have seen mainly outflows. This remains the case, although the outflows have been moderate. However, our overall investment in Australian dollars still totals around ¥1.4 trillion (US\$12.6 billion) – about the same as our euro investment. As a single-currency balance among all our publicly offered investment trusts, this is large.

The fund I manage is focused on credit and I have been involved in the Australian credit market for a long time. It's fair

to say the Australian credit market has been very dynamic in recent years.

■ **SAKURAI** This is also the second time I'm participating in this roundtable discussion. We mainly invest in securitised products. At this discussion last year I was the only investor looking at the asset-backed market in Australia but this time I see I have more peers around the table. This is very encouraging.

As a bank, we gather Australian dollar funds from retail clients. We invest mainly in credit risk – in other words, we do not take interest-rate risk. As a result, we don't do any SSA investment.

Until about two years ago, bonds from financial institutions and corporates were our mainstream investments. However, in 2017 we started investing in securitised products and we plan to continue building this portfolio.

■ **YAMADA** Another person from my company attended the first roundtable discussion. This year, I am attending from the credit team. Traditionally we have invested in SSA and financial-institution bonds. But since last year we have expanded into credit investments.

We initially focused on US dollars and euros. But we have since commenced selling foreign-currency-denominated products – with a primary focus on Australian dollars for new money. We acknowledge the interest-rate reversion with the US, but we are still mainly invested in Australian dollars and it remains our main investment focus. As a life-insurance company, we don't really look at securitised products – we are focused on SSA, government and corporate bonds.

■ **BANK INVESTOR** Our team is dedicated to proprietary trading in the bank. We can deal with any types of investment products including fixed income, credit and equity. I cover credit and securitised products, and we don't just look at public securitised transactions – we are also now exploring opportunities in the warehouse-finance area.

For the past two years, we have been increasing our exposures in the Australian structured-finance area because it has offered superior relative value in the global credit market. This is why we started investing in Australia, and we were particularly active last year. Since we have reached a certain size now, we are reshuffling the portfolio to optimise it.

Mizuho Securities participants:



JULIE EDINBURGH



TOSHI KANEHIRA



DANIEL LEONG



MARK READE



AYA TAGUCHI

■ **LIFE-INSURANCE INVESTOR** We look at Japanese and international credit, especially investment-grade corporate bonds. We deal mainly with fund investments, although we also have some in-house investment. We limit our investments to highly rated, high-grade companies about which we can easily acquire information.

We have exposure mainly to US dollars and some euros. With regard to Australia, through our in-house investment we have some track record of investing in Australian corporate bonds. However, our exposure to this market is less than 10 per cent. This is why I have asked to remain anonymous in this roundtable discussion.

■ **ASSET MANAGER** I am in charge of foreign bonds. Last year my boss attended this roundtable discussion, while this year I am attending on his behalf. Our business is similar to that described by Ishide-san – we are involved in investment trusts for individual investors. We have some investments in corporate bonds but we mainly invest in SSA and government bonds.

■ **IKEDA** I work in the structured-finance department, which conducts proprietary trading. Our investment targets are corporate bonds, export-credit-agency covered financing, securitised product and warehousing. Our investment field is global rather than domestic. Regarding Australia, we have invested mainly in securitised products.

■ **DOMOTO** Our company is commemorating its 10th anniversary. We are a pure-play internet bank. On the investment side, we look at corporate bonds in foreign currencies as well as Australian securitised products and some SSAs. I focus on credit investment.

Regarding Australian dollars, more than 90 per cent is invested in securitised products. As these are spread investments, we are always watching future spread trends.

Davison The regional market has been developing for Australian issuers, particularly the US dollar Reg S market. Do investors buy Australian issuers' bonds in currencies other than Australian dollars?

■ **ISHIDE** We also have US dollar-denominated credit portfolios and we sometimes participate in new issues where the book opens in the Asian time zone – for example US dollar issues by Australian banks.

Davison We understand the development of books opening in the Asian time zone has been a positive development for Asian investors.

■ **ISHIDE** I agree with this.

■ **LIFE-INSURANCE INVESTOR** I echo Ishide-san's views in this respect.

Davison One of the trends we have seen in recent years is for international investors in the Australian market to look at a wider range of product due to lower rates creating a requirement to move down the credit curve to access yield. Has this been the case for the investors around the table, for their funds in Australian dollars?

■ **YAMADA** Yes. Originally we were light on credit, but for a different reason: based on a risk point of view we didn't have much invested in credit in foreign currency-denominated investments. However – and this started last year, including in Australian dollars – even though credit spreads are tightening we are increasing our weighting of credit, including in Australian dollars. Australian issuance volume has not been huge this year, so a big part of our job is finding good targets.

Davison So it is difficult to get the exposure you want in Australian dollars?

■ **YAMADA** Yes, particularly given publicly offered new issues are declining. We tend to participate in private placements, not just from Australian issuers but also from European companies. We certainly believe we need to encourage more new issuance in Australian dollars.

■ **IKEDA** In general, we are seeking investment opportunities to increase our foreign-currency denominated assets across currencies – not just in Australian dollars.

With regard to Australian dollars specifically, we don't have investor clients in our asset-management business as a source of funds – we purely take Australian dollars for our own investment. We have not been especially aggressive in our efforts to increase exposure to Australian dollars – we are trying to maintain, reshuffle and grow moderately towards our targeted exposure.

JAPANESE BUYERS AND DURATION: FINDING THE LIMIT

Japanese demand has supported Australian dollar curve extension, especially for high-grade assets like the local sovereign sector and supranational, sovereign and agency Kangaroos. But the Japanese buy side says its duration demand is finite.

■ **DAVISON** The Japanese investor base has been very supportive of tenor extension in Australian dollars – in rates product and, increasingly, credit. Starting with rates, do investors expect to see further lengthening such as other high-grade issuers joining the Australian Office of Financial Management at the long end of the curve?

ISHIDE I think super-long-dated bonds will be issued by Australian semi-governments going forward, as a result of the rising attention we are witnessing on ultra-long-dated bonds.

■ **EDINBURGH** It has been mentioned that the Australian dollar curve is relatively steep. If this were to flatten to the extent that it becomes similar to the US dollar curve, would this have an impact on how willing investors are to allocate funds to long-dated Australian dollars?

ISHIDE As the US curve becomes explicitly inbound, clearly our carry rolldown would be negative. Of course, in such a situation – especially

for index players – the switch to positive from negative carry is something they would consider. If the relativity to the US curve flattens I'm sure it would have an impact on Australian outlook.

■ **DAVISON** On the subject of longer-dated credit, we saw an interesting transaction in Australia recently in the form of a A\$250 million (US\$185 million), 20-year deal printed on 18 July by Zurich Finance Australia. Corporate issuance of anything like this tenor is very rare in Australia – what were the drivers on this occasion?

LEONG It was a large club deal priced at 4.5 per cent yield, with a spread around about three-month bank bills plus 150 basis points. If you consider where

the five-year Australian dollar deal from the same issuer printed in May 2018 – at 98 basis points over three-month bank bills – the 50-plus basis points pickup for the longer-dated transaction obviously held some appeal.

The deal was anchored by Korean and Taiwanese life-insurance investors. It was targeted as a A\$150 million deal and it reached A\$250 million. It's a part of the curve that Korean and Taiwanese life-insurance investors are comfortable with – they can typically invest even out to 30 years in Australian dollars.

■ **DAVISON** It would be interesting to know whether 20-year duration is too long in Australian dollars for Japanese investors. Would they like to see more

opportunities – including from other sectors – in this part of the curve?

YAMADA This would be too long for us. Australian dollar denominated insurance is our mainstream, but this is mainly 10 and 15 years. We need to match the maturity of our investments and, therefore, our company will invest in credit up to 15 years.

LIFE-INSURANCE INVESTOR So far, investment in Australian dollar 20-year bonds hasn't yet been discussed in our company. Generally speaking, a 20-year investment in a corporate bond from a Japanese company would be possible.

However, for Australian dollars, it would be difficult because of what Yamada-san has already alluded to – insurance companies match the maturities of assets and liabilities. We don't sell insurance products in Australian dollars, so we don't have the liability side and would therefore need to hedge the foreign-exchange portion. Tenor of 20 years is too long to hedge, which is why we think it would be difficult at this point.

“AUSTRALIAN DOLLAR DENOMINATED INSURANCE IS OUR MAINSTREAM, BUT THIS IS MAINLY 10 YEARS AND 15 YEARS. WE NEED TO MATCH THE MATURITY OF OUR INVESTMENTS AND, THEREFORE, OUR COMPANY WILL INVEST IN CREDIT UP TO 15 YEARS.”

KEIJI YAMADA MITSUI LIFE INSURANCE COMPANY



■ **DOMOTO** Our foreign-currency investment balance is very close to the upper caps at present. However, as we invest mainly in residential mortgage-backed securities (RMBS) the balance of our exposures is mainly amortising. When the balance subsides we go for additional investment in primary or secondary markets. The process has levelled off right now.

Davison Does this mean getting higher spread is more about extending tenor than going down the credit spectrum?

■ **SAKURAI** Yes, that's right.

■ **BANK INVESTOR** We are opposite from Sakurai-san in that we are trying to shorten duration – for all products. In order to optimise our portfolio against coming credit-cycle changes, our current investment strategy is keeping duration as short as possible. The bank has Australian dollar retail deposits but we don't invest those funds directly. We are doing proprietary trading – as a result of which we hedge to secure our profit.

For us to consider an investment destination we need a certain level of spread after currency-hedge costs. Thus we

JAPANESE TAKE ON THE **AUSTRALIAN ECONOMY**

Australia is not bucking the trend of global synchronised growth but neither does it hold the shining-star role it enjoyed five or six years ago. Japanese investors have a cautious outlook.

■ **LEONG** What is investors' outlook for the Australian economy and to what extent does the Reserve Bank of Australia (RBA) position versus the Federal Reserve (Fed) and European Central Bank (ECB) affect investment decisions currently and into the future? For example, if the ECB raises rates will this influence appetite for Australian dollar investments?

ISHIDE The ECB or Fed stance will affect our investment in Australian dollars, but not a lot. The RBA's policy rate has been unchanged for the past two years. Furthermore, while the RBA says its next action is a rate hike, when I interpret its most recent statement it seems to me that it is in fact taking a dovish stance.

The RBA is looking at future wage growth but unfortunately wages are not accelerating as much as the RBA wants. It's

the same story with inflation. Conditions for a rate hike are therefore not yet in place.

The housing adjustment continues in Australia and the problems with the banks are being investigated by the royal commission, which will take two more months to complete. It is therefore reasonable for investors looking at Australia to consider that the timing of RBA rate hikes may be pushed back instead of being front-loaded. The Australian dollar is softening as a result.

Will this situation change with the next CPI or wage numbers? Will the next wages and CPI numbers support the RBA's rate hike? This is what I'm focusing on.

■ **DAVISON** What are the securitisation investors' views on the Australian housing market? The view in Australia seems to be that a soft landing is being delivered – do you agree?

DOMOTO Housing-price movements, the recurrent issue of the royal commission and the banks' valuation structures, and delinquency rates are a few concerning points. However, overall the Australian economy as a whole is not volatile. It's not the case that we will cut our exposure in the near future – we don't have this in our plan. It's just that there are a few concerning factors.

SAKURAI The key points I focus on have not changed much. These are the housing market, whether the rate hike will happen and whether population growth will cause real demand for housing to move favourably.

Regarding the potential for rate hikes, the debt burden in Australia is still increasing so I don't think a hike will happen very shortly. Regarding population, Australia's migration policy is changing after a period

in which immigration has been increasing. The impact of this on real demand for housing is something we have to keep a close eye on.

This doesn't mean we expect to stop residential mortgage-backed securities (RMBS) investment imminently. Housing prices are easing, but housing loans in RMBS pools are on average three-years seasoned so mortgage loans have ample buffer at the moment. Less seasoned loans may have to be watched.

With regard to the Australian economy, banks' balance sheets are mostly mortgage loans so the housing market will always be a key focus. We will watch and, if there are new events, we may think about reducing our exposure. However, right now we are not thinking of taking immediate measures.

IKEDA The Australian housing market has been said to be overheating for a while so we have been keeping an eye on mortgage loans, unemployment and the household debt level. I have been looking at Australian Prudential Regulation Authority (APRA) policy and I don't anticipate any big change. Our current stance is that we are not going to change our exposure or our policy dramatically.

BANK INVESTOR I have the same view. APRA policy will not have a big negative impact on us. Yes, there are concerns about the credit cycle and investment environment but it's not that Australia is of particular concern compared with other regions. We will continue with our investments.



“AUSTRALIA'S MIGRATION POLICY IS CHANGING AFTER A PERIOD IN WHICH IMMIGRATION HAS BEEN INCREASING. THE IMPACT OF THIS ON REAL DEMAND FOR HOUSING IS SOMETHING WE HAVE TO KEEP A CLOSE EYE ON.”

HIROHITO SAKURAI SONY BANK

didn't start with investment in the most senior tranche – we started from junior tranches in RMBS and we are considering going further down the structures as an option to maximise our profit.

Regarding asset-backed securities (ABS) investments, we invest from triple-A to single-A since ABS durations are relatively shorter than RMBS. Here, the same principles apply:

short duration, maximising return. This is our basic stance for the current market.

Edinburgh A big story right now is the relative performance of US Treasuries (USTs) versus Australian Commonwealth government bonds (ACGBs) – specifically how USTs

have consistently outperformed on a yield basis of late. What impact has this had on investment decisions, either structurally or at the margin?

■ **YAMADA** We are a life-insurance company and we have product lines for Australian dollar and US dollar denominated life insurance. For these products, the customers take the currency risk, so our investments for those life-insurance policies are fundamentally unhedged. It depends on our customers' preferences, but currently Australian dollar-denominated life insurance is still more popular than US dollars, even though the latter has higher yield. But our Australian dollar cash flow has thinned recently, so going forward this may reverse.

■ **ISHIDE** In the last five years we have seen the investment balance in our publicly offered investment trusts shifting towards US dollars and away from Australian dollars. But of course we also have other investment trusts – including privately placed and pension ones.

At present, 10-year ACGBs are at minus 25 basis points relative to USTs. But the movement has stopped right there for a while. Meanwhile, looking at the entire curve – out to 30 years – the Australian dollar curve still looks steep. So from an investment-decision point of view – meaning a yield-curve, relative-value perspective – it seems there is still relative value. This is evident in the 2041 bond issued by the Australian Office of Financial Management in the second week of July.

Edinburgh There is an observable correlation between the Australian dollar and participation from some Japanese investors. Earlier this year the Australian dollar-yen rate was at ¥88 and participation dropped. Now we are back in the low ¥80s, participation seems to be picking up. How important is the level of the currency to Australian dollar allocation, particularly taking into account investor views on currency outlook?

■ **ASSET MANAGER** Our capital flows are determined by the views of individual investors. Japanese and Australian monetary policies look set to remain unchanged for some time, so it is fair to expect the Australian dollar-yen rate to be range-bound. In this type of environment, funds inflows will happen when the

Australian dollar falls and funds will flow out when it is high – approaching or above ¥88. At the moment it's mainly outflow, but there is some multidirectional flow in smaller volume.

■ **DOMOTO** Our investments are dependent on core deposit trends. In my experience, Australian dollar deposits do not move much with currency movements – certainly our customers' sensitivity to movement in the Australian dollar is not as high compared with some of their other investments.

■ **IKEDA** We do individual funding for Australian dollars so we always need to be mindful of hedge costs.

■ **BANK INVESTOR** It's the same for us – hedge costs are important so of course the currency and basis-swap costs are linked to some extent. They don't always move in a linear fashion, though, so the basis swap is something we think about more than currency.

When we look at investing in Australian or US dollars we see which profit is higher after deducting hedging cost. We compare investment opportunities based on hedge costs in each currency but the currency doesn't directly affect our investment decisions.

■ **SAKURAI** We also get our foreign-currency investments from retail customers, so we have a different approach from the bank investor. As the yen strengthens we tend to get more foreign-currency deposits, which means more investment needs and higher profit. Currency therefore has an impact on volume. The yen recently weakened against the US dollar and customer deposits flowed out as a result. Sometimes we have to sell receivables in order that our investments continue to match deposits.

Edinburgh Are investors' allocations to Australian dollars based on a requirement of achieving minimum coupon or yield hurdles, or are there other factors at play?

■ **LIFE-INSURANCE INVESTOR** We have not been able successfully to overcome the hurdle to make investments in Australian dollars because we don't have Australian dollar insurance products. Our hurdle is finding absolute interest-rate yield that exceeds the expected interest rate.

■ **YAMADA** The hurdle is the same for us. When we sell insurance, the expected interest rate is what we need to exceed. Therefore, for our portfolio we need to make sure we exceed the expected rate. We cannot decide our allocation to Australian

“At present, 10-year ACGBs are at minus 25 basis points to USTs but the movement has stopped right there for a while. Meanwhile, looking at the entire curve the Australian dollar curve still looks steep. So it seems there is still relative value.”

YOSHISADA ISHIDE DAIWA SB INVESTMENTS



dollars because we make investments in Australian dollar assets based on cash flows from our Australian dollar-denominated life-insurance policies. For SSAs, corporate bonds and other credit we compare with the market and we will go ahead with the investment if the spread is reasonable.

■ **ASSET MANAGER** We do not look at expected rates in the same way as the insurance investors. We compare bond investments with benchmark. For SSAs, for example, we are looking for the spread to be attractive and make a decision each time based on the benchmark.

Edinburgh Is your reference to benchmark for Australian dollars specifically or is it also relative value compared with other currencies?

■ **ASSET MANAGER** It depends on the product, but if it's an investment only for Australia the approach is specific to Australian dollars.

HIGH-GRADE SPOTLIGHT

Leong Given the backdrop of the relatively low-yield environment overall and USTs yielding more than ACGBs, is the yield on offer in the Australian high-grade sector enough at the moment or are investors looking at going further down the credit curve or increasing duration to achieve higher yield?

■ **ASSET MANAGER** The Australian interest-rate position has been reversed – it's no longer looked at as a high interest-rate currency. We do not think the low-volatility environment will come back any time soon, so we are very cautious on credit spreads. As a result, we are not thinking of increasing our credit exposure going forward. Nevertheless, if SSAs are issued at attractive levels we will consider investing.

■ **ISHIDE** There was a crash in credit markets in February. Since then spreads have hit the bottom and rallied – as a result of which Australia has been moderately increasing its spread.

Lately there have been some challenges in Australia, such as the royal commission, and the repo rate has stayed at a high level since March this year. Moving into July it is still at the same level.

As funding costs have increased, corporate-bond costs to hold are also too high for brokers. This is one factor that is deteriorating the liquidity of corporate bonds. Secondary-market conditions are not good, either. Traders don't want to be involved with some issuers and some names have not performed well.

Concerns related to the global trade environment have settled somewhat, but in the corporate-bond market it is really only the temporary supply-demand dynamic, with small supply, that is supporting spreads. When there is the next negative event we will have to be cautious in this current environment.

Leong Do any investors see the yield pick-up in credit as sufficient to take the risk of moving away from SSAs and into credit?

■ **YAMADA** It's really all about the market yield. We always compare with the target rate for our portfolio. Looking at the market at any point in time, the yield will not stop us from investing in credit – provided it is reasonable.

Davison For those investors that are active in the Australian dollar corporate-bond market, is there a preference to buy securities issued by Australian domestic credits or do you look at Kangaroo transactions from international corporates as well?

■ **ISHIDE** I had a similar question asked of me at this discussion last year. Since then the Kangaroo market has continued to develop and it's positive to see global companies paying attention to the Kangaroo option as a source of funding. It's true that US tax reform means issuance diversity has decreased. However, yesterday we saw Zurich Finance Australia issue and other companies are looking at opportunities in the Kangaroo market.

This is certainly attracting the attention of global investors. At the same time, global investors, including Japanese, are looking for opportunities to buy Australian domestic companies. They tend to offer a good investment opportunity.

Davison What else are investors looking for when it comes to broadening the credit investment set in Australia?



"We purely take Australian dollars for our own investment. We have not been especially aggressive in our efforts to increase exposure to Australian dollars – we are trying to maintain, reshuffle and grow moderately towards our targeted exposure."

TAKEHISA IKEDA SUMITOMO MITSUI TRUST BANK

GREEN SHOOTS ONLY STARTING TO EMERGE

Some issuers say they have experienced a notable uptick in engagement with environmental, social and governance (ESG) principles on the part of Japanese investors. Those present at the KangaNews-Mizuho Securities roundtable suggest uptake may be patchy and nascent in nature.

■ **EDINBURGH** One of the key things we are seeing globally is the trend for investors in all currencies to focus on the importance of ESG practices, including growing investment allocations to green, social and sustainability bonds. Have Japanese investors seen increased appetite for these products, including in Australian dollars?

DOMOTO This is something we will start studying in the future. So far we have not given ESG investment much consideration.

IKEDA It's difficult to respond to this question. In my department our main target is to seek better spread at this moment. Whether a bond is ESG or green, our focus is on highly profitable opportunities.

ASSET MANAGER ESG is being incorporated into our investment process right now. First, we will look at Japanese and overseas corporate bonds. For green and social bonds we look at the spread and we

decide whether or not to invest on a case-by-case basis.

■ **SWISS** Do you expect that the principles you incorporate will be holistic – in other words, that they will form part of the wider investment process – or might they mandate involvement in specific, labelled assets such as green bonds?

ASSET MANAGER We haven't got that far yet. We are still studying the ESG sector.

LIFE-INSURANCE INVESTOR In yen, not just Australian dollars, we select based on return. Therefore, we don't have any quota for ESG. This is something we need to study further.

BANK INVESTOR We are developing our responsible financing and investment policy measures internally now. We would like to clarify our investment policy including the ESG perspective. Even if we are to include an ESG perspective in residential mortgage-backed

securities, only one green transaction has been issued in this sector in Australian dollars. There is no investment destination, which means it is difficult at this point.

YAMADA For our investment in Australian dollars, as we invest in SSAs there are many issuers that are well established in the ESG and green-bond sectors.

In the case of new issues, we would like to have more disclosure. Sometimes we approach issuers and ask for more disclosure.

SAKURAI We currently don't have any exposure to ESG products nor any specific plans to start this. As the bank investor has mentioned, ESG-type products in securitisation are very rare. This is something we will study further. Thus far we have not invested in any specifically themed ESG bonds.

ISHIDE We have already selected equity ESG investments for our investment trusts. But an ESG investor

mandate is practically nonexistent for bond funds. However, investment in this area by government pension investment funds has been aggressive since last year so public issuers in Japan have been focusing on sustainability in their funding. Finally, we are starting to see some movement for fixed-income investors. But, as I say, we haven't yet seen any mandates in fixed income.

■ **SWISS** Does this mean there is not much demand from retail investors for sustainability with regard to fixed income?

ISHIDE We are seeing ESG demand from retail investors in the equity sector, specifically interest in investments that affect or contribute to society.

Going forward, retail investors will move from equity into focusing on sustainability in fixed-income investments. However, so far we do not have much money in these funds and we don't see any prominent phenomenon as yet.

■ **ASSET MANAGER** Our fund has restrictions on what we can invest in. Meanwhile, buy-and-hold is our approach in corporate bonds in Australian dollars. There's not much of a secondary market in Australian dollar bonds from corporate and SSA issuers, according to our credit team, and they would

like to see an improvement in this regard. We invest mainly in investment-grade bonds. To go below investment grade we would need continuous, multi-year financial statements. We want transparent information provision. If this information were disclosed it would allow us to invest more. •

“In my experience, Australian dollar deposits do not move much with currency movements – certainly our customers' sensitivity to movement in the Australian dollar is not as high compared with some of their other investments.”

HIROSHI DOMOTO SBI SUMISHIN NET BANK



ISSUER JAPAN PERSPECTIVES:

AFRICAN DEVELOPMENT BANK

African Development Bank (AfDB)'s Abidjan-based chief treasury officer, **Keith Werner**, acknowledges that demand for Kangaroo supranational, sovereign and agency (SSA) paper from Japan is facing challenges at the current point in the cycle. But he says AfDB itself has been able to uncover some new demand from Japan.

How has Japanese demand for AfDB's Kangaroo bonds changed in the last 12 months? In particular, in your experience has anything changed when it comes to depth or breadth of demand from Japanese investors – for AfDB in particular or across your sector more broadly?

Overall, the demand from many traditional accounts for SSA Kangaroo bonds has decreased over the last 12 months. There are a number of reasons for this, including lower Australian dollar yield versus US dollars, rising foreign-exchange rolling hedge costs, decreasing return on a bank bill swap rate spread basis, and the decrease in sales of Australian dollar-linked policies from the Japanese life-insurance community.

However, in our case, we actually benefited from some new entrants at the beginning of this year. This resulted in our largest Australian dollar benchmark since 2012, in the form of a A\$380 million (US\$282.2 million) transaction issued in January with an August 2028 maturity. We are ahead of our run rate for overall issuance compared with last year, with A\$735 million issued by late July this year.

■ Do you get a sense of the likely trajectory of Japanese demand for Australian dollars specifically as Australian rates continue to lag the US?

Investors that buy offshore assets with currency hedging may find Australian dollar assets less attractive than they did in the first quarter of this year, for example.

However, a number of Japanese investors sell Australian dollar-denominated insurance policies and

these will continue to be active, although possibly to a lesser degree.

■ Are there any questions you consistently encounter from Japanese investors in SSA bonds?

The questions asked depend on the type of investor and whether they are focused on yield or foreign exchange, or are spread or hedge buyers. However, given the fact that long-end levels have tightened on the back of basis moves, some investors are asking whether reoffers or new-issuance premia will widen with the recently reduced demand and why new lines are tighter than off-the-run lines.

In general, though, investors want to know whether issuers are active and interested in issuing currently, potential minimum size of issuance, and how quickly issuers can turn around.

■ We know the Japanese bid has been particularly supportive of the 10-year point on the SSA Kangaroo curve. But how much further in tenor, if at all, will these buyers go?

There are a few Japanese life insurers who buy long-term assets against 15-year liabilities. But most investors set their longest possible tenor at 10.5-11 years and further extension is unlikely.

■ We continue to hear about Japanese investors migrating to credit as they try to clear yield hurdles. Has the SSA sector lost any investors from Japan as a result, and has it been able to find new buyers to compensate?

While we have seen some investors reducing their orders or shifting their investments from SSA to credit amid lower yields, this has been limited to a certain degree by the fact that some

Japanese investors are precluded from buying financial institutions or corporates.

In addition, as I alluded to before, we began seeing some larger Japanese investors divest from the US Treasury and mortgage markets at the beginning of the year and swapping into the Australian dollar SSA space, given the fixed-income-friendly rate outlook.

■ There has been some talk about growing Japanese investor interest in environmental social and governance (ESG)-themed product. Have you come across this?

This is definitely aligned with our experience. We have seen an upsurge in interest in ESG products, both in dedicated green-bond format – which we were among the first to issue in Australian dollars, at the back end of 2016 – and more recently in the form of our “high five” bonds.

These are themed bonds representing the five operational priorities: “feed Africa”, “light up and power Africa”, “integrate Africa”, “industrialise Africa” and “improve the quality of life for the people of Africa”. They fall under our 10-year strategy of achieving inclusive growth and transitioning to green growth.

There has been a preference by many investors in our inaugural themed deals for corporate social-responsibility reporting. We are also optimistic that the new guidance from the Ministry of Environment of Japan in April as well as the prioritisation of ESG by organisations such as the Japanese Securities Dealers Association and the Government Pension Investment Fund will continue to generate interest in these products. •

ISSUER JAPAN PERSPECTIVES:

GROUPE BPCE

Groupe BPCE (BPCE) returned to the Australian dollar market in April this year, for the first time since 2015, with the pricing of a senior-preferred and senior-nonpreferred transaction. **Roland Charbonnel**, the bank's Paris-based director, group funding and investor relations, speaks with *KangaNews* on Japanese demand for its bonds in Australian dollars and other currencies.

How have you seen Japanese demand for BPCE bonds evolve over time – including interest in your Australian dollar issuance? In this context, to what extent did expectation of Japanese interest prompt your decision to start issuing in the Australian dollar market in the first place?

BPCE has been a regular issuer in the Samurai market since 2012. It has come to the institutional Samurai market at least twice per Japanese fiscal year since the 2013/14 fiscal year and is now the leader for outstanding bonds in the Samurai market – with ¥924.8 billion (US\$8.3 billion). This total figure includes retail issuance.

Over time, BPCE has issued in all of the senior-preferred, tier-two and senior-nonpreferred formats. It has also issued both regular and social bonds. The recent trend in Japanese investor demand has been an increased interest in senior-nonpreferred and social bonds.

Interest in Australian dollar issuance has increased over the years. It has certainly become more frequently mentioned during our meetings with investors in Japan.

There are typically two potential sources of demand in an Australian dollar bond issue in our experience: domestic demand from Australian investors and offshore demand, which predominantly comes from Japanese investors. The perceived interest of Japanese investors in an Australian dollar transaction from BPCE was definitely one of the reasons why we decided to execute a deal in the first place.

■ Since it first issued Australian dollar bonds, in 2014, BPCE has offered all of senior-preferred, senior-nonpreferred and tier-two bonds in the Australian dollar market. You mentioned growing Japanese interest in the senior-nonpreferred asset class, but how does the level of Japanese interest overall compare between these levels on the capital stack?

It is a little bit difficult to compare tier-two with other formats, such as senior preferred and senior nonpreferred,

“IT IS CRITICAL TO UNDERTAKE A VERY CONSISTENT AND REGULAR MARKETING EFFORT BY VISITING JAPANESE INVESTORS, IN JAPAN. THIS APPLIES BOTH TO THE ‘CENTRAL’ INVESTORS IN TOKYO AND TO REGIONAL INVESTORS BASED ELSEWHERE IN JAPAN.”

as our last tier-two transaction in Australian dollars took place in October 2015. At the time our Australian dollar programme had not attracted a lot of demand from Japanese investors.

It is easier to compare senior preferred and senior nonpreferred as we issued both in April this year. In total, 17 per cent of the five-year senior preferred issued in Australian dollars went to Japanese investors and 51 per cent of the 10-year senior nonpreferred issued in Australian dollars went to Japanese investors, mostly to life-insurance accounts.

There is definitely a preference for senior nonpreferred, which is most likely a yield-driven preference from those life-insurance investors.

■ Japanese demand in high-grade and corporate deals tends to be highest

around the 10-year point – but banks do not issue much at this tenor. Where does BPCE find most engagement from Japan in duration and why is this different from other issuer sectors?

In fact we did issue our latest Australian dollar senior-nonpreferred tranche with 10-year duration. Demand for senior nonpreferred at this tenor was driven by Japanese life-insurance investors, which makes a lot of sense given their need for long-term investments. A 10-year tenor is a standard maturity for the

issuance of senior nonpreferred by BPCE, so this provided a meeting point between investor and issuer interest.

When it comes to yen, and on the basis of our latest Samurai bond issue at the beginning of July 2018, we have equally strong interest from Japanese investors for five- and 10-year tenors.

■ What has BPCE done specifically to build its engagement with Japanese investors? What would be your advice to other issuers in this respect?

I would like to mention two very important things. First, it is critical to undertake a very consistent and regular marketing effort by visiting Japanese investors, in Japan. This applies both to the ‘central’ investors in Tokyo and to regional investors based elsewhere in Japan.

Second, a strong moral commitment to the Japanese investor community to be a regular issuer is important. As far as BPCE is concerned, this means coming to the Samurai market twice a year. BPCE has kept its promise on this, which is very much appreciated by Japanese investors. •

ISSUER JAPAN PERSPECTIVES:

DEUTSCHE BAHN

Having debuted in the Kangaroo market in 2017, **Deutsche Bahn** had returned to Australian dollar issuance twice by mid-August 2018, pricing 10- and 15-year deals driven by reverse enquiry. **Christian Grosse-Erdmann**, the issuer's Berlin-based head of capital markets, says Japanese demand has been particularly strong for its long-dated transactions.

How have you seen Japanese demand for Deutsche Bahn bonds evolve over time – including interest in your Australian dollar issuance?

We have a very loyal investor base in Japan which we have been serving through annual roadshows for more than 15 years and through issuance in a variety of currencies, including yen and euros.

Our decision to look at the Kangaroo market was driven by the positive impressions gained on our first roadshow to Australia three years ago. We found that investors had a deep understanding of the railway industry and were asking the right questions. Our focus therefore was equally on Australian and Japanese investors.

We receive questions on both our credit and our sector. We operate an integrated railway business, where we own the rail track and are also the owner and operator of the trains. This is a very traditional model but it is different from what investors might see in jurisdictions such as the UK, where it has been split into pieces. We felt investors had a good understanding of this. They were able to benchmark us against similarly structured rail companies such as SNCF in France.

■ **There has been particularly prominent Japanese demand for Deutsche Bahn's longer-dated Australian dollar issuance, including the 2027 bond issued last year. Where on the curve do you find most interest from Japan?**

It is true that our 2027 bond found strong support among Japanese accounts. Japanese investors also supported the 2032 bond, which we

issued just a few weeks later. As Japanese demand primarily originates from life-insurance companies it is natural for Japanese investors to focus on long-dated maturities.

■ **What has Deutsche Bahn done specifically to build its engagement with Japanese investors? What would be your advice to other corporate issuers that also want to build the interest they get from Japan?**

We have been visiting Tokyo almost every year since 2001 on our annual Asia-Pacific roadshow. Continuous dialogue with investors – in good times and bad – is very important. Lending and investing is a question of trust and we are grateful to be considered a trusted issuer.

■ **There is some evidence of Japanese investors that previously only looked at high-grade Australian dollar product migrating into credit in response to lower headline rates. Does this match Deutsche Bahn's experience?**

Our experience in the Australian dollar market is still young. What we can say is that demand from Japanese investors has been robust. We think that the combination of a good rating and being a strong corporate with government ownership is attractive to our investors.

■ **Do you get a sense of the likely trajectory of Japanese demand for Australian dollars specifically as Australian rates continue to lag the US? What is the status of demand for Deutsche Bahn's Australian dollar issuance from Japan relative to interest in other currencies?**

We recognise that the relative attractiveness of currencies changes over time but we look at the long-term prospects and not the short-term fluctuations. We are aware that sometimes the basis swap will work and sometimes it won't. This is natural, and we are happy to wait for the windows when it does work.

■ **The market for Australian dollars last year was considered more conducive than it is now. Deutsche Bahn priced one deal last year and two so far this year, but have you observed a change in risk sentiment from investors?**

It is difficult to say for sure because we are not constantly testing the market. We have been able to execute two Australian dollar deals this year, which is evidence that there is still demand at good prices.

Spreads have come down in some parts of the curve, which can compensate for some negative basis-swap developments. Overall, we will continue to maintain dialogue with investors and will be responsive to demand if it works for both sides.

Our Kangaroo programme has volume of A\$5 billion (US\$3.7 billion) of which we've now issued just over 20 per cent. So there is room for growth.

■ **Have your deals this year been prompted by reverse enquiry?**

Yes, however we are open to both public and private formats and this will remain our strategy going forward. It's true that longer maturities are more likely to come in the form of private placements but we are open to issuing public deals in the 5-10 year space as well. •

ISSUER JAPAN PERSPECTIVES:

SUNCORP

Simon Lewis, Suncorp's Brisbane-based deputy treasurer, says the issuer's consistent investor-relations work has been key in harnessing demand from Japan. He reveals in particular that Japanese interest in Suncorp's residential mortgage-backed securities (RMBS) deals has increased in recent times.

Can you give some colour on how Japanese demand for Suncorp's Australian dollar issuance has evolved over time? In what products and deal formats do you experience demand from this buyer base?

Over the last 4-5 years, the involvement of Japanese investors in paper issued by Suncorp has evolved in a number of ways. A prominent one is heightened interest in highly rated RMBS paper. We, like many issuers, have spent a lot of time with investors in Japan – in our case visiting at least annually and often more frequently.

Japanese accounts are synonymous with a high degree of quality due diligence. Issuers prepared to invest the time and energy engaging with these investors will find many will be long-term supporters.

There are more than a dozen Japan-based investors that hold Suncorp paper across four key areas: RMBS, 10-year covered bonds, our US dollar 144A programme and senior-unsecured Australian dollar bonds.

In senior-unsecured format, 5-10 year tenor with yield of more than 100 basis points over bank bills has been attractive for offshore investors, particularly in Japan. These buyers also like the fact that Suncorp is an A plus-rated credit.

■ **Looking specifically at RMBS, do Japanese investors raise concerns or questions about Australia's housing market?**

Most investors were becoming concerned by the rapid acceleration of the housing markets in Sydney and Melbourne. However, the more we have talked about the retracement of this

market in the last 12 months, the happier investors seem to have become.

Many have a close affiliation with Australia and will often come to Australia to conduct physical inspections, so they can get a more detailed understanding of the market. Of the dozen or so Japanese investors that hold Suncorp RMBS, many have been to Suncorp's offices, met executives and really explored the way in which the company operates. This makes them more comfortable participating in our deals.

The migration of many investors down the capital structure has been interesting. Investors that initially were only interested in triple-A senior notes are now looking at the class A2 and AB notes.

■ **There is evidence of Japanese investors that previously only looked at high-grade Australian dollar product migrating into credit as headline rates have fallen. Does this match your experience?**

Some issuers may have experienced this migration from a subordinated versus senior perspective. However, we haven't issued wholesale subordinated debt for more than a decade, so we have not experienced this yet.

Many RMBS investors have migrated into our senior bonds. This is a result of them having met and dealt with our team over a number of years.

■ **In high-grade and corporate deals, Japanese demand tends to be concentrated around the 10-year point – but Australian banks do not issue much at this tenor. Where does Suncorp find most engagement from Japan in duration?**

We began issuing 10.5-year covered bonds in 2016, which was primarily driven by Japanese investors – directly and through their Australian-based fund managers. Japanese investors will allocate funds for this duration to their managers in Sydney and Melbourne. We also fielded calls from investors that were interested in participating directly.

Our long-dated covered bond started at A\$250 million (US\$185 million) and has been tapped twice to be at A\$650 million. Over time the spread has narrowed to around 110 basis points from around 140. If the demand is there over the next 3-6 months we will issue in this market again.

■ **Do you get a sense of the likely trajectory of Japanese demand for Australian dollars specifically as Australian rates continue to lag the US?**

The carry trade that persisted over the last 10 years has been a compelling argument for Japanese participation. There is no doubt some of the challenges in the Australian dollar market, such as funding costs, are being driven by the unwind of this trade. The universe of investors buying Australian dollar product has reduced somewhat.

We still think there will be strong interest in Australian dollars issued by Australian banks. This is from a relative-value perspective and given the stable financial-services landscape in Australia and the relative yield we offer even compared with the US.

We will have to continue to work hard as an industry to make sure positive messages about the Australian banking sector remain front of mind for investors, and not take for granted the support they've shown in the past. •

View from the land of the long white cloud

The **KangaNews New Zealand Debt Capital Markets Summit 2018**, held in Auckland on 8 August, attracted the largest delegate representation ever for an event that has run annually since 2013. Discussion captured all the talking points in the New Zealand capital market including macroeconomics, the business environment and trade updates, as well as spotlights on infrastructure, technology, bank securitisation and investing with impact.



GRANT ROBERTSON
GOVERNMENT OF NEW ZEALAND

“Concern about the international picture is something the government will continue to monitor. There are issues well beyond New Zealand’s control that we need be mindful of. Tit-for-tat tariff restrictions, some slowdown in the Chinese economy and various international tensions are risks that, if they develop further, will affect New Zealand.”

“We want all the levers within the machinery of government to consider wider wellbeing outcomes, to ensure that everything the government does is done explicitly to improve the wellbeing of New Zealanders.”





DOMINICK STEPHENS WESTPAC INSTITUTIONAL BANK

"Now is not the time for the government to ramp up debt, given the ageing population and how expensive it will be to repay the debt in future. I was pleased to see the finance minister commit to fiscal strategy and to motivating super funds to support infrastructure development."



STEPHEN TOPLIS BNZ

"The threat is that if inflation does accelerate and central banks respond, it will be a big threat to asset prices. This is a more serious concern to the New Zealand economy than global trade or Trump."

NICK TUFFLEY ASB BANK

"The finance minister has highlighted the fact that we are heavily taxing labour and not really taxing capital. We can expect a shift here. My preference is that if we're going to tax capital we should tax all of it – for example by including a land tax, or at least taxing land more effectively."



DAVID NORMAN AUCKLAND COUNCIL

"There has been a lot of debate about whether we should be spending more now in a time of low borrowing costs, given the infrastructure deficit and the fact that the rating agencies are saying net core Crown debt of up to 30 per cent of GDP would not threaten New Zealand's ratings."





CHANDU BHINDI ASB BANK

“We are selling ‘New Zealand Inc’ and we are informing investors about our own individual story at the same time. At the moment, both narratives are very strong. International investors are very impressed with the New Zealand macro story – feedback we have received on this has been very clear.”



NEIL BRADLEY BANK OF NEW ZEALAND

“There is so much geopolitical noise now that as an issuer we have to be ready to print each and every day. It’s not really about price – it’s about execution and being fully committed to the trade.”

JIM REARDON WESTPAC NEW ZEALAND

“Offshore investors are reasonably comfortable with the New Zealand housing market. During our most recent roadshow, earlier this year, we didn’t receive the interrogation we have in recent years. One area where the RBNZ has done us a favour is in LVRs, which took any pressure off the banks as we continued to fund a housing market that was running hot.”



EVA ZILELI
NATIONAL AUSTRALIA BANK

“We have updated our green-bond programme to align with the SDG framework. Our reference pools are largely linked to retrospective analysis of our balance sheet at this stage, though over time I would like to see a transition to active business decisions being aligned to ESG criteria.”



PETER JONES
ANZ NEW ZEALAND INVESTMENTS



“We believe Auckland Council got a pricing benefit of a couple of basis points because of the nature of its green-bond issue – and this should be encouraging for other issuers. But it’s not just about pricing. We’re trying to communicate that it’s crucial to offer robust reporting through the life of the bond, on at least an annual basis.”

ANTHONY KIRKHAM
WESTERN ASSET MANAGEMENT



“We are seeing a much better response from issuers on our ESG questions nowadays. Development is happening quite quickly on the issuer side, which is important because ESG analysis has become a vital component of our credit-assessment process.”

JACQUI FOX NATIONAL AUSTRALIA BANK

“The green-loan principles have been developed in the last few months. Not all corporates are able to undertake proceeds-specific capital issuance, so this gives those that have ‘sustainability DNA’ in their company the ability to access green finance and demonstrate progress on their sustainability objectives.”



JOHN MAURO AUCKLAND COUNCIL

“There is definitely heightened scrutiny on green-bond issuance. We needed to complete a full PDS – which tacked a few months onto the process. But a bit of extra work on the front end has been worth it, both to hone our own focus and objectives and to normalise with the FMA and others. We’re helping to clear the path for future issues and for future issuers.”





SUSANNAH WOOD COMMONWEALTH BANK OF AUSTRALIA

"The emerging theme in the fixed-income market – primary or secondary – is the need for a variety of different protocols. It's really important in this context to be invested in core infrastructure, so we are able to manage connectivity, data and hedging solutions to meet a range of client needs. We are platform-agnostic and being so is critical for us."

GREG HAYTON KIWI WEALTH

"Markets are becoming a lot more transparent, but one that remains pretty opaque is the new-issue market. The New Zealand time zone doesn't help, especially when we're talking about US transactions. But we certainly welcome any effort that adds transparency, and technology is already helping with the challenge of running a global bond fund from New Zealand."



CHRIS WALSH IPREO

"As technology evolves so do other roles within financial institutions. For example, salespeople should have more time to be with their clients rather than being stuck doing administrative work. Every role changes and adapts as technology evolves, creating efficiency and optimisation."



SIMON BURGESS LIQUIDITY CUBE

"We talk about what the role of banks is, and obviously some of their market-making capability has fallen away. Regulation will make it difficult for big market-makers to maintain their capital requirements, so it may be less about forcing them to do something than evolution that will happen regardless."



KERAN MCKENZIE MYOB

“Too many corporate institutions get stuck waiting for an example of technology or a regulatory change instead of starting to experiment. There are examples from around the world of companies which have spun off different businesses just so they can experiment. Trying new things allows a business to ‘disrupt itself’, rather than being disrupted from the outside.”



STEPHANIE HONEY
NEW ZEALAND INTERNATIONAL BUSINESS FORUM

“President Trump’s focus on trade deficits as a gauge of ‘winning’ trade wars is worrying. The US’s trade deficit with China grew by 8 per cent in the first year of the Trump presidency, while the US’s overall trade deficit was at its highest level in a decade.”



ANDREW MCKENZIE HOUSING NEW ZEALAND

“The ability independently to access long-term financing allows us to enter into long-term supplier arrangements. This provides certainty for firms to invest for the future, employ more people and lower the cost of building homes.”





JOHN-PAUL RICE RUSSELL MCVEAGH

"We have seen legislative change in recent years to facilitate the introduction of the LGFA and covered bonds. This says to me that as a market we are open to promoting innovation and flexibility, and I would expect a similar response to project bonds or other infrastructure-vehicle funding undertaken through the debt capital markets."



STEPHEN SELWOOD INFRASTRUCTURE NEW ZEALAND

"The infrastructure-investment programme over the next decade is of the order of NZ\$110 billion from central and local government, and a further NZ\$20 billion in the private sector. The new government has really picked up on the last one's infrastructure focus, which is good news because we are miles behind where we need to be as a nation."



IAN PURDY ACCIDENT COMPENSATION CORPORATION

"We are really yet to find out whether debt-capital-markets investors are prepared to take development risk. If they are not, we have to work out who will take it – the Crown, mum-and-dad investors or someone else. ACC is fortunate that it is able to take long-term assets in New Zealand, but they may not suit all investors."



SEAN WYNNE CROWN INFRASTRUCTURE PARTNERS

"We are developing models where the Crown and the private sector can invest in bulk housing infrastructure together. The goal is for the bulk infrastructure that was scheduled to be built in the next 20-30 years to be brought forward significantly and to alleviate some of the associated funding pressure for councils."



JOHN DUNCAN AUCKLAND INVESTMENT OFFICE

"Infrastructure is an enabler of growth. The model in New Zealand is skewed to the negative where the US is skewed to the positive, in the sense that the US has the tools to share the benefits infrastructure generates. We are restricted to a limited, land-based taxation model which makes providers reluctant to get in front of their development and infrastructure investment curve."



RAYNOR MCMAHON WESTPAC INSTITUTIONAL BANK

"The change of government has been significant for the infrastructure sector. The key theme is that it is looking at new forms of financing – including less emphasis on PPPs and equity capital in general, and potentially structures that are more interesting from a debt-market perspective. Either way, the pipeline remains enormous."





JOHN DAKIN GOODMAN NEW ZEALAND

"There is no doubt that there tends to be a period when business confidence is low when we see a change of government to the left. The facts as we see them are that, yes, there is a dip in confidence, but we are also going through the largest construction boom in recent history and a lot of other factors remain positive."



JEFF MCDOWALL AIR NEW ZEALAND

"Digital offers a real opportunity for an airline to differentiate itself. There are huge opportunities when it comes to making things like the hassle of getting to an airport and checking in seamless and that's quite apart from the growth of digital ticket sales."



SARAH JUDKINS
NEW ZEALAND MEDIA AND ENTERTAINMENT

"People need to engage with trusted, locally curated news sources. When all you are chasing is an audience it is easy to undervalue your quality content and the fact that people want it and are willing to pay for it. We are increasing our focus on premium content, and we find that people value what they pay for more than what they stumble across for free."



MARC RIVERS
FONTERRA CO-OPERATIVE GROUP

"The global fundamentals are broadly positive for Fonterra. We are seeing strong milk prices and positive nutrition trends, which will flow into the economy through farmers and beyond."



ANDREW BASHFORD WESTPAC INSTITUTIONAL BANK

"The environment in which businesses operate, in terms of macro trends and consumer demands, is changing at an ever-greater pace. Innovation, supported by a culture of change, is required for established business continuously to improve and manage transformation."

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ERNEST BIASI
COMMONWEALTH BANK OF AUSTRALIA

“It is important to enable flexibility in structures. Different investors want to participate according to various criteria, so it is important to be able to structure transactions to meet this demand. Limiting flexibility will ultimately limit issuers’ ability to do this.”

TOBY ANDRES RESERVE BANK OF NEW ZEALAND

“The quality of a security comes down to whether people trust it in a normal market environment and in times of stress. This relates to the portfolio quality underlying an RMBS, the simplicity we would like to see in the products and the transparency around the loans in the pools for investors and for us as a central bank.”



DEEMPLE BUDHIA RUSSELL MCVEAGH

“The original RBNZ MBS proposal included strict eligibility criteria and pool parameters for factors such as loan-to-value ratios and a maximum fixed-rate loan ratio. These were bound to have consequences for bank originators.”



ROBERT BALDI
MOODY'S INVESTORS SERVICE

“For a triple-A rating on a major-bank transaction, we would be looking at 5-5.5 per cent credit enhancement behind a senior tranche. This matches the collateral score we currently apply to the major banks’ covered-bond programmes.”



VICKY HYDE-SMITH AMP CAPITAL

“We would look to Australia, as the parent banks of the majors, as a guide to what would be considered best practice in securitisation. This degree of granularity might not be relevant for the New Zealand market, but by and large we need to be able to compare one pool of assets with another in order to price them appropriately.”



NEW ZEALAND'S GOVERNMENT RESETS THE PLATFORM

After delivering his keynote address at the sixth annual KangaNews New Zealand Debt Capital Markets Summit in Auckland on 8 August, **Grant Robertson**, New Zealand's finance minister, shared thoughts on his government's economic plans and the role of the financial sector.

You have been in office for nearly a year now. What have been your main priorities when it comes to capital markets?

A big priority for us has been looking to a much longer-term view of the New Zealand economy. We believe the drivers of growth in recent years have not been sustainable – they have largely been about population growth and have predominantly come off the back of an overheated housing market.

We certainly need capital markets to be playing a role as we transition to a more productive and sustainable economy. We need long-term investment. Most people would acknowledge that, over the years, the thinness of New Zealand's capital market has held some of this investment back.

This is developing, but what government can do to help is to ensure we provide a long-term pipeline of infrastructure projects in relation to the direction of our spending track, as well as putting this together in such a way that it is attractive from an investment perspective.

I have committed to this as a government priority. In the coming weeks, we will make a further announcement around the way the government will organise itself specifically in relation to infrastructure to provide clarity in the pipeline. We are

aiming to provide a 'one-stop shop' for the private sector on these goals.

My priorities have really been re-establishing this approach to the economy. There are obviously a number of micro- and macroeconomic policies we are investing in, all the way from taxation and reserve-bank reform through to investment and skills in research and development.

■ Can you give an update on the status of Reserve Bank of New Zealand (RBNZ) reform?

The legislation, which was the first phase of the review, has now been introduced. This will alter the reserve bank's objectives to achieving price stability and maximising sustainable employment.

The new reserve bank governor, Adrian Orr, and I have signed an agreement which effectively already implements the balance of the passing of the legislation. In addition, we will move to a committee-based decision-making structure.

The second part of the review is kicking into action now. This will consider broader financial-stability issues, in particular the use of macroprudential tools and the prudential supervisory regime as a whole. We want to determine whether this is working, both for the banks and for other financial institutions.

It is a big piece of work and, to be very clear, we anticipate phase two will take some time to complete. These sorts of reviews should only take place once every 30 years so it is very much a priority to get this right. I'm very pleased with the progress we have made so far.

■ While we are on the subject of financial stability, can you tell us how closely you are watching the banking royal commission in Australia? Is a similar exercise required in New Zealand, particularly given the Australian parentage of the biggest local banks?

We are watching this very closely. The Financial Markets Authority (FMA) and the RBNZ have a conduct and culture review underway. They are updating myself and the minister of commerce, Kris Faafoi, on a monthly basis. Their interim thoughts are that they haven't found anything to the extent or the scale of what has emerged in Australia – which is obviously good news for New Zealand.

We have a slightly different regulatory environment here and a different history and culture when it comes to the way banks and financial institutions operate. But this should not make us complacent.

We expect the FMA and RBNZ to provide us with a joint report in October. This timing is quite specific

as it will also enable them to consider the initial recommendations from the Australian review – which are due in September. We will make any changes necessary after this.

Overall, I continue to have confidence in New Zealand's financial sector, which remains very sound. But there are some practices that the Australian commission has drawn to light that make us all uncomfortable. So if there is any sign of this type of activity in New Zealand it is certainly something I wouldn't want to persist.

■ **Generally, how do you assess the health of the financial-services sector in New Zealand?**

I would say it's pretty good. There are a few issues particularly around insurance – and an insurance-contracts review is separately underway led also by minister Faafoi.

Overall, I see a sector that is continuing to grow and that is offering a diverse range of products. The next review of the default providers of

KiwiSaver is scheduled to take place next year. This is an important time for us to evaluate this product and its relationship to the financial-services industry. But overall I think we're doing relatively well.

■ **What role do you see financial services playing in the transition to a sustainable economy?**

Investment practice is very important and most financial-services companies are now looking at the sorts of ethical-investment guidelines people expect.

It is also about looking at the opportunities of a sustainable economy. It is imperative that we start to make the investments necessary to ensure our economy is fit for purpose, both now and for future generations.

On the policy side, this means a transition to a low-carbon economy.

We have set the ambitious target of net zero emissions by 2050. I am delighted that business is pursuing these goals as well, with 60 of New Zealand's largest companies coming together as the Climate Leaders' Coalition that has committed to reducing emissions and being publicly accountable for this.

This is important, not just to play our part in addressing climate change but in giving New Zealand a credible and long-term base for our economy. This will mean change, but it also represents opportunity.

We are determined this will be a just transition where we support industries and communities to develop new and high-paying jobs. One example is the NZ\$100 million (US\$67.4 million) Green Investment Fund being established by the climate-change minister, James Shaw,

“We need long-term investment. Most people would acknowledge that, over the years, the thinness of New Zealand's capital market has held some of this investment back.”

to leverage private-sector investment to support our transition to a low-emissions economy.

This fund will effectively be a venture investment fund for sustainability in the environment. I am certain we can work with financial institutions on this.

■ **Auckland Council issued a debut green bond earlier this year, which was the first such deal from a domestic New Zealand issuer. Is there a role for government in this market and are there other ways you can mobilise private-sector capital for social benefit? We note that you decided not to proceed with plans for further social-impact bonds put in place by the previous government.**

The New Zealand government does not have a green-bond programme in

place at the moment, but the Green Investment Fund is certainly an initiative in this space.

In regard to social-impact bonds, these are not our focus and we believed the experimental approaches used by the previous government weren't delivering for New Zealanders.

We believe that providing a stable base for people in need is one of the government's core responsibilities. I will continue to work with private providers in the delivery of community programmes – for example in social housing – to achieve this.

■ **You inherited a New Zealand Debt Management Office that is committed to having a minimum stock of New Zealand government bonds (NZGBs) on issue. Do you support this strategy?**

It is important for New Zealand that the market is open so investors can have confidence over the long term. Like the previous government, I have committed

to ensuring minimum NZGB supply of not less than 20 per cent of GDP over time. It is currently about 25 per cent and will stabilise at about 23 per cent according to projections.

Requirements will differ over time. But giving investors confidence around the long-term nature of the New Zealand market is the highest priority.

■ **You have retained the commitment to reducing net core Crown debt to 20 per cent of GDP within five years of taking office, but the view at the KangaNews conference seemed to be that the market does not mind if there is more government debt on issue provided it is seen as being for a productive purpose. How do you balance the government's fiscal goals with infrastructure investment?**

We are certainly willing to fund such projects. What we have done is slow the debt repayment track the previous government had. This is specifically to enable us to make these investments, not just in the infrastructure space but across the board.

We are sticking to the target of reducing net core Crown debt to 20 per cent of GDP within five years of taking office, but this still gives us significant additional headroom – of NZ\$42 billion of investment over the next five years. This is a significant investment in capital in New Zealand.

We will continue to monitor debt levels, and we have reasons to be careful. It's good to be investing in our economy and supporting our infrastructure.

However, New Zealand is a small, open economy which is susceptible to international trends. We are also susceptible to natural disasters and security incursions. This means we need a buffer – and that's what the debt target represents for us.

■ Do you think the government can and should offer specific incentives to attract KiwiSaver funds into local infrastructure ahead of other investment options?

Clearly from the point of view of managers of KiwiSaver funds, we must be able to match or better the rate of return we receive from offshore investment. To do this we need to package better the types of infrastructure projects we are undertaking.

One example is that we are investigating what we can do to support development in the 'Golden Triangle' [the geographic area bounded by Auckland, Hamilton and Tauranga]. We can certainly start by looking at the development of transport infrastructure. But we also need to think about the urban infrastructure built around this

as well as considering ways to ensure we are developing places where people want to live.

Packaging this together, we have come up with groups of projects I believe will not only be investment-ready but also investment-attractive to a wider range of investors.

The same applies to the New Zealand Superannuation Fund, which has put together a consortium to build a couple of the planned new light-rail lines and which, along with several other bids, is currently being assessed.

"I continue to have confidence in New Zealand's financial sector, which remains very sound. But there are some practices that the Australian commission has drawn to light that make us all uncomfortable."

My belief is that New Zealanders would like to see more of their savings invested onshore. As a government, we need to make sure we are doing our part by working with local government and others to achieve these goals.

■ On the topic of productivity, New Zealand's Perpetual Guardian recently trialled a four-day working week and concluded that the experiment was sufficiently successful to consider making the practice permanent. What are your views?

It has been an interesting experiment. Clearly as we move into the future of work we will have to start thinking differently about what work is.

The growth of the gig economy in New Zealand probably hasn't been as marked or as fast as it has internationally. But if we fast-forward 10-20 years, the notion of having one employer at one time for a very long period is starting to be challenged.

This requires all of us to think about different ways of working. If we genuinely believe the amount of

secure, full-time work is going to reduce significantly, options like the four-day week are important not only for people's work-life balance, which was largely the driver of Perpetual Guardian's trial, but also to make sure we make working opportunities available to as many people as possible.

A four-day week is clearly going to be more applicable to some industries than others, but if it is motivated solely and only by improving productivity and giving people a better work-life balance, it is a good idea.

■ You have committed to improving productivity measured by GDP per capita. What specific policies are attached to this goal?

I am not the first finance minister to say New Zealand has a productivity issue. The difference now is that we can identify specific areas that people argue are a constant drain on activity.

The first is infrastructure. We lose more than NZ\$1 billion every year because of the poor state of Auckland's infrastructure – which is why we are prioritising this development not only in Auckland but across New Zealand, with a clear focus on making transport investments that best lift productivity.

However, the number-one issue raised around the country is the lack of access to skilled staff. Clearly migration will play a part in meeting skill gaps where they exist, but as a country we can't sit back and rely on migrants.

The average German worker works 400 hours a year less than the average New Zealand worker, but their productivity is significantly better. We have to be training our own people and accepting that the concept of lifelong learning is now not only important for people's own wellbeing but also essential to our ability to improve productivity. •

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