SOVEREIGN SECTOR: CHALLENGES AHEAD FOR AUSTRALIA

SEMI-GOVERNMENTS: POST-BUDGET FUNDING STRATEGY UPDATES

SUSTAINABLE DEBT: GLOBAL VIEW, NEW ZEALAND AND RMBS

KangaNews

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AUSTRALASIAN FIXED INCOME: GLOBAL REACH, LOCAL EXPERTISE

ASIA DELIVERS SCALE

PUTTING ASIDE A NEAR-TERM DOWNTURN, MARKET PARTICIPANTS IN ASIA BELIEVE THE REGION HAS A BIGGER ROLE TO PLAY IN AUSTRALIAN CORPORATE DEBT ISSUANCE

KANGANEWS FIXED-INCOME RESEARCH POLL

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COPUBLISHED ROUNDTABLE
GLOBAL HIGH-GRADE DEBT AS THE WORLD CHANGES

There can be little doubt that the period of almost unprecedented beneficial funding conditions that pervaded up to the end of 2017 has passed. At their annual global-markets roundtable in London in June, **ANZ** and *KangaNews* heard the latest thinking from key issuer and investor players.

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The **Australian Office of Financial Management** hosted its fourth Australian Government Fixed-Income Forum in Tokyo in June. *KangaNews* was the only media organisation present, and is pleased to share a flavour of this important investor-relations project.

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Australian issuers and investors will need to engage with Asia sooner rather than later or run the risk of their home jurisdiction becoming increasingly marginalised.

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Scaling up and broadening supply through globally harmonised issuance standards will be a key goal for the international green-bond industry in the coming years, according to market participants at the leading international forum for the sector. Asia's significance is only set to grow.

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Green mortgages and the future of sustainable funding

The key to unlocking a new level of green issuance in the Australian bond market could be a deeper understanding of the assets on banks' balance sheets. Institutional assets lend themselves to classification and verification, while the potential of SME and household loans remains untapped.

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New Zealand's green-bond potential

New Zealand's green-bond market is in its infancy. While market participants work to facilitate issuance, domestic investors say they are well advanced in factoring environmental, social and governance criteria into their portfolios.

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ON THE WA UP

Western Australia's treasurer, **Ben Wyatt**, is happy to agree with the analyst consensus that the state's financial situation has resumed a more positive trajectory.

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In the wake of **Victoria**'s 2018/19 budget, the state's treasurer, **Tim Pallas**, discusses infrastructure and operating-cost plans, and how the state plans to fund them.

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QUEENSLAND STICKS TO ITS GUNS

Jackie Trad, **Queensland**'s deputy premier and treasurer, says building infrastructure to support future growth is a key budget priority. But having a sound budget base is the only way to deliver in a responsible manner.

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TCORP SETS OUT ITS PRIORITIES

Fiona Trigona, head of funding and balance sheet, and **Katherine Palmer**, senior manager, funding and balance sheet at **New South Wales Treasury Corporation**, lay out priorities for the coming year – which include a debut sustainability bond.

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EVENT REPORT

London call-in

Engagement with international investors is a significant – and growing – focus for Australian securitisers. The **Australian Securitisation Forum**'s annual showcase returned to London on 4 June, giving Australian issuers and intermediaries a chance to discuss the state of the local product and market with European investors.

The big story in the Australian dollar high-grade market in 2018 has been 10-year US Treasuries consistently yielding more than the equivalent Australian Commonwealth government bonds – with little prospect of a reversion. *KangaNews* spoke to a range of dealers in June to get their read.

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COLUMN

The role of green bonds in making an impact

To truly understand the value of green bonds – and counter the cynic's objection that they are little more than window dressing – it is necessary to take a historical perspective. By doing so, the nature and context of green-bond impact starts to reveal itself more clearly.

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RESEARCH POLL

CONSISTENT CONSISTENCY

The results of the eighth **KangaNews Fixed-Income Research Poll**, the only independent, specialist poll of fixed-income investors' views on research in Australia, are once again supported by a record number of responses. There are some movers within the ranks although the individual category winners continue to show a remarkable degree of consistency.

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COPUBLISHED Q+A

LEADING FROM THE FRONT

In the 2018 iteration of the KangaNews Fixed-Income Research Poll, **Commonwealth Bank of Australia** maintained the dominant position it has established in recent years. The bank's team sat down with *KangaNews* to reflect on the market-shaping factors of the past 12 months and to reveal their main watch points.

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Q+A

AUSGRID KEEPS AHEAD OF THE RUN RATE

Ausgrid Finance added to its landmark US private placement and Australian domestic deals from 2017 in April, with euro and dual-tranche US dollar transactions. **Michael Bradburn**, chief financial officer at Ausgrid, shares views on pricing objectives, market selection and sentiment as the company continues its mammoth term-out task.

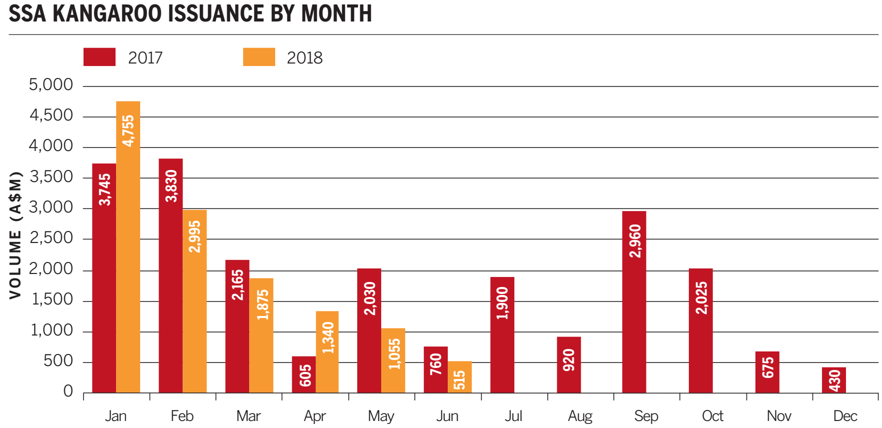
TRANSACTION ANALYSIS

EIB finds substantial demand at long end of the Kangaroo curve

After a prolific start to 2018, long-end Kangaroo issuance from supranational, sovereign and agency (SSA) issuers has tailed off significantly in recent months (see chart), with sizeable transactional volumes seen through the first months of the year reverting back to the small- and medium-sized deals which have previously characterised the market.

European Investment Bank (EIB)'s June deal bucked this trend to some extent, and maintained the issuer's record of printing some of the most substantial long-dated transactions in the Kangaroo market this year.

Issuer: **European Investment Bank**
Issuer rating: **AAA/Aaa/AAA**
Pricing date: **7 June 2018**
Maturity date: **25 May 2029**
Volume: **A$250 million (US$186.1 million)**
Margin: **45bp/s-q swap or 52.75bp/ACGB**
Lead manager: **TD Securities**



SOURCE: KANGANEWS 30 JUNE 2018

TRANSACTION INSIGHTS

Jorge Grasa
Capital Markets Officer, Americas, Asia and Pacific **European Investment Bank**

We haven't seen any substantial long-dated primary deals from SSAs in the Australian market for the last couple of months. Given this reality, what were your expectations around volume for this deal?

The demand picture gave us enough comfort to expect a well-placed A$200 million transaction – our usual size for a new line in this maturity. The positive market reception permitted us to upsize the transaction to A$250 million. We were pleased by the number of accounts in the book given the long maturity. The transaction was placed with offshore investors.

The 10-year tenor is the sweet spot for SSA Kangaroos, but it is relatively rare to see issuers push past 10 years. Was there any particular reason why EIB wanted to do this?

We heard of investors looking for 2029 Australian dollar paper and a May maturity appeared to be the sweet spot. While longer than 10-year Kangaroo transactions are not completely uncommon generally, the almost-11-year tenor is a first for EIB in this market.

Most of EIB's activity in the Australian market this year has been in the climate-awareness bond lines. Was there any specific reason not to issue the latest transaction as a climate-awareness bond?

This year has been particularly strong for EIB's green issuance, and Kangaroo climate-awareness bonds alone have raised A$1.65 billion across the 2023 and 2028 lines.

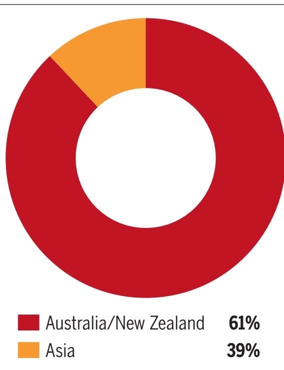
With this in mind, we need to be mindful of the volume of eligible green disbursements on the bank's asset side. We have therefore been striving to add a new point on the long end of our Kangaroo curve as a way of responding flexibly to investor demand – which continues to be particularly strong in these longer tenors.

Market technicals support Westpac's benchmark tier-two deal

Wholesale tier-two deals from the local major banks, at least in public benchmark format, have been few and far between in Australia in recent years (see table). This has created a scarcity-of-supply dynamic which, along with recent redemptions, resulted in significant demand for Westpac Banking Corporation (Westpac)'s latest tier-two benchmark.

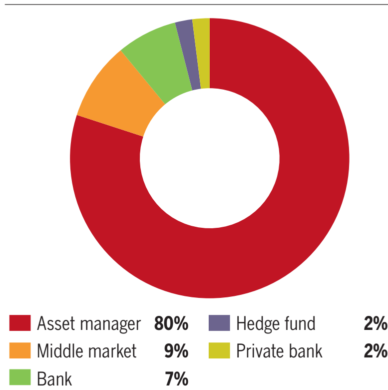
Issuer: **Westpac Banking Corporation**
Issuer rating: **AA-/Aa3/AA-**
Issue rating: **BBB/Baa1**
Pricing date: **14 June 2018**
Call date: **22 June 2023**
Maturity date: **22 June 2028**
Volume: **A$725 million (US$539.6 million)**
Margin: **180bp/3m BBSW**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead manager: **Westpac Institutional Bank**

CHART 1. WESTPAC TIER-TWO BOND GEOGRAPHIC DISTRIBUTION



SOURCE: WESTPAC INSTITUTIONAL BANK 15 JUNE 2018

CHART 2. WESTPAC TIER-TWO BOND DISTRIBUTION BY INVESTOR TYPE



SOURCE: WESTPAC INSTITUTIONAL BANK 15 JUNE 2018

AUSTRALIAN MAJOR-BANK BENCHMARK DOMESTIC WHOLESALE TIER-TWO DEALS

ISSUER	PRICING DATE	DEAL VOLUME (A$M)	MARGIN (BP/BBSW)
ANZ Banking Group	6 Nov 15	600	270
Westpac Banking Corporation	25 Feb 16	525	310
Commonwealth Bank of Australia	1 Jun 16	750	265
National Australia Bank	9 Sep 16	650	240
Westpac Banking Corporation	14 Jun 18	725	180

SOURCE: KANGANEWS 25 JUN 2018

TRANSACTION INSIGHTS

Guy Volpicella
Executive Director and Head of Structured Funding and Capital
Westpac Banking Corporation

Allan O'Sullivan
Executive Director and Head of Frequent Borrowers and Syndicate
Westpac Institutional Bank

Supply of Australian domestic tier-two paper has been limited of late, at least in public transactions. What contributed to Westpac's decision to issue now?

O'SULLIVAN Westpac has issued in tier-two format already this year and as a result we garnered significant reverse enquiry. With Development Bank of Singapore printing a well-supported deal in March, we were confident there would be market capacity and excess demand, and that we would be able to execute this deal at a very competitive price.

VOLPICELLA We are seeing investors recycling out of instruments that have been called in the last 12 months into other wholesale instruments, so we felt this was the right time to come to the market with a benchmark transaction. We still need to replace tier-two supplementary capital, whether or not we decide to call these instruments, as they start to amortise after their call dates.

We believe that maintaining strong capital levels, including supplementary capital, places the bank in a better position to call instruments on their call dates – though we also note that Australian Prudential Regulation Authority approval is always required and not guaranteed.

TRANSACTION INSIGHTS

Regulatory capital flexibility the goal for NAB in green trust deal

National Australia Bank (NAB) freed up regulatory capital for additional renewable-energy lending in June by funding part of its existing loan portfolio via an external trust vehicle. While investor demand makes renewables particularly suitable for this type of transaction, NAB also believes it could be applied elsewhere in the institutional balance sheet.

NAB placed a vertical slice of around half the volume of eight senior-secured loans in the renewable-energy space – seven to wind farms and one to a solar park – into a newly created special-purpose vehicle, NAB Trust Services. Investors receive principal and income from the trust's loans on an amortising, pass-through basis.

Issuer: **NAB Trust Services**
Issuer and issue rating: **NR**
Pricing date: **15 June 2018**
Weighted average life: **approx. 3.2 years**
Volume: **A$200 million (US$148.9 million)**
Margin: **approx. 160bp/3m BBSW**
Number of participating investors: **five**
Lead manager: **NAB**

Dennis Craig
Director, Product and Channel Development
National Australia Bank

This is obviously a relatively unusual type of transaction for the Australian market. What type of investor did NAB think might be interested in a deal like this?

The trust is designed to appeal to investors that would like to be involved in direct lending but perhaps don't have the scale to do so in their own right by participating in loan syndications or institutional term-loan placements. Investors will effectively be renting NAB's expertise in the renewable-energy sector, while providing the bank with incremental capital capacity to reinvest.

One thing that stands out about the deal structure is that it looks a little like a securitisation. Is this a fair comparison?

While investors' recourse is limited to the loans backing the notes, the deal is not tranched and can be differentiated from a traditional structured-finance transaction.

The margin the deal offers will fluctuate from coupon payment date to coupon payment date in accordance with actual payments from the underlying loans. The same applies to maturity profile: while the underlying loans have a weighted-average life of 3.2 years we expect most will be refinanced well ahead of maturity, with proceeds from refinancing also passed through to noteholders.

Can you describe the process of engaging with potential investors on an innovative transaction like this?

We spent several months engaging with investors in the lead up to launch, particularly those we knew would especially value the green credentials of this deal and would work with us to bring it to fruition. We've also had a number of additional investors approaching us with interest since the transaction launched and priced.

Can you give some colour around the composition of the group of investors that elected to participate?

The Clean Energy Finance Corporation cornerstoned the transaction and we also had two other large institutional accounts, one of which was Insurance Australia Group, make significant bids. This was rounded out by two smaller institutional investors. We are engaged with some further investors and have retained a portion of the portfolio to supply their demand.

We understand there is no structural reason why this type of transaction couldn't be repeated across a range of asset classes – but the suggestion is that the green aspect certainly resonated particularly strongly with investors. What do you see as the potential for scale in this type of deal?

This transaction represents the evolution of corporate and institutional banking in Australia – I think we'll see more of these types of transactions in the future.

TRANSACTION ANALYSIS

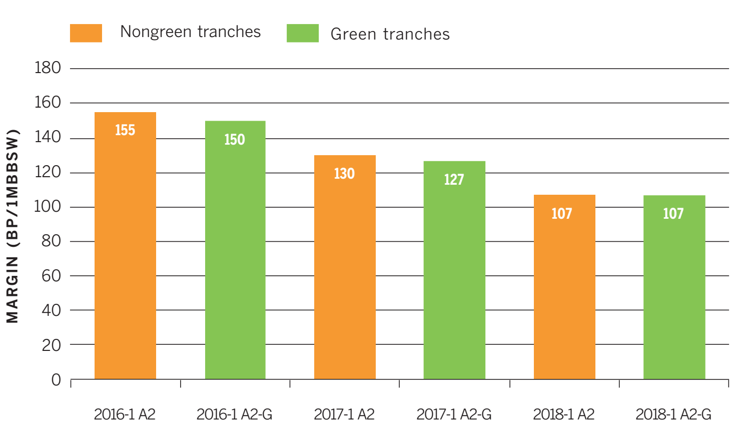
FlexiGroup expands its investor base with subordinated green tranche

FlexiGroup became the first issuer in the Australian market to include green subordinated notes in an asset-backed securities (ABS) deal with its latest transaction. Deal sources say the expansion of green tranches into the double-A rating space is a continuation of FlexiGroup's plan to broaden its investor base through the issuance of green product.

FLEXI ABS TRUST 2018-1

Sponsor: **FlexiGroup**
Collateral: **consumer loans**
Pricing date: **3 May 2018**
Volume: **A$300 million (US$223.3 million)**
Green tranches: **A2-G (A$66 million), B-G (A$15.3 million)**
Top-rated tranche margin: **107bp/1m BBSW (see chart)**
Top-rated tranche WAL: **1.5 years**
Number of participating investors: **20**
Arranger: **National Australia Bank (NAB)**
Lead managers: **Commonwealth Bank of Australia, NAB**

FLEXIGROUP GREEN VERSUS EQUIVALENT NONGREEN TRANCHE PRICE



SOURCE: KANGANEWS 9 MAY 2018

TRANSACTION INSIGHTS

Paul Jamieson
Group Treasurer
FlexiGroup

Paul Kok
Director, Securitisation
National Australia Bank

FlexiGroup has issued senior green ABS notes on two previous occasions. What was the thinking behind the decision to add green B notes in this deal?

JAMIESON We wanted to find how much support there would be for double-A green bonds and help widen the green securitisation market into the non-triple-A space. We achieved a very good coverage ratio for the class B-G notes, as well as the other notes, so it is encouraging.

KOK That's right. The class B-G notes were 4.7 times oversubscribed while the class A2-G notes were 4.4 times oversubscribed. Apart from the short-tenor class A1 notes, which were 1.7 times covered, all other tranches were between 4.7 and 5.5 times oversubscribed.

JAMIESON We could look at going further down the tranches when we issue next year, depending on the feedback we receive from the market and the profile of the green assets.

What does including green tranches do for FlexiGroup as an issuer?

JAMIESON The offer of two green tranches, along with the larger deal size compared with previous years, enabled us to broaden our investor base. We achieved this with four new investors to the Certegy ABS programme and more than A$1 billion of bids at the closing price.

How much more could FlexiGroup issue in green format?

KOK The only constraint we faced in expanding the green tranches was the amount of solar receivables we could put in as collateral. We wanted to be conservative and ensure there was sufficient cover.

JAMIESON We have a strong position in the solar space and it is a large part of our book. The volume growth in the class A2-G notes compared with previous deals is mostly attributable to the growth in the total asset pool, with the solar component of this book about 40 per cent. This is consistent with our recent deals.

TRANSACTION ANALYSIS

Building offshore RMBS distribution still a focus for Australian nonbanks

With growing loan originations and therefore a need for wider investor books, Australian nonbank issuers continue to expend significant effort on marketing their residential mortgage-backed securities (RMBS) transactions offshore.

LIBERTY SERIES 2018-1

Sponsor: **Liberty Financial**
Collateral: **prime and nonconforming residential mortgages**
Pricing date: **27 April 2018**
Volume: **A$1.5 billion (US$1.1 billion) including a €83.4 million (US$96.6 million) tranche**
Volume at launch: **A$700 million equivalent**
Largest tranche margin: **125bp/1m BBSW**
Largest tranche WAL: **2.1 years**
Euro tranche margin: **50bp/3m Euribor**
Euro tranche WAL: **2.1 years**
Geographic distribution: **54% domestic, 46% offshore**
Distribution by investor type: **75% real money, 25% banks**
Arranger: **Commonwealth Bank of Australia (CommBank)**
Lead managers: **Bank of America Merrill Lynch, CommBank, Deutsche Bank, National Australia Bank (NAB), Westpac Institutional Bank (Westpac)**

PEPPER I-PRIME 2018-1 TRUST

Sponsor: **Pepper Group**
Collateral: **prime and nonconforming residential mortgages**
Pricing date: **25 May 2018**
Volume: **A$550 million**
Largest tranche margin: **120bp/1m BBSW**
Largest tranche WAL: **3 years**
Arranger: **NAB**
Lead managers: **CommBank, NAB, Westpac**

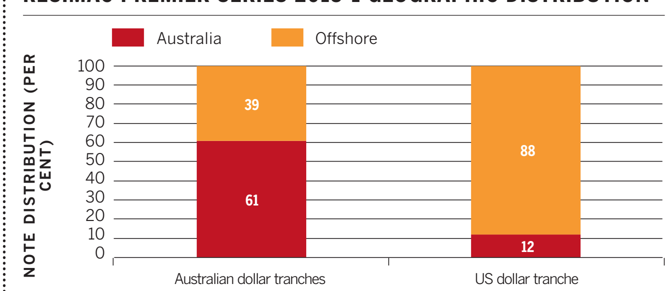
RESIMAC PREMIER SERIES 2018-1

Sponsor: **Resimac**
Collateral: **prime residential mortgages**
Pricing date: **18 May 2018**
Volume: **A$750 million including a US$210 million tranche**
Largest tranche margin: **110bp/1m BBSW**
Largest tranche WAL: **2.7 years**
US dollar tranche margin: **80bp/1m US Libor**
US dollar tranche WAL: **1.8 years**
Geographic distribution: **see chart**
Distribution by investor type: **66% real money, 34% other**
Arranger: **NAB**
Lead managers: **Citi, NAB, Westpac**

FIRSTMAC MORTGAGE FUNDING TRUST NO.4 SERIES 2-2018

Sponsor: **Firstmac**
Collateral: **prime residential mortgages**
Pricing date: **8 June 2018**
Volume: **A$1 billion**
Largest tranche margin: **112bp/1m BBSW**
Largest tranche WAL: **3.2 years**
Geographic distribution: **"focused on Japan"**
Lead managers: **ANZ, J.P. Morgan**

RESIMAC PREMIER SERIES 2018-1 GEOGRAPHIC DISTRIBUTION



SOURCE: HOUSING NEW ZEALAND 6 JUNE 2018

PETER RIEDEL
CHIEF FINANCIAL OFFICER
LIBERTY FINANCIAL

"We are always hopeful of upsizing, but we don't take it for granted. To upsize this transaction to the extent we did exceeded our expectations."

"We seek to allocate investors in the euro notes fully so it is really about what the demand is for that security at a particular point in time. There was a higher level of demand this time around than there was in Series 2017-4, as well as some new investors in the tranche."

"The new demand is coming largely from offshore. We've made three trips to Europe in the last 12 months to meet investors and speak about the Australian mortgage market and Liberty Financial specifically. In our experience, the more often we engage investors the more knowledgeable and confident they will become and therefore the more likely they are to invest."

ANDREW MARSDEN
GENERAL MANAGER, TREASURY AND SECURITISATION
RESIMAC

"Pepper Group has done an excellent job of taking its nonconforming programme to the US market. We will digest our latest deal then look at taking some of our senior nonconforming tranches offshore, whether that is in currency or jurisdiction."

"Most of the market here is focused on senior triple-A, pass-through notes. The class A3a and A3b notes have a slightly different yield profile but they are still triple-A bonds, so we see potential demand for them from Australian investors. It is just a matter of working with the banks to understand where the appetite is and how deep demand is."

JAMES AUSTIN
CHIEF FINANCIAL OFFICER
FIRSTMAC

"The Japanese investor base is one we have been cultivating for quite some time now. I spent six years working in Japan in a previous role and it is a market we have been regularly visiting over the last 5-6 years. We are seeing the efforts we have put into building relationships with Japanese investors really pay off."

"Our next transaction will be targeted at our loyal domestic investor base. This overall strategy of market rotation is serving us well – it is providing us with diversity and means we aren't targeting the same sets of investors too frequently."

"Some of the investors that came into this transaction were new to Firstmac and some were existing buyers of Firstmac RMBS. We have now had a number of Japanese accounts come into our transactions – some new ones this time and other accounts in the past. We are steadily increasing the group of Japanese investors that participates in our RMBS."

"Firstmac 1-2018 was particularly focused on south-east Asian accounts, which focus particularly on US dollars. Therefore, for that transaction we targeted and delivered US dollars. On the other hand, Japanese buyers regularly invest in Australian dollars and our understanding is that these investors are relatively agnostic between US and Australian dollars, partly because the cross-currency basis swap is working in their favour."

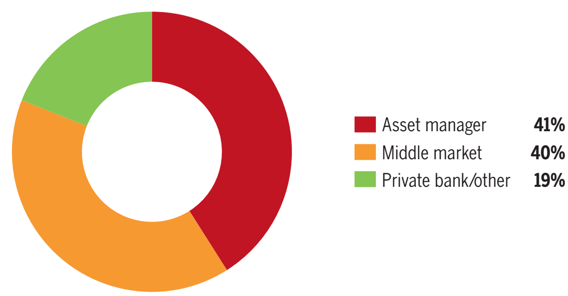
TRANSACTION ANALYSIS

Virgin touches down with high-yield domestic debut

Virgin Australia (Virgin) priced Australia's first single-B rated public bond on 18 May. Deal sources cite a broad spectrum of investor participation as evidence of growing demand for this product, but they caution that the success of similar deals will depend on the specifics of the credit involved and therefore on name-specific support from the buy side.

Issuer: **Virgin Australia**
Issuer rating: **B+/B2**
Issue rating: **B-/B3**
Pricing date: **18 May 2018**
Call date: **30 May 2021**
Maturity date: **30 May 2023**
Volume: **A$150 million (US$111.6 million)**
Coupon: **8.25%**
Margin: **ND (estimated approx. 555bp/s-q swap)**
Geographic distribution: **75% domestic, 25% offshore**
Distribution by investor type: **see chart**
Lead managers: **ANZ, HSBC, UBS**

VIRGIN AUSTRALIA DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: ANZ 21 MAY 2018

TRANSACTION INSIGHTS

STEVEN FOURACRE
GROUP TREASURER
VIRGIN AUSTRALIA

"Issuing in Australian dollars reduces our currency risk, even though there is greater liquidity and possibly tighter pricing achievable in the US high-yield market."

"We were eager to show investors that we have a policy which allows us to hedge our fuel costs out to two years so there is cover in place if prices rise significantly. The fact that we are issuing well in advance of any future maturities, proving the liquidity of the business, is seen as a positive by investors."

ANDREW DUNCAN
MANAGING DIRECTOR, DEBT CAPITAL MARKETS
HSBC

"In the last 2-3 years we have seen individual funds and various fund managers set themselves up to participate in more credit-intensive conversations, and high-yield product is part of this. A number of high-yield specific funds have also been launched and this trend looks set to continue."

PAUL WHITE
GLOBAL HEAD OF CAPITAL MARKETS
ANZ

"We were always confident that we could achieve volume of around A$150 million. Taking indications of interest the day before launch reinforced this confidence, as did the significant level of interest we received."

BARRY SHARKEY
MANAGING DIRECTOR, CAPITAL MARKETS
UBS

"The further down the rating spectrum the more important it is to understand and analyse the credit profile. In Virgin's case, investors recognised the positive changes made in recent years through deleveraging, fleet optimisation and a stable operating environment – underpinning their confidence to invest."

Rising rates support brace of Australian-origin convertible deals

After a three-year issuance hiatus, a brace of Australian firms have completed convertible-bond transactions in 2018. While not predicting a full-scale issuance revival, deal sources suggest equity valuations, normalising interest rates and the ongoing hunt for diversification should support renewed interest in the asset class.

Cromwell Property Group (Cromwell) issued €230 million (US$266.3 million) of seven-year convertible bonds at the end of March via joint lead managers Credit Suisse and Goldman Sachs. The bonds pay a coupon of 2.5 per cent and are convertible into Cromwell's stapled securities at a price of A$1.177 per security, reflecting a conversion premium of 7.5 per cent to the closing price of A$1.095 on 21 March.

Meanwhile, Seven Group Holdings (Seven) issued A$350 million (US$260.5 million) of seven-year convertibles in February.

Australian convertible deal flow has been irregular with a three-year gap between Seven's offering and previous issuance by Cromwell and Paladin Energy in 2015 (see table).

ISSUER	COMPLETION DATE	VOLUME (M)	MATURITY	COUPON (%)	CONVERSION PRICE	CONVERSION PREMIUM (%)
Aveo Group	Jan 11	A$125	Jan 16	8.00	A$1.014	20
CFS Retail Property Trust	Jul 11	A$300	Jul 16	5.75	A$2.40	28
Lynas Corporation	Feb 12	US$225	Aug 16	2.75	A$1.25	14
Beach Energy	Apr 12	A$150	Apr 17	3.95	A$1.88	25
Paladin Energy	Apr 12	US$274	Apr 17	6.00	US$2.19	25
Drillsearch Energy	May 13	US$125	Sep 18	6.00	US$1.66	35
Cromwell Property Group	Feb 15	€150	Feb 20	2.00	A$1.5303	7.5
Paladin Energy	Mar 15	US$150	Mar 20	7.00	US$0.356	25
Seven Group Holdings	Mar 18	A$350	Feb 25	1.70-2.20	A$24.00	30
Cromwell Property Group	Mar 18	€230	Mar 25	2.50	A$1.177	7.5

SOURCE: AUSTRALIAN SECURITIES EXCHANGE, BLOOMBERG 14 MAY 2018

BRETT HINTON
HEAD OF TREASURY
CROMWELL PROPERTY GROUP

"In our first convertible-bond issue Cromwell's security price actually went through the conversion price early in the life of the bond. No investors converted at this point because the value of the investor's call option contains a significant time-value component – if an investor converts it loses this time value so they are better off just selling the bond. Moreover, investors did not want to hold the equity and Cromwell has the ability to cash settle with investors at maturity."

"We issued €230 million of unsecured debt for seven years at an all-in coupon of 2.5 per cent. There will be upward pressure on interest rates over the medium term even in Europe, so not only is this transaction attractive today but it will become even more so in the longer term."

JOE HUNT
EXECUTIVE DIRECTOR
GOLDMAN SACHS

"Cromwell's transaction is the largest Australasian-origin convertible-bond issue in the last 10 years. Convertible bonds are not for every corporate issuer, but recent deals have led some companies once again to consider whether they should form part of the funding toolkit."

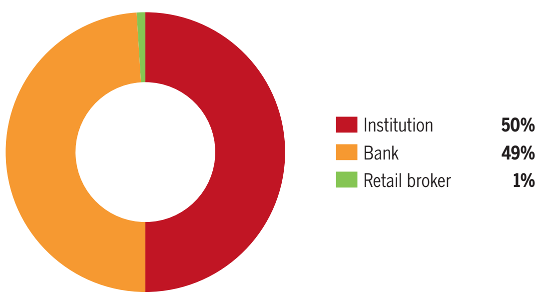
TRANSACTION ANALYSIS

Auckland Council beats a path for New Zealand green bonds

Auckland Council revealed its intention to be New Zealand's first domestic green-bond issuer in March, with market development one of its key objectives. In the wake of a debut transaction pricing on 21 June, deal sources say the issuer achieved this objective, uncovering significant demand and attracting new investors.

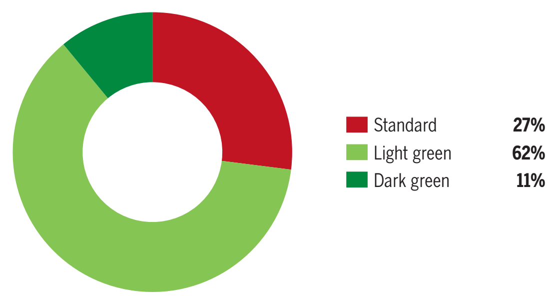
Issuer: **Auckland Council**
Issuer rating: **AA/Aa2**
Issue rating: **as issuer**
Pricing date: **21 June 2018**
Maturity date: **27 June 2023**
Volume: **NZ$200 million (US$138.8 million)**
Margin: **50bp/mid-swap**
Distribution by investor type: **see chart 1**
Institutional investor distribution by mandate: **see chart 2**
Arranger, lead manager and green-bond coordinator: **ANZ**

CHART 1: DISTRIBUTION BY INVESTOR TYPE



SOURCE: ANZ 26 JUNE 2018

CHART 2: INSTITUTIONAL INVESTOR DISTRIBUTION BY MANDATE



SOURCE: ANZ 26 JUNE 2018

TRANSACTION INSIGHTS

ALEC TANG
CORPORATE SUSTAINABILITY LEAD
AUCKLAND COUNCIL

"There is a huge push, nationally and locally, for action on climate change in New Zealand. With this transaction we can point to the exact purpose and direction of the funds, which reinforces our commitment to a low-carbon and climate-resilient future."

PATRICK MULLINS
DIRECTOR, DEBT CAPITAL MARKETS
ANZ

"New Zealand doesn't have many specifically green-mandated funds, but there are many funds implementing environmental, social and governance criteria into their investment decisions. This area is gathering momentum, which was reflected in the pricing outcome of this deal."

ANDREW JOHN
FUNDING MANAGER
AUCKLAND COUNCIL

"We have a significant amount of assets that meet green-bond criteria. In our next 10-year plan we have roughly NZ$12 billion of transport assets, 40 per cent of which is public transport. We also have assets in water, waste water and forestry that would be eligible for green-bond funding."

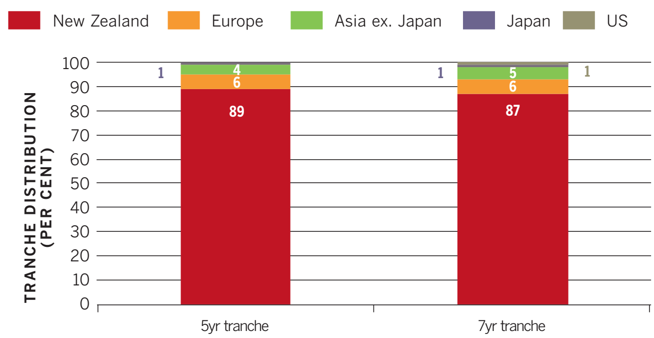
TRANSACTION ANALYSIS

Housing NZ hits the sweet spot in domestic return

Housing New Zealand (Housing NZ) returned to the New Zealand debt capital market in June, for the first time since 1999. Deal sources suggest the addition of a new high-grade issuer in the New Zealand dollar market is a boon for market development, particularly due to the nature of the institution and its intent to be a repeat issuer.

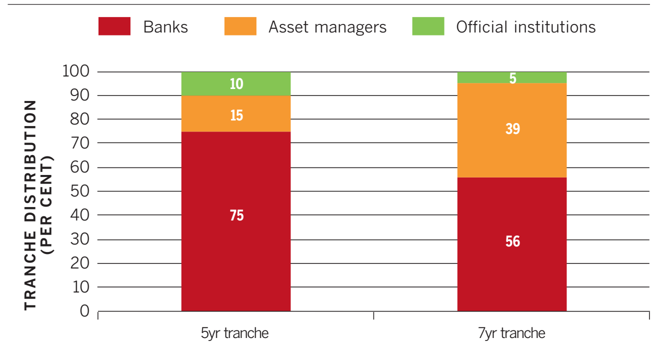
Issuer: **Housing New Zealand**
Issuer rating: **AA+ (S&P)**
Pricing date: **1 June 2018**
Maturity date: **12 June 2023 & 12 June 2025**
Volume: **A$250 million (US$173.5 million) in each tranche**
Margin: **32bp/s-a & 48bp/s-a**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, Westpac Banking Corporation New Zealand Branch**

CHART 1. HOUSING NEW ZEALAND DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: HOUSING NEW ZEALAND 6 JUNE 2018

CHART 2. HOUSING NEW ZEALAND DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: HOUSING NEW ZEALAND 6 JUNE 2018

TRANSACTION INSIGHTS

FIONA DODDRELL
DIRECTOR, DEBT CAPITAL MARKETS AND SYNDICATE
WESTPAC INSTITUTIONAL BANK

"The book built very quickly and it was pleasing to achieve the maximum volume sought at the tight end of initial price guidance for an inaugural transaction."

"It is always difficult to qualify whether investors came into the deal specifically for the environmental, social and governance [ESG] aspect. But New Zealand investors are aligned with those offshore in being increasingly concerned with ESG factors. So to have a high-grade issuer in this market which produces social outcomes is a great benefit."

DEAN SPICER
HEAD OF CAPITAL MARKETS, NEW ZEALAND
ANZ

"We were pleased to see some uptake overseas and we expect, as the issuer develops a curve and the tranches build out, to see more offshore participation."

"There are price points that confirm the New Zealand market can go out to 10-year duration and further. I anticipate that, for an issuer of Housing NZ's quality, this would certainly be achieveable."

HOUSING NEW ZEALAND PLAYS THE LONG GAME

New Zealand's semi-government market received a significant boost in the May 2018 budget when the government mandated a further uplift to **Housing New Zealand** (Housing NZ)'s home-building programme. The agency's Auckland-based chief executive, **Andrew McKenzie**, and Wellington-based treasurer, **Sam Direen**, share insights into the financing mandate, funding strategy and commitment to the New Zealand bond market.

The coalition government's 2018 budget pledged to take action on "the housing crisis and the scourge of homelessness" in New Zealand. What has Housing NZ been mandated to do in this respect?

■ **MCKENZIE** The New Zealand government has revealed plans to increase the number of new public houses by 6,400 over the next four years. Housing NZ has been asked to do at least 70 percent of the building with community-housing suppliers providing the remainder.

This building activity is in addition to Housing NZ's asset-renewal programme, with a significant level of construction activity underway to reset our old stock into warm, dry and efficient homes.

More than 75 per cent of our 60,000 homes are reaching the end of their lives and need to be renewed within the next 20 years. This equates to 2,250 homes per year. The remaining 25 per cent, or 300 per year, will need to be improved within the following 50 years. Clearly our housing portfolio has lumpy renewal periods, reflecting the timing and quality of previous house-building activity.

Financing is required to deliver these additional houses and the concentrated level of renewal activity. The minister of finance and minister responsible for housing therefore agreed to increase the limit on borrowing Housing NZ can access from outside the New Zealand Debt Management Office by just less than NZ$2 billion (US$1.4 billion), to NZ$3.1 billion.

The initial NZ$1.1 billion, approved by the National-led government in May 2017 and subsequently endorsed by the Labour-led government following last year's general election, was to help finance the Auckland housing programme. Housing NZ's overarching initiative in Auckland is to renew stock and increase housing supply using land capacity.

The increase in the borrowing protocol limit is made up of NZ$1.8 billion of term debt as well as an additional NZ$150 million capacity for working-capital requirements. The total bond programme in the four years to 30 June 2022 is NZ$2.9 billion, with around NZ$1 billion of this expected to be issued prior to 30 June 2019.

Why borrow from the bond market instead of taking funding from the Crown?

■ **MCKENZIE** Our stewardship responsibility is to ensure our asset-management plans are delivered on to enhance our building stock – which includes renewing and building modern, warm and dry homes. Our free cash flows from operations are more than sufficient to fund this renewal, but our renewal programme is not smooth.

As noted earlier, more than 75 per cent of our current 60,000 homes need to be renewed within the next 20 years, rather than the 52 years an even spread would suggest. The following 50 years requires a much lower level of renewals. This lumpy renewal profile means there is a need for financing over this time – we view it a bit like working capital over the long term.

Accessing finance outside of the Crown provides the flexibility and appropriate level of control required for our stewardship responsibilities. Importantly, the ability to access long-term financing independently 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.

It is not a new concept for New Zealand government entities with long-lived assets to seek debt-capital-markets financing. Housing NZ itself has undertaken such activity in the past and Transpower, the state-owned enterprise which owns and operates the national grid, is an active borrower in debt capital markets.

But isn't it cheaper to borrow directly from the sovereign?

■ **DIREEN** First off, the benefits of borrowing in our own name, in our view, far outweigh any perceived costs. Notwithstanding this, there are some misconceptions around our cost of borrowing that we'd like to take the opportunity to address.

We have a commercial arrangement with the Crown with respect to our loans, just like other government entities, so borrowing at New Zealand government bond (NZGB) rates isn't actually an option for us. This is a fact that surprised some investors on our recent roadshows.

It's academic, but it's worth considering the counterfactual of a NZ$3 billion increase in the Crown's borrowing programme were Housing NZ not in the market in its own name and the extent to which NZGB yields would increase as a result of the greater supply.

It's reasonable to hypothesise that the greater supply of NZGBs would result in some marginal pressure on yield, so assessing the additional financing costs faced by Housing NZ is not as simple as assessing our on-screen spreads to NZGBs – which, for note, were around 65 basis points in mid-June on the five-year maturity.

Housing NZ recently printed a capped NZ$500 million dual-tranche deal in its first bond-market foray in almost 20 years [see p13]. To what extent did the outcome meet – or even exceed – your initial expectations?

■ **DIREEN** This was effectively an inaugural transaction for Housing NZ so we wanted to ensure the outcome was successful – in the sense that it was a fair price for our investors and for us as an issuer. We believe we achieved this, and we couldn't be happier with the pricing outcome.

Relative to swap and, more importantly for us, NZGBs, our bonds were indicated 3 basis points tighter in the week immediately following pricing and tightened by a further basis point in the week after that.

Given our intention to issue around NZ$1 billion by the end of June 2019 and to be able to sample the market at several maturity points over the following 12 months, a maximum of NZ$500 million seemed like appropriate volume for our debut. We also thought this volume was suitable for us to establish two liquid lines.

We strongly believe international support will build over time, particularly because anecdotal feedback is that investors were either waiting for their credit lines to be established or to pick up our bonds in the secondary market.

Housing NZ has said its issuance approach will include strategic and tactical aspects. Can you talk us through this?

■ **DIREEN** We expect the majority of our issuance to be strategic in nature. In other words, our aim is to establish and maintain a New Zealand dollar programme in the market-friendly parts of the curve.

We have a preference to issue long tenors given the nature of our asset base. We certainly hope the sweet spot in the New Zealand dollar market lengthens over time – towards and beyond the 10-year tenor.

We are purposefully also allocating capacity to tactical issuance and we believe there will be opportunities for us to do so. In particular, we are open to reverse enquiry for long-dated New Zealand dollar issuance off our MTN programme.

We are approaching investor relations and curve-building going forward on the basis that we will be an active issuer over the long term. The Housing NZ board approved our long-term investment plan (LTIP) in late June and we plan to release a summary of this for investors and other stakeholders in due course.

The LTIP assumes net debt increases over the medium term as we address the greater-than-usual renewal requirements of the existing stock of houses, before declining further out as the build programme moderates and free cash flows remain strong.

Our preference is to source this financing from debt capital markets. While both former and current governments have recently supported this approach, any potential increase in the borrowing protocol is ultimately a political decision.

How does Housing NZ intend to develop and maintain liquidity in its bond lines? Does liquidity really all come down to volume on issue or is there anything else you can do to promote liquidity?

■ **DIREEN** Our strategy is to launch new lines at a minimum of benchmark size and to attract a diverse range of investors in order to promote liquidity in our lines from the outset.

Over time, we plan to build a Housing NZ bond curve with suitable gaps between lines – at this stage we believe two years or more is ideal. This will enable us to add liquidity into relevant lines via taps as they roll down the curve and reach specific points of high demand.

It is not just about volume, though, and we believe we have a role to play in further enhancing liquidity in our bond lines. A clear priority for Housing NZ is to diversify our investor base – across region and investor type.

Of course, intermediaries also play a key role in the provision of liquidity in the secondary market as well as bringing new investors onboard. We will be watching closely to see how this develops over time. •

"The ability to independently 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."

ANDREW MCKENZIE

LAURENCE DAVISON
LDAVISON@KANGANEWS.COM

Reach out (or be where)?

Having recently spent some time in Asia talking to advocates of the burgeoning regional credit market, I was struck by some contrasts with Australia. It occurs to me that local issuers and investors will need to engage with Asia sooner rather than later or run the risk of their home jurisdiction becoming increasingly marginalised.

First of all, I should be clear that when I talk about the potential of the Asian market I am speaking about a medium- to long-term horizon. The credit correction of Q2 clearly demonstrated that US dollar Reg S issuance to the Asian investor base does not yet have the same deep foundations as the domestic US market.

Even so, it seems pretty clear that the Asian market is not going away and will only grow in relevance – even to historically wary Australian borrowers. Look at the fundamentals: Asia has a growing pool of true regional wealth, an increasingly institutional investor base with a desire for diverse and high-quality credit, and is largely happy to transact in the world's most liquid and hedge-friendly currency.

"HAVING HEARD THE PHRASE 'DEEP AND LIQUID CORPORATE BOND MARKET' ON WHAT SEEMED LIKE A DAILY BASIS GOING BACK SEVEN OR EIGHT YEARS, ANY IDEA THAT THE GOVERNMENT HAS A ROLE IN PROMOTING AUSTRALIA AS A CREDIT-MARKET HUB APPEARS TO HAVE WITHERED ON THE VINE."

INSTITUTIONAL SUPPORT

There is also institutional support for market development. This is the first telling contrast with the Australian market. As well as being their jurisdictions' central banks and market regulators, the Hong Kong Monetary Authority (HKMA) and Monetary Authority of Singapore (MAS) have market-development mandates – and both are putting words and deeds behind drives to attract bond issuance to their jurisdictions.

The jury is certainly still out on whether the respective bond-grant schemes will move the dial when it comes to issuers' selection of funding options. But there can be no doubt that the HKMA and MAS are committed to building their jurisdictions as bond-issuance hubs in response to the clear desire in the region for credit-market development.

A related example: the HKMA also supported – as sole headline sponsor and de facto underwriter – the International Capital Market Association's recent green and social bond principles annual general meeting and conference. I have a hand in organising conferences, and I can confirm that this would have been no small task. With more than 800 delegates – all of whom attended on a complimentary basis – at one of Hong Kong's top hotels, the catering cost alone would have made most potential sole sponsors blanche.

At the event, the Hong Kong government reconfirmed its recent commitment to an own-name green-bond issuance programme that could make it the largest sovereign issuer of the product in the world. This is another clear sign of recognition of and response to market need – or, more cynically, market fashion – and a desire to respond in a way that maximises the local jurisdiction's relevance.

I had to ponder, watching the local finance minister lay out these commitments, at what an Australian equivalent would be like. What if, having committed to fostering a "deep and liquid corporate bond market" in 2011 the Australian government had followed up by establishing a market-development authority, committed dollars to the industry and instituted a range of financial incentives to Australian and global companies to access the local debt capital market?

Instead, we got some tinkering with the rules around retail issuance that have contributed to the path to market of perhaps half a dozen transactions and the listing of government bonds – that has experienced if anything even less take-up than what were far from optimistic initial expectations.

Having heard the phrase "deep and liquid corporate bond market" on what seemed like a daily basis going back seven or eight years, any idea that the government has a role in promoting Australia as a credit-market hub appears to have withered on the vine.

PRIVATE-SECTOR ROLE

To be fair, it would be hard to say that government efforts to build the Australian credit market have failed. It would be more accurate to say that there was never really anything more than a hollow phrase in the first place. The opening section of the report of 2014's much-ballyhooed financial system inquiry (FSI) repeatedly emphasises the view that it is not the role of government to shape financial markets beyond protecting their stability.

"The inquiry does not believe mandating or subsidising a particular market in an attempt to increase its size (whether it be corporate bond, securitisation or venture capital markets) is an effective strategy in the long term," the report unequivocally states.

Instead, with the FSI's hints on reforms to tax incentives that draw investment funds away from fixed income roundly ignored by government, it has been left to private-sector forces to grow and shape the local credit market. My assessment is that they have done a decent if unspectacular job.

It is certainly the case that corporate Australia is more inclined to use its domestic debt market for refinancing than was the case a decade or more ago. We have also seen a gradual extension of tenor available to investment-grade corporate borrowers – though the stickiness of this characteristic remains unproven – and some landmark transactions in scale and credit profile.

Equally, however, there is little sign so far that the domestic option will supplant rather than merely supplement Australian borrowers' traditional love affair with US public and private markets, or that it is a rival to bank debt when it comes to flexibility or scale. The suspicion that the domestic market is a fair-weather friend is hard to shake.

MOUNTAIN CLIMBING

Putting together the potential evident in the regional market – where, to be clear, demographic and investment fundamentals will be more of a development factor than any government incentive scheme – I am reminded of the old phrase: "If the mountain will not come to Mohammed, Mohammed must go to the mountain."

Australia might have had an opportunity, earlier this decade, to develop a domestic credit market that is also a regional hub. But that window has now clearly closed, and there is a good chance that the next macro market-shaping trend will be a requirement for local issuers and investors to engage with the Asian platform.

For one thing, the fate of Asian flows into Australian dollar credit must now be up in the air. Market participants say such funds have been surprisingly sticky so far, and most agree that there is now a certain baseline level of 'natural' Australian dollars in the region. But the Reserve Bank of Australia is not going to catch up with the Federal Reserve in the foreseeable future, and in this context most market participants admit that the regional flow back to US dollars is only likely to intensify.

> "US AND EUROPEAN FUND MANAGERS WOULD LIVE IF THEY NEVER SAW ANOTHER AUSTRALIAN-ORIGIN BOND. BUT IF AUSTRALIAN SUPPLY GRADUALLY STARTS TO LEAK TO THE ASIAN MARKET IT WOULD CLEARLY BE A CHALLENGE TO PURELY DOMESTIC-FOCUSED INVESTORS."

The old complaint about the domestic market – before regional inflows broadened the demand pool – was that it was effectively a closed shop, dominated by a small number of local accounts that saw themselves, and effectively acted, as price-makers. This is not an appealing setup for corporate borrowers, and indeed going back a few years the mood of many corporate treasurers who did issue in Australia was often one of sulky acquiescence.

This is not to say, of course, that Australia is the only corporate-issuance market with a down side. US private placements (USPPs) also have a relatively narrow investor circle and feature high issuance costs and restrictive covenants. The 144A option is costly and involves constant fight for buy-side bandwidth. European market cost-effectiveness is at the mercy of the basis swap.

To me, all this says that if the propaganda about Asian market development is true it will, in the fullness of time, be more or less a no-brainer for Australian corporate issuers to look to the region as something close to its default debt capital market. In other words, I don't see Asian Reg S as any more of an idiosyncratic threat to the domestic market than it is to Australian-origin USPPs or 144As. It could be a threat to all of them.

What might be unique to Australia is the fact that investors as well as issuers would benefit from starting to engage actively with the Asian market. US and European fund managers, much as they no doubt appreciate issuance diversity, would live if they never saw another Australian-origin bond. But if Australian supply gradually starts to leak to the Asian market it would clearly be a challenge to purely domestic-focused investors.

Taking a wider view is already happening – to some extent. Intermediaries can reel off a list of Australian fund managers that actively participate in US dollar Reg S transactions from local issuers. But it is not a long list – perhaps half a dozen.

At the same time, there are real barriers for some investors. Passive funds are likely mandated against an index that does not include international issuance, while insurance money is hamstrung by the "assets in Australia" regulation that does not let it play in arenas like Reg S. But the bottom line is that all Australian institutional funds need at least to have a thought process in place about how they will deal with the growth of the regional credit market. •

Global green-bond market prepares for **leap to mainstream**

Scaling up and broadening supply through globally harmonised issuance standards will be a key goal for the international green-bond industry in the coming years, according to market participants at the leading international forum for the sector. Asia's significance as a source and target of issuance is only set to grow.

BY LAURENCE DAVISON

On 14 June, more than 800 green- and social-bond market participants from around the world met in Hong Kong for the International Capital Market Association (ICMA)'s 2018 green and social bond principles AGM and conference – the first time this event has been held in Asia.

KangaNews is the only media company to be an observer of the green, social and sustainability bond principles and was on hand to report the event.

The AGM also saw the release of the latest iteration of ICMA's green bond principles and social bond principles, with updates focused on enhancing transparency – for example, around the use of external reviews.

MARKET PROGRESS

Conference speakers highlighted the pace of growth experienced by the green-bond market in particular. The main agenda item was how to build on this growth to make the asset class truly mainstream and thus achieve its objective of martialling capital markets for climate-related change. Time is of the essence.

"The next 12 months will be critical for scaling up the market, and therefore sustainable finance, for years to come. This growth will be important, not least in addressing the huge demand for green investments," said HSBC's group chief executive, John Flint.

Ashley Schulten, managing director and head of responsible investment, global fixed income at BlackRock, commented: "I think we have achieved the vision we set for ourselves 4-5 years ago, of developing a global standard and a market of scale. The vision for the next 4-5 years has to be diversity at scale – to build a global-aggregate index equivalent in green bonds. To do so we need more: more asset-backed securities, more sovereign issuance, more high yield and more from emerging markets."

According to Climate Bonds Initiative (CBI) data, there was nearly US$900 billion of outstanding "climate-aligned bonds" on issue by mid-2017, from more than 1,100 issuers. The consensus at the ICMA event was that this represents a good start but that growth potential remains largely untapped.

For instance, Eila Kreivi, director and head of capital markets at European Investment Bank and chair of ICMA's green-bond principles executive committee, compared green-bond market maturity to "somewhere between a toddler and an adolescent". However, she conceded that it is further progressed now than might have been expected half a decade ago.

"I am pleased to say that Hong Kong will soon join the 'green wave' by issuing green bonds to a ceiling of approximately US$13 billion equivalent. We will do so under global best practice and advise others to do the same."
PAUL CHAN MO-PO GOVERNMENT OF HONG KONG SPECIAL ADMINISTRATIVE REGION

> "I have some concern about taxonomies. It is possible to end up looking at everything through a single lens and see things only in a positive light from one perspective, thus missing what might be more negative social connotations, for instance."
>
> **ISABELLE LAURENT** EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

There appears to be no doubt about the power of green and social bonds to affect change. Conference speakers took on naysayers who see the sector as window dressing or a PR exercise, with a common theme being the wider behavioural change that issuance generally entails – at least within fully bought-in issuers.

Kreivi said: "Cynics often say green bonds are funding things that would be funded anyway. This is true – but it misses the point that green bonds are more about starting processes within organisations that have a wider impact. As an issuer, there is no point planting a rose in front of your house if the inside is a mess – because investors will inevitably ask about the whole house, not just the rose."

Stephanie Sfakianos, head of sustainable capital markets at BNP Paribas, added: "There is no doubt in my mind that BNP Paribas behaves differently as an organisation having issued a green bond and committed to doing so again in future. We are now actively encouraged, and incentivised, to fund green projects. The bank's house is being put in order and the way we operate is changing."

HARMONISATION GOAL

The ICMA principles form a baseline set of guidelines for most global green-bond issuance. But a major discussion point at the event – and one that sparked differing views – is the extent to which further clarity on standards could help unlock the market's vast potential. In particular, speakers debated the extent to which global harmonisation is a worthwhile and achievable target.

Moves are already afoot to introduce international standards. The European Commission (EC) is working on a green-bond "taxonomy", while China has produced a Green Bond Endorsed Project Catalogue. The ASEAN Capital Markets Forum also published, in 2017, its own green-bond standards as a voluntary framework for issuers in south-east Asia.

Most conference speakers believe standards – within regions, and potentially between them – should enhance issuance opportunities especially for private-sector borrowers.

Kreivi explained: "It might be thought that prescriptive rules would deter private-sector issuers. But they actually make it easier for corporate issuers to come to market secure in the knowledge that they are doing things right."

The main purpose of standards is to maximise alignment between issuance and purpose. Natixis's global head of green and sustainable finance, Orith Azoulay, said: "Once the green-bond principles were in place, we needed a common language to facilitate greater granularity in the market. This is where the concept of a taxonomy came in. What the EU is trying to do is to define green standards in terms of policy objectives."

The experience of ASEAN countries is illustrative in this respect. Eugene Wong, managing director, corporate finance and investments at Malaysia's Securities Commission, explained that the region has a multi-trillion dollar infrastructure investment task in the next decade and a half as it seeks to mitigate air pollution and historically high flooding affecting a population of 640 million and growing.

"If we are going to put the right infrastructure in place, now is the time to do it," Wong said. "The challenge is that we are dealing with 10 countries with differing ideas about what is green."

In the case of the ASEAN standards, the decision was to go for a high bar. Wong continued: "We went for no fossil fuels at all even though we knew this would reduce issuance potential. It's hard to move from light to dark green – and dark green is what we want. There are plenty of other ways to do 'good but not perfect' things outside the green-bond standards."

This hints at some of the challenges involved in harmonising standards between jurisdictions – because the ASEAN conclusion is not universal. Yao Wang, director general of the International Institute of Green Finance at China's Central University of Finance and Economics and deputy secretary general of the Green Finance Committee at the China Society for Finance and Banking, explained why China has settled on somewhat less restrictive green-bond standards.

China is the world's biggest investor in renewables, Wang said, but "clean use of coal" has been confirmed as a catalogue item in China. Coal provides 70 per cent of China's energy and Wang argued that making it cleaner is a legitimate priority.

HARMONISATION LIMITS

"There are different understandings of 'green' across jurisdictions and even within regions, and therefore different definitions," Wang said. "To increase understanding and awareness it is important to comprehend the underlying 'green logic' of a specific jurisdiction."

The heart of the debate going on within the green-bond sector is how far to go with harmonised standards. Some speakers at the ICMA event think a drive for harmonisation above all could be counterproductive.

European Bank for Reconstruction and Development's deputy treasurer and head of funding, Isabelle Laurent, commented: "I am a great believer in transparency, disclosure of assets and impact reporting – putting information out is very important. But I have some concern about taxonomies. It is possible to end up looking at everything through a single lens and see things only in a positive light from one perspective, thus missing what might be more negative social connotations, for instance."

The example cited by Laurent was earlier attempts to move to diesel from petrol for automotive fuel. While diesel was, at the time, widely believed to be a cleaner fuel from a carbon-emissions perspective, it is has negative pollution and public-health impacts.

"There will be different priorities across geographies, and what we need to be doing is looking at projects from a multidimensional aspect to ensure above all that they do no harm," Laurent continued. "It may be hard to tweak a global standard to suit local needs and priorities, and thus it might be better instead to help market users with impact reporting and project assessment."

However, other market users maintain that harmonised standards should, if designed right, still allow for variation in preferences between jurisdictions.

"Classification should highlight the fact that it is possible to have different objectives while still being labelled 'green'," argued EIB's deputy head of funding, euro, Aldo Romani. "Standards should be a reference that allows market actors to follow their own preferences, and more clarity does not have to equal one size fits all."

Meanwhile, Sean Kidney, chief executive of the CBI, pointed out that the process towards regional standards at least may be too far advanced to stop. His view is that standards should be encouraged provided they meet the goals of producing scale, simplicity, low transaction costs and global liquidity in the green-bond market.

Kidney said: "We have a final, solid commitment from the EC that there will be a regulated taxonomy in Europe. China will have a catalogue – this is also settled. The only questions are the extent to which European and Chinese standards are harmonised and how well the taxonomies match the goals of the market."

There is one glaring omission to this progressive outlook, though. "The elephant in the room – or rather not in the room – is the question of where the US is," Azoulay acknowledged. "We are missing this voice in the harmonisation exercise, and its absence is a big challenge. The US financial industry loves standards to adhere to, and if it had some for green bonds the US market would surely pick up."

ENCOURAGING ISSUANCE

While views on how to achieve it differ, green-bond market participants at the ICMA event strongly agreed that encouraging further issuance – especially from the private sector – should be the main goal of the industry. Some believe that uncertainty is staying the hand of corporate issuers in particular.

"Our perception is that corporate borrowers tend to be standing aside because they believe there is going to be a lot of further regulation in the space – and they don't like the uncertainty this implies," revealed Sfakianos at BNP Paribas.

Kreivi, meanwhile, argued that the asset class needs a greater number of "enlightened and informed" issuers. In this context, she applauded the decision of the government of the Hong Kong Special Administrative Region to commit to issuing green bonds and noted that under the terms of this commitment Hong Kong could become the largest sovereign green-bond issuer to date.

Paul Chan Mo-po, Hong Kong's financial secretary, told the ICMA conference: "I am pleased to say that Hong Kong will soon join the 'green wave' by issuing green bonds to a ceiling of approximately US$13 billion equivalent. We will do so under global best practice and advise others to do the same."

Hong Kong's commitment to green bonds is not just as an issuer. It also wants to become a hub for issuance by third parties, which it demonstrated via financial and logistical support for the ICMA conference. Mo-po said Hong Kong "will come to be as well known for green finance" as it is in other financial markets. He added: "We see green as the new gold – not just for the economy but also for our common future."

> "As an issuer, there is no point planting a rose in front of your house if the inside is a mess – because investors will inevitably ask about the whole house, not just the rose."
> **EILA KREIVI** EUROPEAN INVESTMENT BANK

In the long term, Sfakianos believes the ongoing build-up of investment assets managed with environmental, social and governance mandates means issuers will inevitably be drawn to the green-bond sector.

She commented: "The green-bond market will become more valuable to issuers as we get out of the bull market. As things stand, it might be the difference between a five-times oversubscribed book and a 10-times one, which doesn't really matter. But as liquidity retreats the demand for green bonds is starting to resonate with corporate issuers."

BlackRock's Schulten used supply dynamics to return to the need for robust standards. She said: "I am not worried about supply – there is certainly no shortage of issuers wanting to discuss their programmes with us. I would rather see a better market than a bigger one, by which I mean clear evidence of environmental benefits and with price tension. We never want to be in the position of having to defend an investment to our clients." •

Green mortgages and the future of sustainable funding

The key to unlocking a new level of green issuance in the Australian bond market could be a deeper understanding of the assets on banks' balance sheets. Institutional assets lend themselves to classification and verification, while the potential of SME and household loans remains almost untapped.

BY LAURENCE DAVISON

With no nationwide standards for home energy-efficiency in place, identifying and verifying suitable assets for a green securitisation followed a pattern that might hint at how green funding options could in time be deployed more widely. But there is a long road, and a lot of heavy lifting, to be done before much of a bank's balance sheet can be accurately labelled for sustainable funding.

In late April, National Australia Bank (NAB) hosted a roundtable – in association with the Australian Securitisation Forum's publication, *Australian Securitisation Journal (ASJ)* – to discuss the bank's green residential mortgage-backed securities (RMBS) transaction and what it means for debt funding.

The deal itself was a A$300 million (US$223.3 million) tranche issued as part of the A$2 billion National RMBS 2018-1 securitisation. The green tranche is based on the Climate Bonds Initiative (CBI)'s Climate Bonds Standard proxy criteria for Australian low-carbon residential buildings, which were introduced in 2017.

These criteria require dwellings to be in the top 15 per cent of residential buildings for emissions performance in the jurisdiction of origin, representing a benchmark sufficient to meet the target of net zero emissions for the building sector by 2050.

In Australia, the Climate Bonds Standard proxy criteria leverage national building codes and energy-rating schemes and certificates. However, so far only three states – New South Wales (NSW), Tasmania and Victoria – meet the proxy criteria.

Rob Fowler, head of certification at the CBI in Melbourne, described a "three tier" approach to certifying green mortgages. The gold-standard approach can only exist in jurisdictions, like the Netherlands and UK, that have publicly available data on the real emissions performance of building stock.

This data is not available in Australia. Indeed, the lack of central-government leadership on emissions issues leaves market participants focused on how private-sector initiatives can take climate-change mitigation forward (see box on facing page).

The second tier is to identify alternative residential-property rating codes. The building sustainability index (BASIX) used in NSW is one example, and Fowler said this forms the basis of the CBI's criteria in NSW. But most states do not have an equivalent.

The third tier, and the only one widely available in Australia, is to identify a proxy for top-performing home assets. "There is a lot of residential stock in Australia and the turnover – the rate at which new builds come into the market – is less than 1 per cent," Fowler explained. "If we can say new builds are more efficient than existing stock, we are able – for a few years and in a time-limited way – to say these new builds are in the top 15 per cent of performers for energy efficiency."

"Our assumption is that we have a lot more assets that could theoretically be classified as green than is the case so far. We have gone through a process of trying to classify assets as green, but it's easier to do with large dollar-value assets."

EVA ZILELI NATIONAL AUSTRALIA BANK

Seeking the engine of green-mortgage growth

Market participants believe government schemes and incentives are the ideal lever for prompting householders to seek top emissions performance from their homes – and thus their home financing. In the absence of this type of leadership, cost-of-funds advantages could be the key.

Andrew Marsden, general manager, treasury and securitisation at Resimac in Sydney, told the *Australian Securitisation Journal* roundtable participants: "A national standard would certainly be very helpful for us, given mortgage lenders have diverse asset portfolios. It would also help us develop new and innovative products and bring a lot of efficiency and motivation around distribution of those products – perhaps with some economic incentives for householders."

This seems to be the approach much of the rest of the world is pursuing. Rob Fowler, head of certification at the Climate Bonds Initiative, said at the discussion parts of Europe, China and – at state level – the US are experiencing a "strong drive" towards government incentives for low-emissions homes.He suggested that a "green homeowners' grant" along the same lines as the first homeowners' grant could fulfil this role in Australia.

"There is a range of initiatives the government could take to make it easier for consumers to realise the benefits of going green," Fowler said. "There would be a lot of work to do around integrity of labelling, but these conversations are happening elsewhere in the world and confidence is growing where they do."

In the ongoing absence of this type of government leadership in Australia, it falls to the private sector to find incentives for borrowers to seek low-emissions housing or to improve the energy efficiency of their homes.

"At root, the incentive for homeowners is the potential for a materially cheaper cost of funding and the question is how we get to the point where this is possible," said David Jenkins, director, sustainable capital markets at National Australia Bank (NAB). "Putting aside what might or might not come from government, it should be cheaper to run a more energy-efficient house."

The link could be whether borrowers seeking energy efficiency can be demonstrated to have superior credit performance than 'normal' mortgagees. In fact, pricing advantages could rest on whether this performance advantage is provable.

NAB's head of group funding, Eva Zileli, explained: "The question is what will entice banks to offer a discount for green loans – and whether a national assessment system could be sufficient. My sense is that, absent third-party incentives, there needs to be an established connection between green mortgages and credit performance to persuade banks to offer discounted pricing."

In theory, the value chain could be reversed – in the sense that banks might be able to provide cheaper rates for green mortgages even if they do not offer incrementally superior performance if the bank can fund these loans cheaper in wholesale markets.

But market users are wary of predicting tighter pricing for green bonds. QIC's head of credit research and strategy, Phil Miall, said: "Growing demand for green product could see a price differential at some point but the domestic market isn't there yet. From our perspective, while we have a strong ESG [environmental, social and governance] framework across all our portfolios we don't have ESG-specific mandates at this stage. The case for paying up to invest in green assets is probably clearer for mandated funds."

As well as government involvement and pure private-sector plays, there may be a role for the regulator in incentivising sustainable finance. Jenkins explained that, once again, Europe is leading the way in this respect.

"We could ask if there should be a regulatory penalty for brown assets or an incentive for green assets," he said. "If the dial is shifted such that there is a policy framework that rewards assets that contribute to a low-carbon future, conceptually this should allow banks to lend at a lower cost to those assets."

NAB was able to include as eligible green collateral mortgages written on NSW houses approved from June 2004 onwards – excluding the Sydney local-government area (LGA) – NSW including Sydney LGA houses approved from July 2005, Victorian homes approved from May 2011 and Tasmanian homes approved from May 2013.

INVESTOR CHALLENGES

Identifying qualifying green mortgage assets was no mere academic exercise. Having a credible standard for qualifying assets was critical to attracting investor support to the RMBS transaction. The buy side was certainly aware of the challenges. "Data is a critical issue," explained Grace Tam, Sydney-based

"If we can say new builds are more efficient than existing stock, we are able – for a few years and in a time-limited way – to say these new builds are in the top 15 per cent of performers for energy efficiency."

ROB FOWLER CLIMATE BONDS INITIATIVE

associate director at the Clean Energy Finance Corporation (CEFC). "We lack data on residential properties in Australia, even though this sector contributes about 12 per cent to total national emissions. The CBI has established a baseline, which we view as very positive."

Phil Miall, head of credit research and strategy at QIC in Brisbane, added: "There are two areas of particular importance for us. First is that the standards and the assets genuinely support environmental sustainability. Second is that there's clarity and transparency regarding the green criteria and how the underlying assets meet these."

As a new transaction type for the Australian market and one without standard practice for identifying qualifying assets, it was critical to walk investors through the deal's green bona fides.

"We worked very closely with investors so they could understand the qualifying criteria and were comfortable that this wasn't 'greenwashing'," Lionel Koe, director, securitisation at NAB in Melbourne, said. "We talked at length with investors about the formulation of CBI's criteria, potential criteria changes in future, and the strength of the underlying pool and its structural features. This got them comfortable and led to a very successful transaction."

Having standardised criteria for classifying mortgages as green was a vital first step. "The process was actually relatively easy once we had the CBI proxy criteria for Australian low-carbon residential buildings," Eva Zileli, head of funding at NAB in Melbourne, told the roundtable participants. "Without these, the challenge would have been establishing a means by which to classify a mortgage as green. The criteria solve this issue, giving us a scaleable standard to apply to our portfolio."

NAB has already issued green and social bonds, all of which have underlying assets from the bank's institutional lending book. The green RMBS marks the bank's first foray into green funding supported by household loans.

"We took a conservative approach to the pool for the RMBS transaction, starting with the inclusion of new-build only. This puts aside a lot of homes that have been upgraded," explained David Jenkins, director, sustainable capital markets at NAB in Sydney.

For instance, in NSW a home renovation costing A$50,000 or more and requiring development approval also needs a BASIX certificate. But NAB excluded these from its green RMBS pool because it believed doing so gave certainty around best in class. According to Jenkins, the bank also excluded apartments in NSW entirely because its loan tagging did not incorporate the certainty of BASIX 40 certification it felt it needed.

"This illustrates the challenges involved in identifying appropriate assets subsequent to the loans being written," Jenkins added. "If you don't have your own information from the outset and it is not readily available publicly, you have to rely on build and approval dates."

FUTURE POTENTIAL

There is clear potential for a bank like NAB to ramp up its green funding significantly – if it can clear the hurdles of understanding, labelling and classifying appropriate assets in areas that are less bespoke than the institutional book.

Zileli explained: "With a balance sheet the size of NAB's, our assumption is that we have a lot more assets that could theoretically be classified as green than has been the case so far. We have gone through a process of trying to classify assets as green, but it's easier to do with large dollar-value assets especially in the infrastructure space."

She continued: "It's much harder at SME level. The size and quantity of loans needed to support a green bond would mean quite intensive work. If the system doesn't facilitate a simple way of identifying a loan as green – via adding an appropriate field at origination – it becomes operationally cumbersome."

Jenkins explained that there is an obvious reason why institutional loans formed the first collateral for green and social bond issuance, describing this part of the asset book as the "low-hanging fruit" when it comes to identifying and classifying green assets. NAB has a system called LoanIQ, which allows it to drill down into what are larger, lumpier loans to develop comfort around eligibility, scale and use of funds.

"Consumer mortgages are at the other end of the scale, but the product is fairly generic and the accreditation system is relatively robust – albeit with plenty of room to evolve," Jenkins added. "It is the space in between that is hardest to define. There are still gaps, but we are trying to fill them."

The real challenge will come with SME loans, which do not have the economies of scale that make institutional lending suitable for bespoke classification but also lack the homogeneity of mortgage product that lends itself to relatively easy tagging.

Zileli revealed: "It's an area I have an eye on, and NAB has a working group looking at other loans on the balance sheet. But it's absolutely correct to say this is the biggest challenge yet for attribution and verification." •

"We lack data on residential properties in Australia, even though this sector contributes about 12 per cent to total national emissions. The CBI has established a baseline, which we view as very positive."

GRACE TAM CLEAN ENERGY FINANCE CORPORATION

FEATURE

NEW ZEALAND'S GREEN-BOND POTENTIAL

New Zealand's green-bond market is still in its infancy, but green issuance could be a natural fit for some of the biggest sectors of the economy. While market participants work to facilitate labelled issuance, domestic investors say they are already well advanced in factoring environmental, social and governance (ESG) criteria into their portfolios.

BY MATT ZAUNMAYR

The green-bond asset class has an unusual relationship between supply and demand. Issuers want to see specialist green-bond funds, to provide incremental liquidity for their debt. But such funds will not be established in scale until there is sufficient volume and consistency of supply to make them functional.

In Europe, the sector has evolved to the stage where specific demand systemically exceeds supply. But this is not yet the case in Australia or, to an even greater extent, New Zealand.

In general, first-mover issuers have tended to be happy to print deals even in the absence of specific, incremental demand for the product because they are keen to be seen as sector leaders. The question is whether a supply-led market can be sustainable in the long term and, if not, whether supply in a small market like New Zealand can ever be sufficient to justify the establishment of specialist investment funds.

International Finance Corporation (IFC) issued the first green bond in New Zealand, in July 2017 – a NZ$125 million (US$86.7 million), 10-year Kauri led by ANZ and BNZ. At the time, Flora Chao, IFC's Singapore-based senior funding officer, told *KangaNews* there was notable investor interest for New Zealand dollar green bonds – on a scale greater than that tapped by the supranational with its debut deal. Since then, Contact Energy (Contact) has had its borrowing programme and existing term debt certified as green while Auckland Council printed NZ$200 million in its debut green bond in June 2018 (see p12).

Even so, whether a steady supply of green bonds can be fostered in the New Zealand market is a matter for debate. Institutional investors say they are more than happy to buy green bonds should they meet investment criteria – but their focus seems to be more on a holistic ESG approach. Supply is arguably an even bigger question mark.

NATURAL ADVANTAGE

Some market participants are optimistic about the opportunities for New Zealand green bonds. Sarah Minhinnick, Auckland-based director, debt capital markets at BNZ, which hosted a green-bond seminar in April, identifies two sectors – property and energy – as particularly well-suited to green-bond issuance.

"Around 80 per cent of energy in New Zealand is already produced by renewable sources and a lot of new construction is being built to meet green principles. These two sectors present significant possibilities for New Zealand dollar green-bond issuance," she says.

Vicky Hyde-Smith, Wellington-based head of fixed income, New Zealand at AMP Capital, says it would be beneficial if other issuers displayed the type of commitment shown by Contact. "There is a large focus on renewable energy in New Zealand's energy sector," she says. "By not highlighting this, issuers run the risk of global investors mischaracterising and penalising them for being part of the fossil-fuels component of the sector."

Joanna Lawn, Auckland-based head of issuer relationships at NZX, says the exchange believes there is "a natural advantage for New Zealand in having green financing". She points to the country's leadership in establishing an emissions trading scheme, emissions-reduction targets and an energy sector with a high and growing proportion of energy derived from renewable sources.

"There is a role for the government to play – and it has been proactive in the space already with some of its policies," adds Mike Faville, head of debt capital markets at BNZ in Auckland. "When the government considers things like green infrastructure funds, green investment principles and innovative funding to address water-quality issues it legitimises the whole space."

No-one expects the market to explode overnight. On the issuer side, Faville warns that it takes time for borrowers to become ready to execute green deals. "We can't expect an avalanche of green bonds from supranational, sovereign and agency issuers, either, given they have to ration their green-bond assets globally," he adds.

BUY-SIDE VIEW

Issuers in New Zealand have spoken of market-development goals as the driver of their green issuance rather than of obvious incremental demand for green product.

While demand tends to outstrip supply across the New Zealand domestic bond market, paradoxically the local situation potentially causes issues around demand of green bonds specifically. With limited green-bond supply, it is hard for investment managers to justify the establishment of specific ESG bond funds. If the incremental demand these funds provide is not available, it is harder for issuers to justify programmatic green issuance.

Speakers at the BNZ seminar say they are confident that a local green-bond market will emerge – though it will take some time. Lawn reveals that the NZX is "having discussions with issuers and investors, and that there has been a shift in appetite to invest in assets that address ESG principles".

The challenge is likely to be scale – specifically, whether a subset of issuance by borrowers active in the New Zealand dollar market can account for sufficient supply to justify investor focus. Iain Cox, Auckland-based head of Australasian fixed income and cash at ANZ Investments, says the credit ratings of many of New Zealand's borrowers, particularly corporates, would present a challenge for his firm in establishing a green-bond fund.

ANZ Investments' funds are limited to holding single-A rated bonds and above, meaning the universe of New Zealand dollar issuers from which it could potentially buy green bonds is essentially limited to government, Kauri, major bank and a small clutch of local corporate issuers.

"If a bond issue complies with the market principles of what constitutes a green bond, has regular reporting on end usage and meets our investment criteria, we would certainly consider it. But it has to come at the same price point as a vanilla senior-unsecured bond would," says Cox.

A similar view comes from Fergus McDonald, Auckland-based head of bonds and currency at Nikko Asset Management, given the relatively small portion of funds available to product below single-A band. The question, says McDonald, is whether there is sufficient appeal and interest in the New Zealand market for a dedicated green-bond fund.

"New Zealand is a high-quality but concentrated market. To have a fund based on green bonds, which are likely to be a small subset of the market, is always going to be challenging," he says.

Auckland Council's green-bond debut gives a snapshot of the investor audience for the product in New Zealand in mid-2018. According to data from the deal's lead manager, ANZ, nearly three-quarters of the bonds were sold to green-mandated accounts – but this includes just 11 per cent of "dark green" mandates (see p12).

However, New Zealand's large retail fixed-income investor base means the limitations on institutional-investor mandates do not necessarily score a line through the possibility of a green-bond fund for triple-B, and even lower-rated, issuance. Indeed, NZX is focusing specifically on stoking supply in the retail-accessible sector.

ESG FACTORED IN

The bigger story, however, is likely to be how green bonds fit into institutional-investor mandates, not as part of specifically labelled funds but within wider ESG overlays across assets under management. Investors report that they are focused on applying ESG criteria to their broader investment decisions, a trend which is consistent across jurisdictions.

McDonald says: "Issuers in the New Zealand market are mostly already ESG friendly, so even if we established a fund based on these principles it would be almost identical to what we currently offer."

Fund managers acknowledge the need to take a long-term view of their investments, particularly regarding their exposure to environmental issues which have the potential to leave them with stranded assets.

Typically, factoring ESG into fixed-income investments has involved negative screening of sectors such as tobacco, gaming or pornography, or applying minimum standards for countries and, increasingly, fossil fuels. However, fund managers say the approach is becoming more nuanced than just exclusion.

Rebekah Swan, head of distribution at AMP Capital in Wellington, says: "We acknowledge that there needs to be a transition to a low-carbon economy and as such we are moderating our investments in sectors such as fossil fuels. At the same time, however, some companies in this sector are making a meaningful transition to achieving better ESG outcomes and are actively altering their strategies. We want to encourage this rather than exclude them from investment."

> "There are companies in the fossil-fuels sector that are making a meaningful transition to achieve better ESG outcomes and are actively altering their strategies. We want to encourage this rather than exclude them from investment."
>
> **REBEKAH SWAN** AMP CAPITAL

AUSTRALIAN *VIEW*

The green-bond market in Australia has been up and running longer than that of New Zealand. But a lot of the same challenges around scale and consistency of supply, and the viability of specialist funds, still apply.

Fund managers suggest that supply of green bonds in Australia is still not consistent enough to establish local green bond-specific funds. Instead, wider environmental, social and governance (ESG) policies are the go-to strategy on the buy side.

According to KangaNews data, supply of green and other labelled bonds in 2018 is lagging slightly behind that of 2017. Perhaps more concerning for the domestic market is that the entirety of supply, other than two securitisations, in 2018 by mid-June had come from offshore borrowers.

Marayka Ward, senior credit manager at QIC in Brisbane, says an Australian green-bond-specific fund would likely need to be able to access issuance from offshore markets given the smaller size and greater concentration of the local sector.

"While green bonds serve an important purpose for funding sustainable investments, QIC believes increasing engagement is among the best methods for improving corporate ESG practices," Ward tells *KangaNews*.

Mathew McCrum, Melbourne-based managing director at Omega Global Investors, reveals that his firm applies both positive and negative screens to its investment decisions as its means of implementing ESG criteria.

"Negative exclusions are more common in corporate bonds, which you would expect for industries such as gaming, tobacco and munitions. But we are also seeing more positive inclusions, which involves research and developing understanding of sectors such as renewable energy," he says.

QIC believes investment performance is strengthened by integrating ESG criteria across the investment framework, according to Ward. She adds: "A focus for QIC is on finding trades where we can trade up in ESG quality without taking away from spread, duration or overall credit quality".

Ultimately, McCrum believes there will not be any difference between standard and responsible investing, with themes such as bondholder engagement, governance, due diligence and the broader impact of companies in the societies in which they operate already influencing investment routines.

"There is a growing appreciation that fund managers need to be considering these factors in investment processes," says McCrum. "At the end of the day, all these issues will have an effect on returns."

McDonald adds: "It is more about trying to make a difference than having a moral stance. It is more nuanced than looking at an industry or company that may have high emissions and just excluding it from investment. Companies may be actively moving to decrease emissions and a company that is committed to this should fit within an ESG investment framework."

Numerous fund managers in New Zealand and around the world have signed up to the UN principles for responsible investment (UNPRI), which are leading them to open their books to scrutiny and commit to more ethical investments.

"We are a UNPRI signatory so we need to think about ESG factors with all our investments. Green bonds obviously fit the 'environment' aspect, but it is more about further embedding ESG into our credit process," Cox tells *KangaNews*. "We are open to investing in green bonds that help in the transition to a lower-carbon world – subject to them meeting our investment criteria."

This holistic ESG approach on the buy side allows asset managers to meet the standards increasingly demanded by their end investors and international obligations. But it also requires issuers, regardless of their sector, to implement and account for their own ESG strategies to maintain access to capital.

When it comes to implementation, New Zealand fund managers say they are following global practice – for instance using ESG scoring such as that provided by MSCI in investment decisions.

Cox provides an example of a foreign bank with a subsidiary in New Zealand that went through ANZ Investments' credit council for approval. The company failed, due to its parent's ESG score. But, by working with the issuer, ANZ Investments was able to establish that the New Zealand subsidiary would perform better than its parent and decided to invest a small amount at shorter-dated maturities.

"We are a UNPRI signatory so we need to think about ESG factors with all our investments. Green bonds obviously fit the 'environment' aspect, but it is more about further embedding ESG into our credit process."

IAIN COX ANZ INVESTMENTS

"Having a poor ESG score or an ESG score downgrade won't necessarily make us pull out from any potential investments. But we will look to use our influence to encourage a changing of practices for the better," says Cox.

A BROADER MANDATE

While it is difficult to envision New Zealand dollar green-bond specific funds being viable in the near term, local fund managers acknowledge the potential for more broadly mandated funds that include allocations to other labelled securities, such as social bonds, or the inclusion of unlabelled bonds that meet ESG criteria.

According to a report released by the International Capital Market Association in February, global social-bond issuance rose to US$8.8 billion in 2017 from US$2.2 billion in 2016, with the majority of issuance coming from public-sector issuers. Cox says ANZ Investments would consider launching a fund that invests in "the social and material infrastructure of New Zealand".

He tells *KangaNews*: "The fund would invest in New Zealand through social-impact, green and infrastructure bonds, where roads, hospitals, schools and social housing is being built with a view of positive society-wide results. However, we first need some issuance to get track record sufficient that we can buy relevant product in the primary and secondary markets."

Social bonds – especially project-specific social-impact bonds – can carry their own challenges for fund managers, however. McDonald says, for Nikko, "having a variable return on a social outcome is somewhat problematic for our portfolios. We're not experts in the social-work field so it is difficult to assess these opportunities. This area may need a specialist fund and investors that particularly want to make a difference in this arena".

Conversely, McDonald reveals that it is easy for Nikko to buy green bonds within the firm's existing portfolio-management framework, as long as they meet the criteria and standards for risk and return.

SUPPLY FACILITATION

With a relatively limited universe of issuers in New Zealand, carving out names to supply green bonds when there is only a small sample to demonstrate the performance of the asset class is also likely to be viewed as suboptimal by investors. Nonetheless, the buy side can see the green trend growing in offshore markets and its participants are eager to facilitate the same in New Zealand.

Even Australia – itself a relatively small market in global terms – has developed a small network of specialist funds (see box on facing page).

Hyde-Smith suggests a way to bridge the gap between offshore and domestic green-bond markets may be for New Zealand issuers to begin by issuing green bonds offshore. "If an issuer has limited balance-sheet capacity to issue these bonds, it may be better first to issue offshore – where the issuer can demonstrate the bond's performance relative to its senior curve. It can then bring that back to the domestic market as a point of reference," she says.

BNZ's Faville says work is being done behind the scenes to help stoke domestic supply. He points to regulatory discussions around allowing green bonds to be issued under the qualifying-financial-product exemption, which gives borrowers a shortcut to the market.

Most domestic credit issuance in New Zealand comes to market in retail format, and Faville argues that the first domestic green-bond deals are also likely to experience a demand boost from being available to retail investors.

Lawn says NZX is actively looking to facilitate the issuance of green bonds. The exchange recently launched a five-year strategy to foster growth in New Zealand capital markets, with the development of the listed market – including environmental product – as one of the major focuses. Lawn identifies two main regulatory obstacles to listing bonds in New Zealand: the breadth of the local investor base and the review period.

To address this, Lawn explains that NZX has begun a consultation process by which it hopes to change listing rules. Its proposals are that investor spread rules be completely removed for bonds and that, if a bond is issued under a quoted-financial-product offer under schedule one of the Financial Markets Conduct Act, there be no further review undertaken by the regulation team at NZX.

The exchange released a consultation paper outlining the proposed rule changes on 11 April, with the deadline for further submissions set for 8 June. Any updated rules are expected to become effective from the start of 2019. "This should expedite the process of bonds coming to the market – and the same logic will apply to green bonds," says Lawn.

Faville adds: "We are hopeful of more listed green bonds in New Zealand before too long. Frameworks have been put in place for some issuers, such as Auckland Council, and reducing impediments to issuance can only help bring issuers to market." •

> "Having a variable return on a social outcome is somewhat problematic for our portfolios. We're not experts in the social-work field so it is difficult to assess these opportunities. This area may need specialist funds and investors that particularly want to make a difference."
>
> **FERGUS MCDONALD** NIKKO ASSET MANAGEMENT

GLOBAL HIGH-GRADE DEBT AS THE WORLD CHANGES

While markets have remained liquid and tradeable throughout 2018, there can be little doubt that the period of almost unprecedented beneficial funding conditions that pervaded up to the end of 2017 has passed. At their annual global-markets roundtable in London in June, **ANZ** and *KangaNews* heard the latest thinking from key issuer and investor players.

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- **Stefan Goebel** Treasurer RENTENBANK
- **Peter Green** Head of Public Senior Funding and Covered Bonds LLOYDS BANK
- **Jens Hellerup** Head of Funding and Investor Relations NORDIC INVESTMENT BANK
- **Mitch Reznick** Co-Head of Hermes Credit HERMES INVESTMENT MANAGEMENT
- **André Severino** Head of Global Fixed Income NIKKO ASSET MANAGEMENT

MODERATORS

- **Paul Snowden** Head of Debt Syndicate, Europe ANZ
- **Glen Sorensen** Director, Syndicate ANZ
- **Samantha Swiss** Chief Executive KANGANEWS
- **Katharine Tapley** Head of Sustainable Finance ANZ
- **Paul White** Global Head of Capital Markets ANZ

THE GLOBAL ENVIRONMENT

White Can investors describe how market conditions have affected them so far this year?

DAY Two aspects dominate for us this year. One is liquidity withdrawal. The Federal Reserve (Fed) is reducing its balance sheet and increasing rates. We have the European Central Bank (ECB) potentially starting to taper towards the end of the year. Everything the world has experienced over the last 2-3 years has been about central banks pumping cash into the system and the impact on asset prices of that cash looking for a home.

One of our biggest concerns is what could happen as this reverses. We are already seeing some clues. January was a bit like a dream. Since February we have seen an equity market sell off, an emerging market wobble and Italy. There have been multiple volatility spikes and we think these could worsen as the liquidity withdrawal continues to gather pace and rates in the US continue to rise.

We will take as little risk as possible in the next year. It will be about capital preservation and avoiding accidents.

Another factor about the world right now is that not everywhere is the same. The backdrop in Australia is very different from the US – there is no inflation, the property market is wobbling, the central bank is firmly on hold and there are no issuance pressures.

We are seeing Europe in a more hawkish light, especially after the ECB meeting in the first week of June. But core inflation is still a long way below where the ECB would like it to be even here.

There are still places to find value and to hide. But it is important not to take too much risk because these volatility spikes are real and as long as the US economy stays strong – or until the equity market really starts falling – the Fed will not stop raising rates. Nor will what is happening in emerging markets be a problem until it affects the US. Caution really is the mantra.

SEVERINO The market is trying to figure out how much time is left in this economic cycle. The US is in one of the longest growth cycles on record – albeit not quite as long as Australia! With massive fiscal stimulus through tax reform, we now think the US growth cycle has at least a few more years of expansion.

This seems like a good environment for US corporates and we have seen investment-grade corporate credit perform very well until this year. There is divergence between the US and Europe that Jon Day spoke about – and the fact that the US is now the high yielder relative to Australia and New Zealand, which is interesting.

We are cautious about when this cycle might end, but we have kept our chips in the credit game. One of these volatility spikes might be the catalyst for the cycle to start to turn and we are watching for when we might pare back risk. But at the moment we are still invested in corporate credit.

After a good period of growth Europe has disappointed this year. We think the ECB is less hawkish than the market, though, and we saw some of this come through with Mario Draghi's comments in the week commencing 18 June around rate rises not coming as soon as the market had anticipated. The ECB is being very transparent about winding down QE and the market is taking this in its stride.

In spite of the volatility spikes it has been a generally benign year, I would say. We saw some sharp moves as a result of the Italy situation but these have come down in the last few days.

Sorensen I have actually been quite surprised at how short the volatility spikes have been.

■ **SEVERINO** I am not that surprised the market is taking these spikes in stride. We are still seeing relatively solid synchronised global growth and we remain in a benign inflationary environment. It can feel like a game of musical chairs with easy monetary policy – but the music is still playing.

White Have issuers seen any impact from the volatility?

■ **DORE** The volatility levels have not affected World Bank's ability to access markets. We funded less this year than the previous year but this was simply due to internal factors – lower funding needs. We executed more than 500 transactions in 27 currencies during our fiscal year ending June 2018 despite the market volatility. This is among the highest number of currencies or deals we have executed in one fiscal year.

The market has been incredibly resilient. If one compares the impact of the headline events this year to previous years, the volatility impact has generally been much lower.

■ **CHAO** The fact that the effects of volatility are being felt more on the credit side has also helped us in certain ways. For example, we have received an increase in reverse enquiries in peripheral currencies such as Turkish lira. In general, we don't have too many concerns right now.

■ **GREEN** If anything, markets have been more interesting. There was a level of complacency through 2017 that any trade could get done. The market is now more discerning around the trades that work and the price at which they will work.

We have executed the trades we wanted to when we wanted to do them. But we are being more careful around expectations of price and size, and we are accessing markets with more pragmatism.

This is no longer an issuers' market. Earlier this year it moved to being an investors' market, and it is maybe slightly more of a balance between investor and issuer dynamics right now. Investors are receptive if you approach the market sensibly and don't push too hard on price or size.

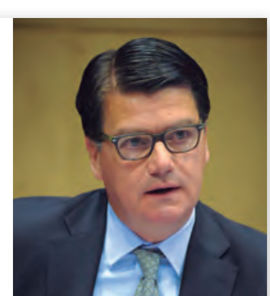
We have continued to be able to diversify our funding across global markets. The UK's term-funding scheme ended in February so the UK banks as a whole have entered into a more normalised funding pattern after a lull in activity through the end of 2016 and into 2017. The banks have all continued to take funding where it is needed, using product diversification to good effect.

As an industry it is very easy to focus on bad news. We have forgotten that it should be good news that central banks are removing stimulus. It means the world economy is improving and there is more confidence. We just need to know how to operate in a world with less liquidity.

Snowden Thinking specifically about relativity between the US dollar and euro markets,

"What we have seen from our investors in Japan is that Australian dollar assets are still in demand – and more so for the unhedged investor. Some institutional buyers still want unhedged Australian dollar bonds and retail investors like to play the currency."

ANDRÉ SEVERINO NIKKO ASSET MANAGEMENT



ANZ participants


PAUL SNOWDEN


GLEN SORENSEN


KATHARINE TAPLEY


PAUL WHITE

which has been the most attractive for issuance and how have the past 6-12 months evolved in this respect?

■ **AINSLEY** We have seen very good demand in two-year US dollars. Mainly this is due to rates being about 60 basis points higher in the year to date. We issued a 10-year US dollar benchmark in January, and we are pleased we did because the same transaction probably would not be possible at all today.

I expect the long end of the US dollar curve to show higher rates through the course of this year, with the Fed's reduced balance sheet exerting some pressure on rates.

Higher rates are quite helpful for the euro market. We have seen investors come back into shorter maturities – five years, for example. This positive backdrop has allowed us to secure large volume at tight levels in our home market. The share of our funding issued in euros is currently above 50 per cent, which is relatively high in historic terms. We have also experienced a receptive market environment in other currencies, and have issued in 12 so far this year.

■ **HELLERUP** The US dollar has worked very well out to five years and, with yields in euros rising, euro-market appetite is shortening somewhat too. We have seen fewer non-European borrowers issuing in euros and swapping back to US dollars this year. The cross-currency basis swap is important and we have seen the basis-swap level fall in euros.

US RATES RELATIVITY

Sorensen André Severino mentioned earlier the somewhat unique current situation of New Zealand and Australian yields being below those of the US. Nordic Investment Bank in particular has sourced a good portion of its funding in New Zealand dollars – but where is that market now?

■ **HELLERUP** The New Zealand market has been accommodative this year and we were able to complete a transaction at the start of 2018. We were happy with the funding level achieved, which was in line with our curve and with other markets.

However, Australian dollars have not really worked. We are not looking for a funding level that comes down to the last basis point: we have an Australian dollar curve and we want to diversify our funding. But it is difficult to convince management that we should execute transactions 10 or more basis points wide of our global curve. Going forward we would like to be active in both markets.

White The big question for the Australian and New Zealand dollar markets is what will happen as US yield continues to be higher – and in all likelihood increases its relative edge. What impact is this having?

■ **SEVERINO** The Fed is firmly on the path of higher rates, while in New Zealand the central bank seems to be on hold and in Australia the next move could be lower – albeit maybe not for a year or more. Our view is that the spread differential will continue to move in favour of US rates.

■ **DAY** I prefer to invest in Australia than New Zealand right now, because there is still very little inflation pressure and housing-related issues are starting to increase in Australia. This will be managed by the government and resolved or it will turn out to be something nastier. But what it will do is have an impact on consumption, which is not a conducive environment for the Reserve Bank of Australia to raise rates. Australian employment data are okay but wages are still very weak.

New Zealand is more interesting as wage pressures are starting to build while other inflationary pressures are not. The bond market has performed particularly well.

Versus the rest of the world, both Australia and New Zealand are very good places to be. By and large neither of the central banks will lean towards raising rates, though, which means they will be left behind versus other markets.

■ **BUTCHER** I have been very pleased with the performance of New Zealand to date. There are robust fundamental reasons for this, particularly around monetary-policy settings. We

"This is no longer an issuers' market. Earlier this year it moved to being an investors' market, and it is maybe slightly more of a balance between investor and issuer dynamics right now."

PETER GREEN LLOYDS BANK

have certainly been blessed by the fact that the cash rate has remained low and stable for a considerable period. We have seen substantial issuance and investor demand for the 3-7 year part of the curve because, at this stage, the Reserve Bank of New Zealand is forecast to be on hold for another 12-18 months. This appears to have captured investor demand in the short-to-mid part of the curve.

The second pillar has been robust fiscal performance of the New Zealand government relative to other sovereigns. This has helped the New Zealand Local Government Funding Agency (LGFA) and other New Zealand government issuers to track demand at the back end of the curve.

Every year I get concerned, but every year I see good reason why New Zealand government bonds are tightening relative to US Treasuries. It could be a different story going forward, of course.

Sorensen Is there any change in offshore demand for LGFA and Queensland Treasury Corporation (QTC) bonds?

■ **BUTCHER** Offshore investors are increasing their allocations. The only jurisdiction which is broadly not is North America, where accounts are more focused on New Zealand versus US spreads. But allocations to LGFA certainly continue to grow in the UK, Europe, Asia, Japan and Australia.

■ **FAJARDO** We are aware of the potential for a long period of flat-to-negative spreads between Australia and the US. We spend significant time marketing to investors to diversify our investor base. We see periods where the Australian-US spread might work, where investors are happy to buy on an outright basis as a spread to government bonds, or to be active when hedge costs work for them.

We have had very solid demand from on- and offshore investors this financial year, to the extent that we were able to complete our annual funding programme for 2017/18 in January and undertake prefunding of more than A$3 billion (US$2.2 billion).

One noticeable change for QTC in the last 12 months has been engagement from the offshore investor base – particularly from Asia – in longer-tenor QTC bonds. This investor base has helped drive an additional A$415 million increase in our 2047 bond line so far this financial year, which was very pleasing. Going back a little further, we issued our 2030 line in October last year with approximately 40 per cent allocated to offshore accounts.

Swiss Are these longer-tenor investors predominantly based in Japan or do they come from the Asian region more widely?

■ **FAJARDO** It is a mix. We recently roadshowed through Asia, meeting more than 30 investors in Malaysia, Singapore, Taiwan, Korea and Japan. We targeted new potential investors as well as existing ones and were very pleased with the take-up of meetings and the broad engagement with our credit.

One of my takeaways was that while investors are obviously seeking pickup in yield some are trying to achieve this in the rates space rather than by moving down the credit curve. This is why we have seen continued interest in the 30-year QTC line. Some investors have asked us if we would issue a 50-year or even a 100-year bond.

White How is the increasing rate differential affecting demand for global borrowers in Australasia and does it change Australian and New Zealand dollar strategy?

■ **DORE** The rate differential seems to have caused changes in demand patterns but we are optimistic that demand will remain strong for our bonds and investors will continue to support our development mandate. We have had very good domestic-investor participation in our Kangaroo and Kauri bonds, for which we are extremely grateful. Our approach in the Australian and New Zealand markets will remain unchanged. We will continue to be active, issuing liquid bonds across the yield curve.

There is no doubt that lower yield will affect offshore-investor demand because many investors see these products as a way to enhance yield beyond what they can achieve in the US market. However, some offshore investors, like official institutions, will continue to see value in diversifying their investment portfolios into these currencies.

■ **GOEBEL** Demand for Rentenbank bonds in the long end of the Australian dollar curve mainly comes from Japanese accounts. However, we have seen a slightly different buyer base in this part of the curve of late.

It is traditionally dominated by money associated with life-insurance policies denominated in Australian dollars, but recently we have seen some large FX arbitrage trades coming into the market, looking to swap the best-possible currency back into yen at an attractive spread. The picture therefore becomes slightly more diverse within the long-end investor cohort.

On the other hand, we have certainly noticed life insurers struggling with comparatively low Australian rates. It remains to be seen whether their long-end demand will remain intact.

"All of IDA's projects focus on sustainable development, so its bonds offer a unique investment opportunity for investors wanting to incorporate ESG factors into their investment decisions."

ANDREA DORE WORLD BANK

BAD BOYS OF BREXIT AND OVERRATED USCITALIA

European market participants say concern around political risk in Italy is likely overplayed if not entirely unreasonable. The UK, meanwhile, may have to fall back on fundamental credit quality.

SNOWDEN Is Italy an idiosyncratic or a systemic risk? Should we take the Italian government's threats to breach EU debt rules seriously, and if so what are the potential consequences?

GOEBEL It seems to be a reasonably contained systemic risk. The rating agencies are relatively unconcerned because Italy is a structurally rich country and one which has successfully dealt with shaky political situations ever since the end of the Second World War.

There are some known elements in what we are seeing right now, although markets were taken by surprise. The Italian Treasury was receiving 30 basis points only two weeks ago – at the beginning of June – to pick up two-year funds. In an instant, the spread widened to plus-200 basis points briefly until the level came down somewhat.

One can always be surprised that investors are surprised by a known set of facts. In this sense I would not overevaluate the market reaction, which speaks more to short memories than a particularly dire situation in Italy.

DAY This is another example of the impact of liquidity withdrawal leading to panic. This time last year an event like this perhaps would not have caused such upheaval.

After the election we had three or four weeks of calm so investors got confident, but the level of uncertainty increased again. Italy is one of the world's largest bond markets and it is a big concern for the rest of the world if it is not functioning correctly.

Long term, I agree with Stefan Goebel. Italian political turmoil has been occurring for decades. It is very possible the current government will not last until the end of this year, given the way coalitions work. Besides, any fiscal changes will not be immediate – they will be next year or even the year after.

We are approaching the European summer, which is one reason Italian market volatility has calmed. It is unlikely we will see any political developments until after the summer, so I expect we will see a gradual tightening of spreads during this time. This could change come autumn, though.

EELES It is interesting that during this period the most liquid Italian bonds – government bonds – really suffered, while Italian credit significantly outperformed. To my mind this is the market effectively saying it does not see a knock-on impact for the Italian economy – yet.

The market sees considerable political uncertainty ahead. The Italian government is speaking populist policies, but the reality of what it can deliver is further down the track. It comes back to the point about these kinds of events being a shock to the system in the short term and subsequently being wound out.

SNOWDEN Where are we with Brexit in market terms?

GREEN The markets closest to home are pricing more of a premium for the UK than the US or Australian markets – and a premium for the uncertainty is warranted to some degree.

However, if you balance this with the credit fundamentals of the UK banks you could argue there is some mispricing of risk. Compare the level of liquidity and capital held by the UK banks with some of the core European names that price substantially through UK credit in Europe.

Some of this comes down to domestic investors in Europe preferring to buy local names, which is understandable when there is wider market uncertainty and volatility. But I would argue that some of the more developed markets deal with the uncertainty premium better than others. Having said this, it is not having any meaningful effect on our ability to access any market we choose.

"ONE CAN ALWAYS BE SURPRISED THAT INVESTORS ARE SURPRISED BY A KNOWN SET OF FACTS. IN THIS SENSE I WOULD NOT OVEREVALUATE THE MARKET REACTION, WHICH SPEAKS MORE TO SHORT MEMORIES THAN A PARTICULARLY DIRE SITUATION IN ITALY."

STEFAN GOEBEL RENTENBANK

At the same time, we have to keep an eye on the arbitrage equation and we hear that the tightening of the US dollar-euro cross-currency basis swap has shifted demand.

If we see a quicker exit from QE than I currently expect, euro-based funding swapped against Euribor might become more expensive. In this scenario, and all other things being equal, foreign-currency issuance becomes relatively more attractive again. But there are many moving parts involved in this equation.

GREEN We have been a long-term issuer in the Australian dollar market. We reintroduced the Lloyd's Bank name in Kangaroo format a couple of years ago and have issued several successful transactions at holding- and operating-company level and across a range of maturities.

Our experiences have been very favourable. Where we have been surprised is by the on- and offshore demand we have seen for our transactions. We have seen traditional 10-year Japanese demand. But we also had a strong Taiwanese bid for our seven-

> "Because impact and use-of-proceeds bonds are relatively new, more and more investors are asking questions about the metrics they are being shown. This creates dialogue, and most issuers are keen to hear what investors would like to see."
>
> **JUSTIN EELES** AFFIRMATIVE INVESTMENT MANAGEMENT

year Australian dollar deal priced earlier this year, which we executed during a Taiwanese holiday.

The Australian dollar market remains strategic for us. It enables us to diversify by currency and investor base – because it is an investor base that rarely participates in our non-Australian dollar transactions.

We have always taken the view that we will access the market when pricing is in line with our global curve, and while diversification is attractive we would not want to pay too much of a premium for it.

It is good to have the Australian dollar benchmark curve in place. We have issued A$2.25 billion in the last nine months. We have good dialogue with Australian dollar investors and aim to meet them at least once a year. Our view is that this has paid off in their support and our ability to access attractive funding.

■ **SEVERINO** What we have seen from our investors in Japan is that Australian dollar assets are still in demand – and more so for the unhedged investor. Some institutional buyers still want unhedged Australian dollar bonds and retail investors like to play the currency. For institutional investors that hedge, Europe looks relatively attractive now. We have seen good flows into Europe.

As has been mentioned, the US is very expensive to hedge – and high hedging costs drive down total return. This is why there have been more flows into Europe recently. Even events in Italy so far haven't really slowed the pace of investment.

■ **AINSLEY** KfW Bankengruppe (KfW) remains one of the main issuers in the Kangaroo market. This year we are struggling a little with pricing, with the cross-currency basis swap not moving in our favour.

Over the years we have established a full Australian dollar curve, giving us the opportunity to tap some off-the-run maturities including attractive two-year funding.

We intend to keep our strong footprint in the Australian market. It is a strategic market for us and when pricing returns to a more attractive level we will be back.

When I talk to our dealer banks and investors, I don't get the sense there is a lack of demand. There is natural demand from Japan, especially in the long end, but there are also balance-sheet buyers with a need to invest in Australian dollars.

Swiss The Swedish krona has overtaken Australian dollars as KfW's third-largest currency of issuance in this funding year to date. Is this a temporary phenomenon?

■ **AINSLEY** I expect so. These statistics are skewed by a large green bond denominated in Swedish krona that we issued in January, which was our largest bond in this currency to date. Our Australian dollar volume is not too far behind.

White Has International Finance Corporation (IFC)'s approach been affected by market conditions?

■ **CHAO** The Kangaroo market is a strategic funding market for IFC and it forms a significant part of our funding requirement. During the current fiscal year we have issued around A$1.8 billion. While we also benefit from Japanese demand, one noticeable development has been central-bank participation at the long end. This has been particularly surprising as central banks usually play in the mid-part of our curve.

If Japanese investors might need to move away from Australian dollars we hope to see investors elsewhere who will continue to look at the long end. We also hope the small number of Australian domestic investors that play in the long end of the curve will continue to be there to support us.

We are particularly focused on increasing the volume of our Kangaroo social bond.

Sorensen Earlier in this discussion, Jon Day mentioned concerns around the Australian housing market. What are the other watch points for global investors?

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>
> **JOSE FAJARDO** QUEENSLAND TREASURY CORPORATION

> "The fact that the effects of volatility are being felt more on the credit side has also helped us in certain ways. For example, we have received an increase in reverse enquiries in peripheral currencies."
>
> **FLORA CHAO** INTERNATIONAL FINANCE CORPORATION

SEVERINO Most recently we have been primarily focused on the housing market in Australia as well as the lack of wage inflation and weak consumption keeping the Reserve Bank of Australia on hold.

DAY We are keeping an eye on the high level of personal debt in Australia and New Zealand, particularly around what the consequences might be if people start losing their jobs in larger numbers.

We don't see this as a high risk right now but it does sit in the background – and it is another reason why it will be challenging for the central banks to raise rates. On the other hand, it is also another reason why both these bond markets look like a good place to be.

SUSTAINABLE FINANCE

Tapley Can issuers update on the scale of their green- and social-issuance programmes, specifically the proportion of total funding these now provide and their targets in this respect?

AINSLEY KfW has issued €13.5 billion (US$15.6 billion) of green bonds in five currencies since 2014. We see Scandinavian investors in particular as being at the forefront of the green-bond market and very supportive of these products.

We would like to issue US dollar and euro green bonds on a regular basis. I expect we will monitor these markets for issuance opportunities later this year, and may look at other markets such as Australian dollars.

Tapley World Bank introduced a new issuer, the International Development Association (IDA), during 2018. Presumably IDA plans to issue green or social bonds in the future?

DORE While IDA is a new, and triple-A rated, issuer in the capital markets it is not a new entity. IDA was established in 1960 with the sole purpose of financing development projects in the world's less developed countries. We recently executed IDA's first bond transaction – a five-year, US$1.5 billion benchmark bond – on the back of a US$4.6 billion orderbook. We wanted to debut in the most liquid market and it was a very successful transaction with 130 investors in 30 countries.

IDA's funding programme, though much smaller than that of World Bank, will have a similar focus on diversification and cost efficiency. IDA will offer investors a broad array of products ranging from benchmark bonds to tailor-made notes designed to meet specific investor demand.

We will certainly consider setting up a green-bond programme for IDA as part of its overall funding strategy, but we will also focus on IDA's entire balance sheet and overall social purpose. All of IDA's projects focus on sustainable development, so its bonds offer a unique investment opportunity for investors wanting to incorporate environmental, social and governance (ESG) factors into their investment decisions and achieve a positive impact for society.

Tapley IFC issued a Kangaroo social bond in 2018. Why has it evolved to the broader sustainable market from green bonds?

CHAO We issued our debut green bond in 2010 and since then we have raised US$7.5 billion. Our social-bond programme is much newer. Our inaugural issue was a US$500 million transaction in March 2017. Since then we have issued almost US$1 billion off this programme, and a big part of this additional volume is the A$300 million Kangaroo social bond.

The rationale for focusing on the two themes was pipeline-driven: we looked at the projects we had that related to social and green and, given the volume, we decided two programmes made sense. When we talked to investors in Australia we saw heightened interest in both green and social bonds. A large part of our mission at IFC is to create new markets, so we decided to push the envelope and execute a social bond. We ended up pricing the transaction 1-2 basis points tighter than our IFC plain-vanilla Kangaroo curve, which was particularly exciting.

All our projects undergo a rigorous ESG process and we are looking at ways to encapsulate this within our current programmes. It is still in the works at this stage.

Because IFC is part of the International Capital Market Association (ICMA)'s green-bond

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>
> **MARK BUTCHER**
> NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY

working group, and we co-chair the social-bond working group, we wanted to support the development of the social-bond space. So we created our social-bond programme based on two previous IFC programmes – one focused on women and the other on services that address the base of the pyramid: the four-and-a-half billion people that live on less than US$8 per day.

Tapley How do investors view the extension of green-bond issuance into broader categories of sustainability?

EELES The evolution is good as it shows market development and, for us, it extends the opportunity set. We look beyond green bonds – although green is clearly the larger part of the use-of-proceeds bond market.

We will look at the framework and issuance strategy of any bond issuer that has a potential positive externality and assess whether the bond meets our criteria. It doesn't necessarily have to be labelled as such, but the label gives it some credibility and enables it to meet criteria as a useful starting point. However, we will always dig deeper and we are always very open to the expansion of frameworks.

REZNICK We do not have a sustainable or green-bond fund. We fully integrate ESG principles into everything we do and the way we invest. But these securities need to stand on their own investment merits, because we do not have specific mandates. For us, ESG is sustainability but not necessarily green.

To your question, we are absolutely in favour of additional ethical securities which support a deeper and more mature market. We would also welcome sustainable-bond indices incorporating green and social bonds. Indices create depth and liquidity and they provide investors with greater scope. Green and social bonds should not be heterogeneous products. They should be part of a sustainable-bond market where the inclusiveness creates liquidity and depth.

Market cap remains small but it is growing rapidly. The next steps I would like to see are more complete capital and ratings stacks. I would be delighted to see more issuance at the triple-B, or even the double-B, level.

Everyone agrees this is the way to go so the next step in the dialogue is to see more principles-based measures, to assign attribution and to deliver returns to society and investors. I absolutely believe there is a path to this.

Chao Do you rely on sustainability research and ratings from the likes of MSCI or Sustainalytics?

REZNICK I would distinguish what is offered by the credit rating agencies from what I would refer to as other assessment services. The latter are principally

unregulated, and they provide good services. But there might be a single-B MSCI ESG rating and a triple-B-plus credit rating. I would absolutely like to see the proviso that the triple-B-plus rating takes into consideration aspects of the company's ESG policies insofar as they have an impact on cash flows and, ultimately, credit risk.

We rely on these services as a complement to a whole suite of factors that go into the investment decision. If they are material and probable, ESG factors will have an impact on the investment decision. But the key issue is to couple ESG factors with engagement and bring assessment services to life to create a more dynamic view of ESG factors. As an analogue, there is no desire for us to invest based purely on credit ratings.

EELES We also use but do not rely on inputs. The credit rating agencies are looking at assessing green, social and sustainable bonds, but I don't believe their methodologies are particularly developed at this stage.

We have our own verification team. We look at all the different structures and business practices. We focus keenly on the responsibility of issuers and how their business strategies are developing to decide whether it becomes an acceptable option for our investible universe.

We made the call to have our own team because we focus on what we would call impact bonds. This is because we are not just investing in a very traditional way for return – in a defined risk framework, using traditional benchmarks – but we are picking from a smaller investible universe that is narrowed down by the verification team. We produce an impact report

"It is no longer enough to provide a CO_2 number on a portfolio basis, we need to provide installed megawatt-hours. A portfolio approach is not enough; investors would like to have data on a single-project basis."

JENS HELLERUP NORDIC INVESTMENT BANK

CAUTIOUS SECONDARY CONFIDENCE

Volatility may have returned in 2018 but trading markets have largely avoided panic or wild swings. Investors share their views on what this says about secondary-market mechanics.

WHITE Can we draw any positive conclusions about the way secondary trading markets have adapted to the post-global-financial-crisis regulatory and risk-management environment from the fact that volatility has remained contained throughout the past few months?

REZNICK In a way, there are almost two markets. There is a smattering of smaller, less-liquid, small-cap names that don't really trade at all. We tend to gravitate towards large-cap structures with sufficient liquidity for banks to hedge the risk through single-name credit default swaps (CDS).

Liquidity is generally healthy for large, liquid names and frequent issuers with or without single-name CDS. What is interesting is that, during pockets of volatility, implied volatility has spiked but realised volatility hasn't. This is because there is a recognition that volatility is rate- or equity-led rather than credit-led, and the macro backdrop seems fairly sanguine.

In this environment, investors are less inclined to part with securities they like, because they can't get them back. This is despite volatility spiking more often than last year, and perhaps by investors managing pockets of risk through CDS.

Things have evolved a little. We have seen substantial high-yield outflows in the US and a meaningful level in Europe. Investment-grade is more balanced but the technicals will have a substantial effect, particularly taking into account the 300 basis point real cost in the front end of the curve, as well as the hedging cost, to invest in the US.

These kinds of technical factors did not exist in 2017, but they do now. As a buyer, you can't sell the market in size so you have to be more careful around exactly how and where in the curve you want to allocate your credit risk.

EELES Echoing the liquidity component, where we have seen volatility has been in the most liquid elements. As Mitch Reznick points out, and it is very true for our opportunity set, we don't want to sell our bonds because it can be challenging to buy them back.

As an impact-focused investor, the bonds we hold tend to be smaller than the average size from the same issuers but they have also tended to outperform during bouts of volatility and underperform when stability returns. This may only be by a basis point or two, but it shows that where investors are trading is in large, liquid lines they know they can transact in again.

Banks are clearly more balance-sheet constrained than they were. However, our opportunity set is in an area where issuance volume has been high – one of the benefits of which for issuers is access to an increased demand pool.

"IN THIS ENVIRONMENT INVESTORS ARE LESS INCLINED TO PART WITH SECURITIES THEY LIKE, BECAUSE THEY CAN'T GET THEM BACK. THIS IS DESPITE VOLATILITY SPIKING MORE OFTEN THAN LAST YEAR, AND PERHAPS BY INVESTORS MANAGING POCKETS OF RISK THROUGH CDS."

MITCH REZNICK HERMES INVESTMENT MANAGMENT

each year, and a key part of what the verification and impact team does is spending many months poring over data.

One of the biggest benefits of the growing impact-bond universe is increased transparency. It is a new part of the market in which issuers want to inform investors about what they are doing and are also interested in investor feedback around how to develop frameworks.

We find engagement key and we seek to quantify impact, so information from issuers is invaluable. Clearly the impact of financial return is measurable, but we are also trying to measure the climate and other effects of the investments we make.

Tapley How do you fulfil these requirements without significant impact reporting from issuers – and are you pushing for issuers to do more impact reporting and make it available to investors?

EELES To answer the second part of the question first, yes we most definitely are. Obviously investors don't want to become a burden, but we have found the process to be positive.

Because impact and use-of-proceeds bonds are relatively new, more and more investors are asking questions about the metrics they are being shown. This creates dialogue, and most issuers are keen to hear what investors would like to see. This informs the process and becomes a positive feedback loop. It brings about more external conversations between organisations, which again is a positive thing.

We have co-developed the 'carbon yield' methodology with climate-data specialist ISS-Ethix Climate Solutions and Lion's Head Global Partners with funding from the Rockefeller Foundation. This is a publicly available methodology to quantify greenhouse-gas avoidance for green bonds. If more measures like this are available for investors and issuers to distil into common metrics it will make reporting easier.

“The high level of personal debt in Australia and New Zealand is something we are keeping an eye on, particularly around what the consequences might be if people start losing their jobs.”

JOHN DAY NEWTON INVESTMENT MANAGEMENT

I think one of the greatest challenges when poring through data is being presented with a number but not necessarily a methodology of how it was calculated, which is important to be able to compare on a like-for-like basis.

■ **RENZICK** It is interesting that reporting and information take nonfinancial factors and convert them into something that is measurable, like KPIs or financial factors where you can show measurable quantity of progress.

It is early days. What I am interested in next is how we agree on what these measures are – is it carbon footprint? Or is it carbon footprint by revenue, per cash flow or per employee?

But the dialogue is great. Like Justin Eeles, I think companies are responding very well to investor requirements. They know we are providers of capital and they want capital at the lowest weighted-average cost, so in most cases they are keen to respond.

Tapley Use-of-proceeds reporting is now almost standard procedure, but what about reporting the impact of underlying investments?

■ **HELLERUP** This is where developments have been at their greatest over the last couple of years. It is no longer enough to provide a CO_2 number on a portfolio basis, we need to provide installed megawatt-hours. Even with the CO_2 number, investors need to make some assumptions and therefore need the background information. A portfolio approach is not enough: investors want data on a single-project basis.

We have this information already based on our own calculations, but to make it public we need to get consent from project owners. This can be a challenge, and we need to have close dialogue with project owners.

■ **TAPLEY** We have exactly this challenge in reporting on ANZ Banking Group’s green and sustainable-development-goals (SDG) bond programmes.

We completed our first green-bond impact report at the end of 2017 and access to information on the underlying projects, which we do not own, was a challenge with heavy reliance placed on interpreting publicly available data.

As a leader in the development of this asset class in our home market, we are committed to producing best-in-class impact reporting for our programmes. We intend to work with investors to do this given some of the data challenges and current lack of reporting ‘rules’.

■ **DORE** A lot of progress has been made on harmonisation and on reporting the impact of issuers’ green portfolios. This is now being extended to areas like social. The SDGs provide a good framework and we’ve been using this for World Bank bonds.

Determining the appropriate metrics to use can be difficult. For example, when assessing the impact of an education project is it the number of school spaces built, the number of teachers added or the number of students who graduated and who can find jobs and make a productive contribution to society? Or a combination with other metrics? It’s an interesting field that will benefit greatly from developments in data and technology.

■ **CHAO** It is more challenging on the social side because there are many different ways to measure impact. At its annual general meeting in Hong Kong in June, ICMA released its harmonisation for social-bond impact reporting framework, which we hope will help.

For IFC, we look at the baseline and expected marginal impact of the projects we finance. The metrics we have range from women entrepreneurs to small-business finance. We have heard from investors that the baseline plus the marginal impact above it is very helpful. It is an expected impact so, going back to Jens Hellerup’s point, the tough part, and the part we need to work on, is being able to see what the actual impact is over time.

■ **REZNICK** If supranational, sovereign and agency issuers, as the pioneers, establish paths for reporting it will support lower-credit-quality issuers to do the same. To Flora Chao’s point, many corporates don’t know what they don’t know. It takes time but, as norms are established, it makes it so much easier for the ideas to penetrate further in the market. •

“Higher rates are quite helpful for the euro market. We have seen investors come back in shorter maturities – five years, for example. This positive backdrop has allowed us to secure large volume at tight levels in our home market.”

LARS AINSLEY KFW BANKENGRUPPE

REGION TO BE *cheerful*

Pricing became challenging for Australian issuers in the Asian-targeted US dollar Reg S market later in the first half of 2018, after a flurry of corporate transactions over the preceding 12 months. But market participants in Asia insist the regional liquidity pool will increasingly challenge old favourites like US private placements (USPPs) and domestic issuance for Australian-origin flow.

BY LAURENCE DAVISON

Spend any time on the ground with Asian debt-market participants and one message comes through loud and clear: the regional liquidity pool is growing, institutionalising and hungry for high-quality credit supply. In fact, there is a clear consensus that, in the fullness of time, Asia being a much more prominent source of debt funding to corporate Australia is all but inevitable.

This would mark a major change in strategy for corporate borrowers – a fact Asian bankers acknowledge may entail an extended transition period.

Investment-grade Australian companies continue to lean towards banks as their main source of debt funding. As for capital markets, the US – in either of the two formats able to be sold to local investors, 144A or USPP – and the domestic market tend to attract the bulk of Australian corporate flow, supplemented by euro-denominated issuance during periods when the landed-cost-of-funds equation works.

Australian corporate issuers have already come to see the Asian investor base as a useful supplement to Australian and US dollar-denominated books. Asian buyers have taken the majority of some Australian dollar deals though this has tended to be the case for credits with clear regional ties and no established investor following in Australia – Korean names in the Kangaroo market, for instance. An Asian contribution of 10-30 per cent of Australian domestic corporate books is more typical.

While market users say the pool of Australian dollar-denominated savings held in Asia has proved surprisingly resilient to declining rates – so far – they freely admit that the US dollar is the currency of choice for most institutional investors in the Asian region.

However, historically Asian demand for Australian-origin deals denominated in US dollars has tended to be squeezed out by the ample liquidity available from domestic US investors. USPP deals are generally reserved for a relatively narrow, but deep-pocketed, US insurance-fund buyer base, while intermediaries say Asian accounts are often scaled dramatically in even the largest Australian 144A transactions.

Until recently, Australian corporate deals targeted specifically at Asian investors were few and far between. There are several reasons why this was the case, perhaps most significantly the fact that – with ample liquidity available from other sources – there was simply no reason actively to pursue investors in the wider region.

At the same time, some issuers have been focused on the perceived inconsistency of Asian markets while there has also been concern about the supposed prevalence of 'hot money' from the private-bank sector in particular.

A BIGGER POOL

Intermediaries acknowledge that development of critical mass for investment-grade issuance in the Asian liquidity pool, centred around US dollar-denominated Reg S transactions, is a relatively recent phenomenon. But they say it is now undeniably in evidence – and the long-term momentum is only going in one direction.

"The market has developed to the stage of being consistent and reliable, which wasn't the case even as recently as 2015-16," comments Daniel Leong, director, debt syndication at Mizuho Securities (Mizuho) in Hong Kong. "It is now often possible – notwithstanding more challenging conditions in the near term – to do good-sized US dollar deals at extremely competitive pricing without needing to include a 144A component at all."

The most significant fundamental change is the growth of Asian wealth management, which has seen institutional funds of all varieties emerging in jurisdictions like Singapore, Hong Kong, Korea and Taiwan – often with a substantial mainland Chinese component – to join the longstanding powerhouse in Japan.

Sean Henderson, HSBC's Singapore-based co-head of debt capital markets, Asia Pacific, explains: "Reg S dollars has attracted Asian demand for a long time, but going back a decade the fund managers were often the branches of large global firms and thus mandated only to buy local Asian credit. We now have local asset managers investing Asian savings, which means they don't have the same restrictions about where an issuer is from – provided they can get comfortable with the credit and return."

"We now have local asset managers investing Asian savings, which means they don't have the same restrictions about where an issuer is from."

SEAN HENDERSON HSBC

ASIAN MARKET AUTHORITIES TARGET DEALS

The Monetary Authority of Singapore (MAS) and the Hong Kong Monetary Authority (HKMA) are not content to watch and hope that transactions land in their jurisdictions. Market users are not universally convinced of the efficacy of incentive schemes designed to attract deal flow, but they applaud the effort.

The MAS's Asian bond grant "seeks to further develop Singapore's bond market by supporting the issuance of Asian bonds in Singapore". Specifically, it offers to refund up to 50 per cent of eligible expenses attributable to new bond issuers in Singapore, up to a maximum of S$400,000 (US$296,080) for rated issuance.

The grant is available once per issuer and for transactions completed from 2017 to 2019. Deals must be for a minimum of S$200 million, have tenor at issue of at least three years, be Singapore Exchange listed and attribute at least half of the arranger revenue to "financial sector initiative companies in Singapore".

Market users tell *KangaNews* the latter criterion means transactions have to be arranged by intermediaries based in Singapore, though they do not have to be Singapore-domiciled institutions.

"Singapore already offers an excellent ecosystem of financial institutions, professional services like legal and accounting, credit rating agencies, and market infrastructure for Asian companies to issue, market, list and trade their bonds," Jacqueline Loh, deputy managing director at MAS, says.

She continues: "The scheme aims to broaden the base of issuers in our bond market, which will add to the breadth and diversity of debt instruments for the investing community. I am glad to say that the industry has been supportive of this initiative, and together we are confident this will enhance Singapore's value proposition."

The HKMA's pilot bond grant scheme is similar, though National Australia Bank's director, debt syndicate and origination, Asia, Lorna Greene, says the early signs are that it is somewhat more flexible.

For instance, while the HK$2.5 million (US$318,500) maximum grant to rated issuers will – like the MAS scheme – be distributed based on 50 per cent of issuance costs, it can be attributed to two separate transactions.

Scheme efficacy

Both schemes work as a rebate paid via arranging firms subsequent to bond issuance. This creates a potential administrative drawback. Jonathan Horan, partner at Linklaters, explains: "There has certainly been interest in the Singaporean bond grant scheme in recent months and we know applications have been made by some Australian issuers. We are not aware of any grants that have been confirmed yet for Australian issuers, and it is generally taking a few months to process applications – which means issuers don't know if they will qualify when they execute."

However, Greene says this should not be an insurmountable problem. "The value of the grant scheme depends on how banks manage the process," she comments. "If you deal with MAS ahead of time it is possible to get an in-principle approval. You do have to file after the deal is complete but this should be with clear information about the likely outcome."

As ever, the best approach may be a cautious one on issuers' part. Horan continues: "In my opinion, issuers should view the grant scheme as potential upside but approach transactions on their own merits without factoring anything else in."

"Issuers should view the grant scheme as potential upside but approach transactions on their own merits without factoring anything else in."

JONATHAN HORAN LINKLATERS

Describing himself as "a great believer in demographics", Henderson argues that Asia's combination of a burgeoning middle class, ingrained savings patterns and population trends makes greater prominence for the region's capital markets inevitable. The process is gradual and – as the mid-2018 credit downturn demonstrates – not immune to temporary setbacks. But Asian-market relevance to a wider range of borrowers is already a fact.

Trevor Vail, head of credit trading at ANZ in Singapore, tells *KangaNews*: "The first necessary step was getting to the point where Asia could refinance itself. The growth of middle-class money means it has reached this point, and is now moving on to a stage where it needs asset diversity. Australian credit is getting a much, much wider audience as a result."

According to Citi data, 2016 saw more than US$190 billion of Reg S issuance in G3 currencies from Asian issuers excluding Japan. The figure jumped to US$320 billion in 2017 and while the run rate is marginally down in 2018 to date it has held up better than many established markets.

> "Asian issuance was historically dominated and driven by 144A. But this has changed, to the point where something like 90 per cent of issuance now comes in Reg S format. Frankly, Australia sticks out like a sore thumb in the region in the extent to which it remains focused on the US."
>
> **OWEN GALLIMORE** ANZ

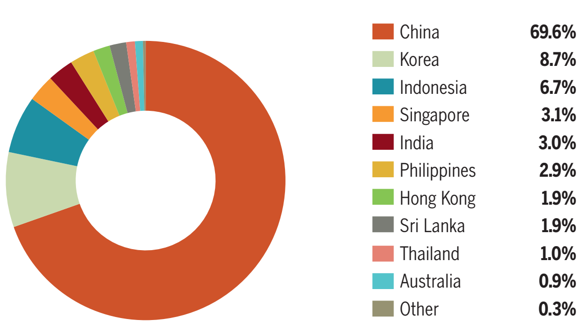
An ANZ research report notes that while Asian issuance was 3 per cent down, year on year, by mid-June 2018 this compares favourably with a 31 per cent decline in domestic US high-yield issuance and a 12 per cent fall in volume in the European market.

AUSTRALIA IN DEMAND

Australian issuers are yet to make a significant contribution to issuance of this scale. In fact, by mid-June they had contributed less than 1 per cent of total volume to a market that continues to be dominated by Chinese names (see chart 1).

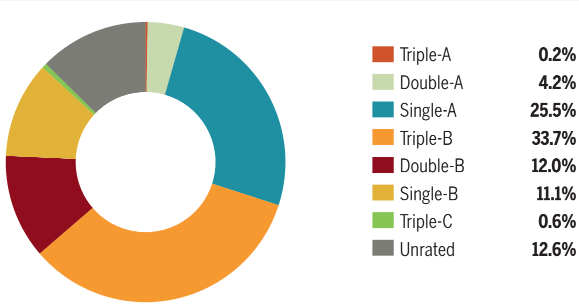
The volume of supply from China is misleading to some extent, intermediaries say. While the investment-grade sector has risen in prominence in the Asian Reg S market, accounting for nearly two-thirds of issuance so far in 2018 (see chart 2), it is undeniable that high-yield transactions still represent a significant component. Chinese issuers have provided more than three-quarters of high-yield supply in the year to date and just less than two-thirds of the investment-grade market.

CHART 1. USD ISSUANCE, ISSUERS FROM ASIA EX. JAPAN 2018 YTD



SOURCE: ANZ, KANGANEWS 21 JUNE 2018

CHART 2. USD ISSUANCE, ISSUERS FROM ASIA EX. JAPAN 2018 YTD BY RATING



SOURCE: ANZ, KANGANEWS 21 JUNE 2018

Lorna Greene, director, debt syndicate and origination, Asia at National Australia Bank (NAB) in Hong Kong, also reveals that China-origin corporate supply – especially at speculative grade – has a significant sub-benchmark-sized and off-market component. She describes this aspect of the market as "friends and family" deals, which do not reflect the nature of the opportunity for investment-grade corporate issuers.

There is, meanwhile, clear and growing fundamental demand from Asian investors for Australian investment-grade issuance. "Investors are more than happy to see Australian issuers tapping the regional US dollar market because they are hungry for diversification and Australia is seen as a strong jurisdiction," adds Eliza Lin, NAB's Singapore-based co-head of markets, Asia.

James Arnold, head of Asia-Pacific debt capital markets syndicate at Citi in Hong Kong, tells *KangaNews* the potential scale of demand is hard to overestimate. "There is so much regional issuance coming out of China in particular that the Asian investors that buy Australian Reg S deals are never going to get full on Australian names," he explains. "In fact, once they have bought in US dollars they are more likely to look at the same issuers' transactions in other currencies as well – including Australian dollars."

HUNGER FOR DEALS

Asian investors and regulators appear to be committed to winning deal flow from competing jurisdictions. In place of the Australian buy side's historical wariness of unfamiliar credits and those expected to be less liquid, Asian institutional funds are aggressively hunting for diverse supply.

Several bankers suggest that Asian investors are no longer content to put a bid into a US dollar book, even in 144A format, in the hope of getting a fill. Instead, accounts in the region are starting to demand that deals launch in their time zone and that they get a guaranteed supply of bonds in the primary market. Both these characteristics, the same intermediaries argue, are further signs of a maturing market.

This demand is reflected in a specific preference for US dollar transactions in the most Asian-friendly format. Mizuho's Leong adds: "Asian investors love Reg S deals because their allocations are higher – they often get overlooked or scaled out of 144A transactions. This is a loyal investor base that is often willing to buy inside an issuer's 144A curve."

> "A growing number of Australian issuers already have the confidence to do 'Asia only' transactions – even when they are looking for relatively large volume."
>
> **RUSSELL BAINES** WESTPAC INSTITUTIONAL BANK

Alongside investor demand, Asian jurisdictions are proactively bidding to be the venue for regional issuance. The Monetary Authority of Singapore has introduced a grant scheme to incentivise first-time issuers to execute and list in the territory and the Hong Kong Monetary Authority recently followed suit with a similar initiative of its own (see box on p42).

Demand fundamentals are evident, but intermediaries disagree on the extent to which the Asian bid can be relied on to produce superior pricing outcomes. Lin suggests that Asian investors generally view Australian-origin deals as relatively tightly priced – a view supported by at least one Asian-based fund manager from a global firm who spoke to *KangaNews* – but the desire for diversification makes these accounts willing to participate anyway, provided they perceive pricing to be fair.

By contrast, Winston Herrera, Hong Kong-based head of primary credit trading, Asia Pacific ex Japan at BNP Paribas, comments: "Australian issuers tend to trade quite cheaply to Asian triple-B names, and very cheaply relative to US ones. Our sense is that investors are beginning to recognise this value, which is why there has been such a positive response to Australian Reg S deals."

Another piece of evidence suggests that Asian investors may have been willing – for some time – to engage with Australian-origin US dollar credit at tighter levels than these issuers can find in their preferred US domestic market. Vail reveals that ANZ has habitually been buying Australian-origin paper issued in 144A format from US investors in the secondary market then recycling into Asia – at tighter spreads.

"What we are now saying to issuers – notwithstanding negative near-term spread movement – is that the Asian pool of money can be just as competitive as the US, if not more so," Vail tells *KangaNews*.

ISSUER RELUCTANCE

Some Asian market participants profess themselves amazed at the extent of Australian issuers' loyalty to the US domestic markets. They generally give a pass to the major banks and the top-tier of corporate borrowers, on the basis that very large funding requirements probably still need the depth of the US market to provide execution certainty.

Even so, the idea of 144A as a kind of blue-ribbon issuance option gets short shrift. Desmond Fennell, Singapore-based director and head of fixed-income syndicate, Asia at Commonwealth Bank of Australia (CommBank), reveals: "We have encountered Australian issuers with limited funding needs that have told us they are building up scale sufficient to go to the 144A market. We have to ask why this is the case, especially when there is a cost-effective option on their doorstep."

Ongoing Asian funds growth suggests to some bankers that even the biggest Australian names might not need to assume that 144A will be a critical element of all US dollar benchmarks in future. For instance, Alvin Wei, director and head of DCM, greater China at CommBank in Hong Kong, tells *KangaNews* that as an issuer the bank has traditionally done its US dollar deals in Reg S and 144A format, leveraging the Asian bid to build price tension. Historically, Reg S demand was more limited – typically not more than about US$1 billion.

"Issuers can get multibillion-dollar books nowadays, though – and I can foresee a time in which an issuer like CommBank does both Reg S-only and Reg S/144A deals," Wei concludes.

Meanwhile, the scale of USPP flow from Australia – which typically accounts for 10-20 per cent of total issuance in this market – gets if anything an even more baffled response in Asia. "Australian issuers' attachment to USPP is something we don't see elsewhere in the region – as can clearly be seen by the proportion of total USPP issuance that comes from Australia," suggests Jonathan Horan, partner at Linklaters in Singapore.

Asian intermediaries do not deny the depth or reliability of liquidity in US domestic markets, or the fact that the largest traditional rival – the euro market – is only occasionally appealing on a cost basis.

> "The Asian investors that buy Australian Reg S deals are never going to get full on Australian names. In fact, once they have bought in US dollars they are more likely to look at the same issuers' transactions in other currencies as well."
>
> **JAMES ARNOLD** CITI

> "We have encountered Australian issuers with limited funding needs that have told us they are building up scale sufficient to go to the 144A market. We have to ask why this is the case, especially when there is a cost-effective option on their doorstep."
>
> **DESMOND FENNELL** COMMONWEALTH BANK OF AUSTRALIA

However, they also point to the legal cost of preparing a 144A transaction – one says this can run to US$150,000 – and the relative inflexibility of the market, specifically the 135-day rule that effectively limits issuance windows, as major drawbacks of the format. While the USPP market has no shortage of liquidity, sources add, its investor base is relatively narrow and the demand for financial covenants makes it more like a bank product than traditional bond issuance.

The proof of the pudding is in the eating – and Asian investment-grade issuers appear already to have relocated their issuance to their local market. "Asian issuance was historically dominated and driven by 144A," says Owen Gallimore, corporate credit analyst at ANZ in Singapore. "But this has changed, to the point where something like 90 per cent of issuance now comes in Reg S format. Frankly, Australia sticks out like a sore thumb in the region in the extent to which it remains focused on the US."

Richard Mazzochi, Hong Kong-based partner at King & Wood Mallesons, adds: "From what we see, local issuers in Asia have almost completely abandoned 144A. I'm not sure why this hasn't yet been the case for Australian issuers, too. I have to put it down to a degree of intransigence on their part, perhaps combined with an – incorrect – sense that Asia is 'too hard'."

DEAL SIZE AND EXECUTION

One hurdle might be deal size. Market users acknowledge that Asian institutional investors have traditionally preferred minimum deal size of US$500 million for benchmark transactions. This minimum – which is too large for many Australian corporate issuers, at least as a single maturity point – has been relatively hard to shift given Asian investors want liquidity in a market that tends to be more actively traded than the likes of USPP.

It is changing, though. The consensus among bankers is that US$300 million is now acceptable as a Reg S benchmark – and several of the Australian-origin deals done in this format have been in the US$300-400 million range. How much further movement there could be is a matter for debate.

NAB's Lin suggests: "I don't think US$300 million is a hard benchmark for investors. The question is liquidity, or expectation of liquidity – and that does tend to start at US$300 million."

Herrera at BNP Paribas argues that US$200 million might work for a benchmark deal in the Reg S market, though he warns that this volume would likely take some accounts out of the running due to perceived lack of size and liquidity.

Gallimore, meanwhile, goes even further. Not only does he point out that Asia has a vibrant private-placement market but he also questions the conventional wisdom around benchmark size. "You'll hear people say that issuance size is a problem but whenever it has been tested this has proved not to be the case," he tells *KangaNews*. "We saw a successful deal at US$125 million volume in June, for instance."

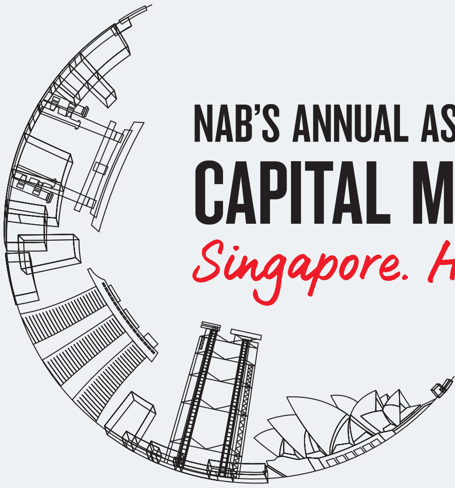
The most prevalent suspicion among Asian bankers when it comes to ascribing a rationale to the limited supply of Australian issuance into the Asian Reg S market is simply caution on the part of Australian corporate treasurers. In one sense this is not unreasonable, as the Asian market has yet to build an extended track record of reliable execution in a range of market conditions.

Asian intermediaries admit that a repriced credit market has made Reg S more challenging – though they point out that the same is true of most global markets. Leong at Mizuho argues that the real issue is the flatness of the US dollar yield curve and the consequent lack of term premium. Five-year Reg S money is still available relatively cheaply, he adds.

In the long term, market users cannot see anything other than a more active Asian market for Australian corporate issuance purely based on the underlying macro trends in the region.

"A growing number of Australian issuers already have the confidence to do 'Asia only' transactions – even when they are looking for relatively large volume," insists Russell Baines, head of DCM and syndicate, Asia at Westpac Institutional Bank in Singapore. "It already makes sense to do deal marketing in Asia on the way to Europe and the US, and the need for diversification in the Asian investor base is only going to grow." •

> "I don't think US$300 million is a hard benchmark for investors. The question is liquidity, or expectation of liquidity – and that does tend to start at US$300 million."
>
> **ELIZA LIN** NATIONAL AUSTRALIA BANK



NAB'S ANNUAL ASIAN DEBT CAPITAL MARKETS CONFERENCE

CAPITAL MARKETS AND CONNECTIONS

Singapore. Hong Kong. Tokyo. May 2018

National Australia Bank

THE 'MEGATRENDS' RESHAPING ASIA PACIFIC DEBT MARKETS.

At NAB's 2018 Asian Debt Capital Markets Conference, experts, issuers and investors zeroed in on the forces that will build connections and foster future opportunities.

A more uncertain global environment will do little to derail the megatrends creating opportunities in Asia Pacific for Australian and New Zealand issuers, and Asian investors alike, according to participants at National Australia Bank's (NAB) 2018 Asian Debt Capital Markets Conference.

With the global interest rate environment shifting, volatility is foremost on many issuers' minds. But as Geoff McMurray, General Manager, Capital Management & CRO at chemicals firm Incitec Pivot Ltd, pointed out, "volatility is nothing new," and simply highlights the need for firms to cultivate diversity in their investor bases. "It's about making sure you have capacity in your funding markets and not just keeping yourself tied to one market where there's no capacity to fund if things change."

WEALTH TO PUT TO WORK

The drive to diversify will encourage more issuers to focus on the fast-growing Asia Pacific region, where investors have strong appetite for Australian and New Zealand debt. A recent poll of Asian and European investors by NAB and Asiamoney found that around 28 percent plan to increase their Australian bond portfolios over the next year.[1]

"Asian investors make up a significant part of all transactions providing depth, diversity and liquidity in the Australian bond market," said Cathryn Carver, Executive General Manager, Corporate & Institutional Banking at NAB.

There are several factors that explain the appeal of Australian and New Zealand debt, including both markets' track record of growth and stable governance, attractive yields and diversification opportunities.

INFRASTRUCTURE, ESG IN FOCUS

The interests of issuers and investors are increasingly aligned in several key sectors, including infrastructure. As Peter Jolly, Global Head of Research at NAB, noted, infrastructure in Australia is not keeping up with the rapid expansion of the population, "which is good, as it means opportunity for growth."

Education is another promising field. The links in the sector between Australia and the rest of Asia Pacific are a natural reflection of shifts in Australia's student base, with China alone now accounting for 29.5 percent of the country's international students.[2] Institutions like Australian Catholic University (ACU) are turning to the bond markets to finance research programs and institutes, often with social or environmental components.

Asian investors are also increasingly open to different currencies, supporting issuer diversification goals. Issuers at the conference noted rising investor interest in US-dollar denominated Regulation S (Reg S) issuance, in line with the exploding popularity of the format in the region.

"(In) the last couple of years (Asian) markets have been maturing and investors are willing to invest (in Reg S issuance) if the credit rating is right," said Mr. McMurray of Incitec Pivot. "We've done a Reg S transaction that was very successful. In terms of ranking markets Asia is now one of our highest priorities."

The interests of Australian and New Zealand issuers are also converging on sustainable assets. Environmental, social and governance (ESG) factors are becoming a significant consideration for investors, with 25.8 percent of those in the NAB/Asiamoney poll intending to increase their ESG bond exposure.

"Investors are showing increasing interest in corporate issuers' ESG policies and we've also seen a real pickup in interest in the last 12-18 months from Australian and New Zealand corporates in exploring issuing in ESG formats," said Melissa Gribble, Head of Capital Markets Origination FI at NAB. "Going forward we're expecting a pickup in issuances from sectors that have so far been underrepresented from a specific funding perspective despite a strong focus on ESG initiatives, such as infrastructure and utilities."

FUNDAMENTAL FORCES, NOW AND IN FUTURE

One question is whether the broadly positive factors creating a more integrated regional debt market are vulnerable to volatility spikes or macroeconomic shocks. But the consensus at the event was that the forces fostering regional connections are too fundamental to be reversed completely. As Mr. Jolly noted, strong population and hence infrastructure growth are set to continue, while the push towards greener policies and renewable energy sources represents a new source of growth region-wide.

This means the bonds between Australian, New Zealand and Asian issuers and Asia Pacific investors will continue to expand in the future. Investors will continue to seek out Australian assets for their "yield, stability, consistency and sustainability," Ms. Carver said, while the depth and dynamism of the region's investor base will stand issuers "in very good stead; contributing to building infrastructure and helping to ensure vibrant communities."

1. https://www.euromoney.com/article/b17y5pmkkv8lw3/yield-hungry-investors-head-to-oz
2. http://www.xinhuanet.com/english/2018-03/07/c_137022654.htm

ON THE WA UP

The end of Australia's resources-sector investment boom was not kind to its most commodities-exposed state, **Western Australia** (WA). But with a new government in place since 2017, WA's Perth-based treasurer, **Ben Wyatt**, is happy to agree with the analyst consensus that the state's financial situation is now on a positive trajectory.

Analyst response to the latest state budget was broadly positive, with a Commonwealth Bank of Australia report noting that even in the absence of further radical action on expenses there is "no doubt WA has turned the corner". To what do you attribute the improvement in fiscal metrics?

A combination of stabilising revenue and the government's determination to lock in low recurrent spending growth is driving the improved budget outlook for WA.

On the revenue side, the impact of the construction slowdown following the end of a number of major resources-sector projects has now largely washed through the state's revenue, with signs that property- and payroll-tax collections are recovering from recent contractions.

Iron-ore and other commodity prices have also stabilised in recent times, while export volumes have increased on the back of resource-project expansion and new development.

The state's share of goods-and-services tax (GST) has begun a gradual recovery from the unprecedented lows seen in recent years, with WA to receive 47.3 per cent of its population share of GST collections in 2018/19. This is up from 34.4 per cent in 2017/18 and is expected to grow to 64.9 per cent by 2021/22.

Constraining recurrent expenditure growth and returning the general-government operating balance to a surplus position are major priorities for the state government. The 2018/19 budget showed that underlying general-government expense growth of just 1.6 per cent is expected for 2017/18, while annual growth averaging just 1.2 per cent per annum is forecast across the forward-estimates period.

Recent measures to reform the public sector and contain recurrent expenditure growth include machinery-of-government changes that have reduced the number of departments of state to 25 from 41, tightening the public-sector wages policy to limit increases in wages to A$1,000 (US$744) per annum, a 20 per cent reduction in the number of senior executive-service positions, implementation of a voluntary targeted-separation scheme aimed at achieving 3,000 public-sector severances, removal of the operating subsidy for below-cost electricity tariffs, and savings in government office accommodation and state fleet costs.

Disciplined recurrent-expenditure management, combined with the revised outlook for the state's revenue since the government came to office, has resulted in declining forecast operating deficits in 2018/19 and 2019/20 – of A$906 million and A$160 million – before a projected return to surplus in 2020/21. This will be the state's first operating surplus since 2013/14.

In this context, is an upwards rating trajectory now an achievable goal for the state? If so, what will you be focusing on to convince the rating agencies to reverse direction on WA?

The credit ratings applied to the state and its central-borrowing authority, the Western Australian Treasury Corporation (WATC), are clearly a judgement for the credit rating agencies. Nevertheless, as the state's balance sheet improves through stronger operating outcomes, particularly for the general-government sector, WA's credit-rating metrics will also improve.

The 2017/18 budget introduced a new set of whole-of-government financial targets that are focused on returning the state's finances to a stronger footing.

Progress against achieving our targets – and implementing key reforms out of the recent service-priority review, the inquiry into government programmes and projects, and the sustainable-health review – is expected to assist the government in locking in lower levels of recurrent spending, support a return to sustained operating surpluses and help us convince the credit rating agencies that things have clearly changed for the better in WA.

Analysts noted after the budget that the state's long-term capex estimates appear quite low. Obviously you would disagree with this, but can you give an update on the capex task, especially around infrastructure, and why you think this can be delivered in line with projections?

The projected decline in the forward estimates for the asset-investment programme, to A$4.9 billion in 2021/22 from A$6.2 billion in 2018/19, represents a normalising of infrastructure investment towards longer-term historical average levels following an extended period of record investment as the state's economy stabilises from the boom-bust period of the last decade. This includes the near completion of a record A$7 billion hospital rebuilding programme.

It also reflects the government's commitment to responsible financial management, with the net-debt impact of new investments minimised by reallocating funding from other, lower-priority projects wherever possible.

You have said in the past that there is really only one potential state-asset transaction WA could conduct that would have a meaningful impact on debt – being a sale, or partial sale, of Western Power. What is the state government's position on a potential transaction?
The McGowan government will not privatise Western Power. It is committed to keeping this important asset in public hands. However, as part of its strategy to improve the state's financial position, the government is investigating other commercialisation opportunities including the state's land-registry business.

You have mentioned WA's improved GST revenue. Can you give an update on the latest position, projections going forward and whether the state government's position on GST distribution has changed as the acuteness of the situation abates?
Commonwealth grants to WA are forecast to increase gradually over the budget period, to around A$12 billion by 2021/22 from around A$10.5 billion in 2018/19. This increase largely reflects an expectation that WA's GST grant share will rise to around 65 per cent of our population share by 2021/22 from 47 per cent in 2018/19.

But this increase in our share doesn't change the fundamental need for reform to the GST distribution process. Even by 2021/22, WA's share of the GST will still be lower than that faced by any other state since 1942/43. Reforms are also required to reduce the volatility of GST grants and avoid extreme GST losses from state policies that aim to grow the economy.

Analysts point out that WA has the shortest weighted-average maturity of debt among Australian states, at 3.9 years. Do you leave determination of appropriate term of debt purely to WATC or does the state government give direction in this respect?
We have heard from some independent market analysts over time that the duration of WATC liabilities remains shorter than other Australian states. This was particularly true six years ago and before.

Significant changes to WATC's balance sheet were effected between 2013 and 2016, lengthening the liability portfolio's duration by more than a year to 3.5-4 years. Short-term paper issuance was reduced to about A$2 billion from more than A$8 billion, largely by creating a pool of floating-rate notes with tenors to five years that is now in excess of A$8 billion.

The WATC board, which is accountable to the treasurer, imposed targets to reduce debt maturing within 12 months to less than 20 per cent – it had previously ranged from 30-50 per cent for more than 20 years – and maintain liquid-asset portfolios in the state equal to or exceeding this figure. These changes were viewed positively by the rating agencies, with one elevating WA's liquidity score to "exceptional" from "strong" in July 2015.

Operationally, each client balance sheet in WA is optimised and managed relative to its revenue sensitivity to interest rates on a decentralised basis. Each client entity is presently subject to a 15 per cent maximum amount of debt maturing within 12 months, though this can be modified with approval if valid economic circumstances warrant. WATC manages the aggregate and its board, chaired by the under treasurer, observes, questions and occasionally initiates rule changes.

A report issued by Moody's Investors Service (Moody's), with data current as of the financial year ending in 2016, estimated WATC's weighted-average debt maturity at 3.6 years. Other Australian states ranged between 2.7 and 7.5 years. Moody's further estimated that WATC's debt maturing within 12 months was 11.9 per cent, with other states ranging from 11.1 per cent to 20.4 per cent. But of course these comparisons are only relevant if the asset durations are equal.

Two Australian states have issued green bonds with both reporting very positive experiences and a desire to return to the market. What is your view on green bonds, and might we see WATC in this market in the foreseeable future?
WATC is constantly monitoring new opportunities to fund debt more cost effectively and diversify its investor base. To date, WATC has chosen not to pay above its domestic curve to achieve greater investor diversity. Specifically, all costs, risks and operational complexities considered, WATC has not been able to find an opportunity to issue green bonds to produce better cost outcomes for our state than our normal bonds.

If we see such an opportunity, we would strongly consider issuing. A decision to pay above our domestic curve to diversify our investor base would only be undertaken with careful consideration, as a policy decision, whether it be via green bonds or any other source of funding. •

"Progress against achieving our targets is expected to assist the government in locking in lower levels of recurrent spending, support a return to sustained operating surpluses and help us convince the credit rating agencies that things have clearly changed for the better in WA."

FUNDING GROWTH IN *VICTORIA*

Tim Pallas, Melbourne-based treasurer of the state of **Victoria**, has been in the fortunate position of overseeing what is arguably Australia's best-performing state economy from a budgetary perspective. In the wake of the state's 2018/19 budget, Pallas discusses Victoria's infrastructure and operating-cost plans, and how it intends to fund them.

Analysis of the state budget focuses on the government's apparent decision to prioritise infrastructure and service provision for a growing population. For instance, Moody's Investors Service highlights "a small deficit of 0.8 per cent of revenues compared with the 2.5 per cent surplus initially forecast". What is your approach to balancing the needs of a growing state with budgetary caution?
The 2018/19 Victorian budget outlines the government's long-term financial-management objectives, and fiscal measures and targets. This guides investment and balances the needs of a growing state with ensuring financial sustainability. The fiscal-management objectives include sound financial management, improving services, building infrastructure and using public resources efficiently.

Consistent with past budgets, these broad objectives, measures and targets were reinforced with three specific sustainability goals. These include ensuring net operating surpluses in each year over the next four years, ensuring expenditure growth is no greater than revenue growth, on average, over the budget and forward estimates, and ensuring net debt to GSP is no greater than its peak over the past five years by the end of the forward estimates.

The budget delivers against all these targets. Surpluses are projected in every year, at A$1.4 billion (US$1 billion) in 2018/19 and averaging A$2.5 billion per year across the forward estimates. Average expenditure growth, at 3.9 per cent over the four years to 2021/22, is lower than average revenue growth of 4 per cent. Meanwhile, projected net debt to GSP is 4.6 per cent at June 2018 growing to 6 per cent by June 2021 and remaining at that level in 2021/22.

As noted by Moody's Investors Service, the government's infrastructure-investment strategy is supported by the state's robust economic conditions which are delivering strong revenue growth over the forward estimates.

■ Can you give an update on state infrastructure projects – their nature, purpose and progress?
The Victorian government has continued its record infrastructure investment in the budget. In 2018/19, A$36.3 billion of state capital projects will either be commencing or underway in the general-government sector.

Projects in the budget include A$4.3 billion for better roads around Victoria, A$1.9 billion to continue the overhaul of Victoria's public-transport network, A$1.3 billion for acute health infrastructure and A$1.3 billion for new schools and existing school upgrades.

Australia's construction industry is currently experiencing high levels of activity along the eastern seaboard, particularly in the transport sector. This is having a positive impact on jobs and economic activity but is also resulting in challenges from a market-capacity and cost perspective.

The government is being proactive in managing these issues. First, we are providing A$12.7 million to the Earth Resources Regulator to help keep the cost of raw materials down. We are implementing reforms to streamline tender processes to reduce unnecessary time and costs to industry. We are establishing the Office of Projects Victoria, which uses specialist skills and expertise to oversee the successful delivery of major infrastructure projects. In addition, we are srengthening the high-value, high-risk framework in line with the increased scale and complexity of the infrastructure programme. Finally, we are continuing to invest in the TAFE and training sector to give Victorians the skills needed to meet the demands of our growing state economy.

■ Commonwelath Bank of Australia analysis of the Victorian budget notes that net debt to GSP is set to stabilise at a "very modest" level. But it also says this forecast is based on "a large drop in capital spending over the out years that, frankly, seems very unlikely to materialise". What gives the state government confidence that the infrastructure task will not continue to be a high-cost item – especially given ongoing robust population growth?
Over the four years to 2021/22, government infrastructure investment averages A$10.1 billion a year, more than double the average of A$4.9 billion a year from 2005/06 to 2014/15.

The net-debt forecast reflects the government's commitment to substantial and ongoing investment in transformative projects, including the Metro Tunnel, the level-crossing removal programme, the West Gate Tunnel project and the western roads upgrade.

The tapering off of expenditure in the out years follows the normal profile of capital expenditure as evidenced in successive budget papers. As projects conclude, new project decisions are expected to be made by government to respond to Victoria's needs while adhering to the fiscal parameters and capacity constraints of the day.

■ Victoria has been able to fund a significant portion of its capex spend in recent years from the proceeds of asset transactions – including the sale of the Snowy Hydro plant to the federal government. Is the asset transaction pipeline now closed, or are there any other state-owned assets that might be suitable for recycling into the private sector?

Asset recycling is an important source of infrastructure funding. The government continuously reviews its balance sheet for opportunities to recycle assets and reinvest proceeds to build the productivity enhancing infrastructure of the future. Recycling assets, particularly those that are mature, can unlock capital to build productive new assets for the benefit of all Victorians.

The government's most recent examples of this are the 50-year lease of the Port of Melbourne, which was finalised in September 2016, the divestment of the state's equity interest in Snowy Hydro, which is expected to be completed by the end of June this year, and the commercialisation of the land titles and registry functions of Land Use Victoria, which is expected to be completed in the second half of 2018.

■ Noting Victoria's forecast increase in opex spend in fiscal year 2019, of nearly 10 per cent, what can you say about your government's approach to maintaining discipline in ongoing expenses?

The government has met its sustainability target of ensuring expenditure growth is no greater than revenue growth, on average, over the budget and forward estimates.

Employee expenses, including superannuation, are forecast to grow by 10.1 per cent in 2018/19. This is in part due to Victoria's recent strong population growth – population growth in Victoria was 2.3 per cent in 2016/17 and is forecast to be 2.3 per cent in 2017/18 and 2.2 per cent in 2018/19. An increasing population requires more public-sector employees to deliver government services including teachers, nurses, doctors, paramedics and police.

In the year to June 2017, the government employed a significant number of new front-line staff including around 3,000 public-health workers, 1,500 teachers and staff in schools, and 1,000 police and emergency-services staff.

It is expected that, as a result of decisions in the most recent and previous budgets, there will be an increase in public-sector workers in 2018/19 in the public-health sector, schools, emergency services including police, and the Victorian public service – including to deliver the government's infrastructure programme.

The two important determinants of employee expenses are the number of employees and wages growth. The government manages wages growth through a wages policy that delivers financially sustainable wage outcomes that recognise and reward the services public-sector employees provide.

The government's wages policy establishes the "fair pay guide", which assures increases of 2.5 per cent a year. Increases above 2.5 per cent are available where genuine service-delivery improvements can be demonstrated.

■ The funding requirement for the state for 2018/19 is lower than previously forecast on the back of a change in working-capital management strategy. Will this change have a one-off or a recurring impact on debt issuance?

In 2017/18, I commissioned a review into the efficiency of working-capital management across the state. The findings of the review indicated that efficiencies could be made by centralising working-capital balances held by government agencies back within the state's centralised banking system.

As a result, government agencies will be required to do this, which will result in the return of excess funds to the public account.

The strategy will result in a one-off return of surplus financial assets held by the general-government sector being available to meet the funding required by the general-government sector in 2018/19.

The A$2.1 billion long-term funding requirement announced following the budget reflects the borrowing needs of the nonfinancial public sector.

■ Treasury Corporation of Victoria (TCV) was Australia's first state issuer of green bonds, but has yet to return to market for a follow-up deal. What role do you see green bonds playing in the state's debt-funding task going forward?

We continue to follow developments in the sustainable-finance market very closely and are supportive of them. We believe this market will develop considerably over the years ahead, including providing TCV with an opportunity to issue further green bonds.

Unfortunately, our reduced financing task in 2018/19 means that we are unlikely to issue a green bond this year. Instead, we will concentrate issuance into building liquidity in our existing domestic benchmark bond lines. •

"The government's infrastructure investment strategy is supported by the state's robust economic conditions which are delivering strong revenue growth over the forward estimates."

QUEENSLAND STICKS TO ITS GUNS

Jackie Trad, **Queensland**'s deputy premier and treasurer, says building infrastructure to support future growth is a key budget priority. But, she adds, having a sound budgetary base is the only way to deliver what the state needs in a responsible manner.

Queensland delivered an unexpectedly large surplus in 2017/18 and state general-government revenue is now estimated to be 4.3 per cent higher than it was in the 2017/18 budget – reflecting a surge in revenue from coal royalties, Commonwealth transfer payments and electricity dividends. How much of a boon to this year's budget were these factors – and to what extent are you expecting the outlook to become more challenged as a result?

Our government has an ongoing commitment to delivering improved frontline services and the infrastructure that our growing state expects in a fiscally responsible manner. This commitment underpins all our budget decisions, both this year and over the forward estimates.

While we have seen an uptick in royalties this year, we aren't relying on heroic royalty assumptions to support our fiscal position over the forward estimates. In fact, we forecast and plan conservatively to ensure continued operating surpluses going forward.

Over the last three years, we have seen more than A$5 billion (US$3.7 billion) in combined operating surpluses. As in 2017/18, these operating surpluses have been directed to vital infrastructure and paying down debt.

■ **With spending growth forecast to be 2.9 per cent over forward estimates, and growing faster than revenue, how confident are you that the state government will be able to deliver continued net operating surpluses?**

Delivering ongoing operating surpluses is a key part of the Queensland government's economic plan and the administration has consistently delivered operating surpluses since forming government in early 2015.

Our revenue forecasts have been affected in the short term by some prepayment of Commonwealth funding as well as a decline in goods-and-services tax payments. The modest increase in operating expenditure is vital to continue delivering improved front-line services and infrastructure.

■ **The state government is investing close to A$46 billion in infrastructure over four years. What is the nature, purpose and progress of the key state infrastructure projects?**

We know that our A$45.8 billion spend on infrastructure over the next four years will gear our state for growth. We are experiencing strong growth currently, and our population recently hit five million people.

We also know that in order for Queensland to continue to deliver a great standard of living we need to make infrastructure investment today. We are investing in the economic and social infrastructure that will create future jobs, encourage private-sector investment, and increase the productivity, efficiency and competitiveness of our state.

The programme includes much needed additional investments in roads, rail, water, energy, hospitals, schools and digital infrastructure projects.

Our investment in roads and transport infrastructure includes Cross River Rail, which will remove the bottleneck at the core of south-east Queensland's rail network to deliver a transport system that benefits the entire region, as well as upgrades to the M1 motorway and the Bruce Highway, and the Toowoomba Second Range Crossing project.

Improving social infrastructure, such as hospitals and schools, will cater to our growing population, deliver better health and educational outcomes, and increase the opportunity for Queenslanders to participate in the economy.

From the Cairns Convention Centre to Rookwood Weir and Townsville Stadium, we are delivering the right projects in the right places at the right time.

■ **There has been a media narrative in Queensland around the suggestion that the government has abandoned earlier commitments to paying down debt. How do you respond to this?**

Our debt is stable and it is sustainable, with debt remaining at 10 per cent of GSP over the forward estimates in line with other states. Unlike other states, our borrowings go towards building the productive infrastructure our state needs, not to funding our public-service superannuation schemes. Our investment in productive infrastructure, guided by our state infrastructure plan and the independent infrastructure assessor, Building Queensland, is key to ensuring continued long-term strong economic growth in Queensland.

The state government has also reduced the level of Queensland's debt. In the general-government sector, debt levels are the lowest they have been since 2011/12. Even at the end of the forward estimates, in 2021/22, general-government debt will be lower than it was in 2014/15. Importantly, the cost of servicing our debt has fallen from 4.7 per cent of state revenue in 2013/14

QTC TALKS FUNDING STRATEGY

Philip Noble, chief executive at **Queensland Treasury Corporation** (QTC) in Brisbane, shares his thoughts on the state's funding strategy.

■ Queensland, through QTC, is one of a select few states to have issued a green bond. What role do you see green bonds playing in the state's debt-funding task?

The global green-bond market has grown and changed significantly in recent years but it is still very much under development. We are committed to supporting its development and, as announced in our recent borrowing-programme update, we expect green bonds will continue to complement our benchmark-bond issuance. But we don't have set targets as a portion of total funding.

We closely watch how the market is evolving as issuers, investors and others strive to define and adopt best practice. In response to recent changes, we have made some enhancements to our approach which give us greater flexibility for issuance and increases the scope for issuance opportunities. This supports the state government's focus on transitioning to a low-carbon economy.

We also recently became a programmatic issuer for Climate Bonds Initiative (CBI)-certified green bonds, which streamlines the issuance process and supports us issuing at least once a year. We have also significantly increased our eligible CBI project pool to more than A$4 billion (US$3 billion), which has increased our scope and ability to undertake future green-bond issuance.

■ QTC's funding update also flags the potential for issuance of bonds with maturities out to 30 years. Has the development of the long-dated sovereign market in Australia been helpful in this respect?

Based on our strategy to smooth and extend our maturity profile, the majority of our funding last year was focused in the 8-12 year part of our curve. This strategy enables QTC to maintain resilience in our ability to manage our refinancing profile.

We have also extended our curve out to 30 years with the issuance of a 2047 maturity bond in 2016/17, which has grown to A$505 million as at 30 June 2018. Our intention is to continue to build this line, although our capacity to issue in this part of the curve relies on matching demand – and only a small number of clients require funding longer than 15 years.

■ Is the prospect of a long period of flat-to-negative Australian dollar-US dollar bond spreads something you are preparing for?

We are mindful of the potential for a long period of flat-to-negative spreads. However, there are different types of investors with different drivers that motivate their investment decisions. For example, some may look at outright yield, spread to government bond, or the hedged cost to their local currency. The spread to the US is just one factor.

This is why we invest in ongoing investor engagement and are always looking to diversify our investor base across regions and types.

to less than 3 per cent over the forward estimates.

■ Analysts describe the extra funds announced for infrastructure and capital works as the "real positive" in the budget. Queensland has fallen behind other states in public capital expenditure of late, so what has been the catalyst to prioritise this now and does the spending programme now match the other states?

The catalyst to prioritise infrastructure spending now is to support growth and create jobs. It's as simple as that. We are recovering from the failure of the former government to deliver a pipeline of infrastructure, and by 2019/20 infrastructure spending per capita will be higher in Queensland than in the other states.

■ The state's credit profile could potentially be challenged, according to Moody's Investors Service, by a growing imbalance between revenue and expenditure growth which could lead to a growth in debt over the forecast period. How much headroom do you believe you have to be able to maintain the current credit rating according to these metrics?

We will continue to manage debt in a sustainable manner, and our debt projections are lower than they were in the 2017/18 budget. We are maintaining operating surpluses over the forward estimates with a forecast operating surplus of A$690 million in 2021/22. It is important to note that this revenue profile has been influenced by the sequencing of some Commonwealth funding commitments later in, and beyond, the forward estimates.

Queensland's balance sheet is strong. Our debt level has been reduced and we continue to maintain a fully funded superannuation scheme. •

"For Queensland to continue to deliver a great standard of living we need to make infrastructure investment today. We are investing in the economic and social infrastructure that will create future jobs, encourage private-sector investment, and increase the productivity, efficiency and competitiveness of our state."

TCORP SETS OUT ITS PRIORITIES

New South Wales Treasury Corporation (TCorp) revealed a A$6.6 billion (US$4.9 billion) term-funding requirement for the 2018/19 financial year on 19 June, in the wake of the New South Wales (NSW) state budget. **Fiona Trigona**, head of funding and balance sheet, and **Katherine Palmer**, senior manager, funding and balance sheet at TCorp in Sydney, lay out the state's priorities for the coming year – which include a debut sustainability bond.

The forecast represents a A$3.5 billion decrease from previous estimates. How is TCorp managing the messaging around its lower-than-expected term-funding requirement for 2018/19?

TRIGONA The NSW government created a whole-of-government asset and liability committee (ALCO) in 2015. During 2017/18, ALCO recommended a number of policy initiatives to help manage the state's financial risks. One of these included expanding the scope of cash-management reforms to provide a whole-of-government view on the use of surplus funds.

These reforms have been very useful in determining the risks at whole-of-state level and how to achieve efficiencies. Internalisation of cash is an ongoing process and we are starting to see the benefits of this work come to fruition.

To date, approximately A$3 billion has been brought under centralised management. These surplus financial assets have been used to reduce TCorp's current funding requirements. The reforms initiated by ALCO will continue as opportunities are explored to improve the state's asset and liability management.

Our strategy – and this is also part of the ALCO – is to lengthen the debt maturity profile for TCorp's borrowing clients and balance sheet. Reducing refinancing risk is also very important, so over the last couple of years TCorp has been buying back shorter-dated bonds when it has been conducive to do so.

TCorp plans to issue a sustainability bond in 2018/19. How did you get comfortable with taking the next step towards issuance of this type, and why did you decide on sustainability bonds specifically?

PALMER TCorp has been watching this sector closely for a while. However, the size of the funding programme has been significantly smaller than normal in the previous 2-3 years due to the state government's asset-recycling initiative. During this period, we focused our attention on the benchmark bond programme in order to maintain liquidity in these bond lines.

This coming financial year sees a return to a more normal funding requirement, which supports our desire to explore sustainability issuance.

We have been observing the evolution of environmental, social and governance (ESG) themes through the market. This includes the fact that TCorp's investment-management team has appointed a dedicated investment-stewardship team of two, with the purpose of integrating ESG themes into investment decisions and active-ownership activities.

TCorp has been collaborating on this project with NSW Treasury and the Office of Environment and Heritage. The Office of Social Impact Investment, a joint NSW Treasury and Department of Premier and Cabinet initiative, is also involved. Within this group we have been able to tap into a range of expertise around green and social bonds.

We investigated the possibility of launching a sustainability programme, under which TCorp can issue green bonds, social bonds or a combination. The term 'sustainability bonds' really reflects the evolution of the market.

This proposal received endorsement from the ALCO earlier this year, and the potential issue was highlighted in a press release from the treasurer in June 2018.

What sort of issuance scale will you be looking for?

"Life-insurance accounts will buy our 10-year bonds, but in the current environment they have tended to prefer the yield associated with even longer-dated lines."

FIONA TRIGONA

PALMER The intention is to issue off our established debt programme, initially the Australian dollar domestic note programme, to enable repeat issuance. A couple of years ago, we saw Treasury Corporation of Victoria (TCV) issue A$300 million and Queensland Treasury Corporation issue A$750 million in their respective green bonds – and this seems to be a good indication of transaction volume at this time.

We don't envisage that our sustainable bonds will match the size of our general-purpose benchmark bonds. But it is likely that this programme will broaden our investor base. We aim to issue under the programme this financial year, subject to market conditions.

TRIGONA This has the endorsement of the state treasurer, which is important for us in being able to progress with the programme. We have also sought investor views around the ESG space. Many global investors we have met over the last couple of years have discussed ESG themes and asked whether we intend to issue in this space.

When I last visited US investors, ESG interest came through very strongly in their questions. The level of interest in green and sustainability bonds from Japanese investors is also increasing.

TCorp says its benchmark programme will take on the bulk of the issuance task. How much of the programme will focus on long-dated maturities?

TRIGONA TCorp's strategy to lengthen its maturity profile is ongoing. In financial year 2017/18 we issued a new 2029 bond and increased the 2030 line via syndication. We now have a suite of bonds in the longer tenors that are open to investors. We will issue into these lines as well as building the size of the 2037 bond to at least A$500 million, subject to market conditions.

We issued A$120 million of the 2037 line initially and have executed some taps with domestic and offshore accounts since. Growing this line to benchmark size is important because it allows for increased market making. We view A$500 million as a good launch pad for liquidity in the ultra-long tenor, and of course there is the possibility of continuing to build volume in the line if demand supports it.

We have received reverse-enquiry demand for this line from both domestic and offshore accounts.

Would you prefer to use syndication or private placements to grow the line further?

TRIGONA We would assess the market at the time and prefer to have a broad set of funding mechanisms available. As with our other bonds, we are open to reverse enquiry. In addition, if demand levels are significant there is the potential to execute a syndicated tap. As mentioned earlier, our assessment of prevailing market conditions at the time will also play into the method we select to increase a bond.

Do you have any plans to issue a 30-year bond?

TRIGONA We have no concrete plans to issue a 30-year bond during the 2018/19 financial year. Our priority will be to increase the volume of existing longer-dated TCorp lines.

Our funding requirements are driven by our own borrowing clients. Given that these clients are predominantly fixed-rate borrowers, outright rates are very important. The 2037 bond currently allows our borrowing clients to lengthen their debt profile at cost-effective rates.

We have a suite of bonds between the 2027 and the 2030 lines, and there is room in our yield curve to fill other gaps as well depending on prevailing market conditions at the time.

Do you find that investors that come into your longest bonds are the same ones that buy elsewhere in the longer-dated part of the yield curve?

TRIGONA There is certainly life-insurance money which is important for this part of the long end of the curve in Australia and offshore. Japan is a case in point, where there is considerable demand for 12-15 year assets. Life-insurance accounts will also buy our 10-year bonds, but in the current environment they have tended to prefer the yield associated with even longer-dated lines.

TCorp bought back some inflation-linked bonds during fiscal 2017/18 after reverse enquiry. Is there any desire to issue new inflation-linked bonds on the basis that it might help reach new investors?

TRIGONA The desire for TCorp to issue inflation-linked bonds is driven by the requirements of TCorp's borrowing clients. TCorp' clients have not borrowed in inflation-linked format in the last year.

If investor demand for linker bonds increases and the funding levels are attractive, we can recommend to our borrowing clients the possibility for them to borrow in this format. While we rarely issue in this format without a client loan to match, market dynamics and our clients' borrowing needs move very quickly – and in this scenario we would respond accordingly. •

"We investigated the possibility of launching a sustainability programme, under which TCorp can issue green bonds, social bonds, or a combination. The term 'sustainability bonds' really reflects the evolution of the market."

KATHERINE PALMER

HIGH-GRADE DEMAND IN A **RISING RATES WORLD**

The big story in the Australian dollar high-grade market in 2018 has been 10-year US Treasuries (USTs) consistently yielding more than the equivalent Australian Commonwealth government bonds (ACGBs) – with little prospect of a reversion. *KangaNews* spoke to a range of dealers in June to get their read.

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■ **Helen Craig** Deputy Editor KANGANEWS

DEMAND FACTORS

Craig Conventional wisdom has been that global investors' currency diversification needs mean Australian dollars will not fall entirely out of favour regardless of relative-value dynamics. What impact have higher UST yields had so far?

■ **DONALDSON** It is true that there have been some signs of weakening in appetite for 10-year bonds and there is no doubt these can be attributed to the inversion of the ACGB bond spread relative to UST.

The interesting feature here is that there are always opportunistic investors looking for capital gains when markets cheapen up. What we have found, in looking at the market over 20-30 years, is that the 10-year bond spread is still mostly a function of cash-rate expectations.

It may be that we see some investors step out of Australia as the spread to UST becomes more inverted. But there are also investors that are attracted to the steeper curve. When you are talking about a 10-year bond curve that is pushing towards 3 per cent against a 1.5 per cent cash rate that looks likely to remain unchanged, the equation is incredibly appealing.

Maybe our market will become more opportunistic in nature. But there will be a broader variety of international investors looking at it, and if it does cheapen up some will be more than happy to enter it.

■ **MCCOLOUGH** The numbers from Japan's Ministry of Finance data on investment into Australia on a six-month rolling basis continue to stack up well. The message I received from life insurers and fund managers in Tokyo in the first week in June was certainly that there are some markets, for example high-grade peripheral Europe, which are offering more appealing investments. But equally Australia is certainly not considered a bad investment.

The most consistent piece of positive feedback was around the Reserve Bank of Australia (RBA) providing unchanged policy. This provides stability, which means less volatility, and is supportive of Australia – regardless of the relative value of ACGBs being below USTs.

■ **GRICE** There is still a strong relationship between the level of the Australian dollar and participation from certain sectors of investors in Japan. In January and February, when Australian dollar-yen was at ¥88, lower participation, particularly by Japanese life funds, wasn't surprising. Now we are back in the low ¥80s, we are seeing participation tick up.

■ **MCCOLOUGH** It is outright yield in a global sense, not just relative to the US, that is important for offshore investors. What we hear is the same message that has been expressed for several years: that Australia is still the highest-yielding triple-A market in the world. This message remains strong.

■ **DONALDSON** The other factor I would mention is that the long end, which in Australia still looks very cheap globally, is doing a lot to pin down the 10-year part of the curve and limit widening.

Historically it has been very difficult to find a relationship between foreign ownership and the 10-year bond spread. The two things don't show great movement together. There is a much stronger relationship between the Australian dollar and foreign ownership.

A unique feature of this period is that the Australian dollar is holding up well even with the Australian-US spread negative. This is only going to be exacerbated on the yield side – probably decisively so. The fact that the currency hasn't been on a weakening trend is reflective of underlying demand for Australian assets, which we don't think is fading.

Most investors looking at our market do so on an unhedged basis. But the cost of hedging has come down relative to other currencies, so many investors are now opting to put their money into the market and move down the curve. The extra 100 basis points pay off for going further out along what is still a very liquid curve is very appealing.

WHETTON If investor groups are concerned about the lack of yield versus USTs – though I wouldn't necessarily point to any investor cohort in particular – what we may see is a switch to semi-government or supranational, sovereign and agency (SSA) product from ACGBs, in order to keep the diversity of holdings within the Australian dollar segments of their portfolios. It is possible that this switch within sectors will be protracted if the Australia-US spread remains negative for the foreseeable future.

Actually we think this is a likely outcome. The Federal Reserve (Fed) will certainly continue to hike and the RBA is far from raising rates. Even if it does it will be gradual. Our expectation is that the spread differential will remain negative.

At the same time, as Adam Donaldson suggests, very high repo rates have been punishing for front-end investors in high-grade bonds with the result that some have gone further out the curve.

The strength of offshore demand for longer tenors – by which I mean 12-30 years – has been notable in recent years. From conversations with investor clients we understand that they remain very attracted to longer-dated ACGBs, because they yield more than USTs, Bunds, Gilts and Japanese government bonds (JGBs).

It is inevitable that there will be some leakage from time to time as the 10-year ACGB and UST bond spread differential continues to grow. But, at the same time, a wholesale dumping of Australian dollar product seems highly unlikely while the hedge costs out of US dollars remain favourable. Indeed, the fact that there is no longer a cost to hold Australian dollar bonds and take the currency risk out could lift demand.

Craig How do you expect supply and demand dynamics in the SSA and semi-government market to change?

WHETTON There is no doubt that there is an increase in semi-government supply coming, and quite quickly, after a number of years of restricted issuance volume.

At the same time, the banking landscape in Australia, both pre- and post-royal commission, is seeing slower credit growth. So the banks' loan books obviously aren't growing to the extent they were and the major banks' need for high-quality liquid assets (HQLAs) is somewhat diminished.

We expect limited growth in banks' demand for semi-government bonds going forward. We think the states will make up the difference from domestic and offshore real money. We also note that the long end has strong liability demand, which is typically offshore. In a way, the semis will be able to increase issuance and attract a new buyer base.

Meanwhile, SSA issuance remains concentrated at the 10.5-year point by virtue of where the cross-currency basis swap allows transactions to be executed in Australian dollars. These transactions are supported very specifically by Japanese demand.

EVERITT SSA Kangaroo issuance has evolved to become a largely long-dated market. This is not to say mid-curve deals are no longer achieveable. They are – but the last couple of years has only seen a handful of larger-volume mid-curve trades each year. These transactions have been sufficient to satiate the level of demand in the primary and secondary markets.

Demand patterns have been relatively consistent in recent years. The most reliable buyer base remains active in long-end bonds, and as we start to see yields back up the level of engagement increases dramatically.

Craig What impact has the availability of extended tenor had on keeping offshore investors engaged with the Australian dollar market?

GALT Currently, 30-year ACGBs are trading at about a 10 basis point premium to USTs. The shape of the Australian curve is rewarding investors that are inclined to go longer.

This appetite for longer duration has been one of the core themes for our market in recent years. A universe of buyers is becoming increasingly comfortable with the liquidity dynamics at the back of the Australian curve.

> "Maybe our market will become more opportunistic in nature. But there will be a broader variety of international investors looking at it, and if it does cheapen up some will be more than happy to enter it."
>
> **ADAM DONALDSON** COMMONWEALTH BANK OF AUSTRALIA

ASSET CLASS *CREEP*

Many international investors, most notably some major accounts from Japan, have broadened their Australian dollar holdings into higher-yielding asset classes. Market participants argue this is largely additional to their demand for high-grade bonds, though.

Craig What impact has migration to credit had on demand for government-sector issuers?

WHETTON I'd say very little, because there are very distinct investor cohorts with different motivations. Generally, the Japanese have been very uncomfortable with the idea of credit. They simply don't understand it as well.

Fund managers and life insurers are attracted to supranational, sovereign and agency bonds and buy synthetically via cross-currency swaps. I would argue that semis will come back into favour as yields rise on an outright basis. These investors like sovereign credit and, as sovereign and subsovereign yields rise, they are more likely to prefer high-grade paper than they are to invest in corporate credit.

Bank books, on the other hand, are very active in residential mortgage-backed securities (RMBS) and corporate credit. I expect this to continue to be the case.

DONALDSON Investors in corporate credit are opportunistic, in the sense that they are very willing buyers of 10-year paper if they can get supply which meets their yield hurdles.

In practice, the actual volume of corporate debt going into Japan remains contained with the vast majority ending up in US dollar private placements because of the depth of that market.

I agree with Martin Whetton that the move down the credit spectrum into RMBS is driven more by the banks than it is by any other investor cohort. Data on RMBS deal flow show demand is very strong and increasing. We think Japanese financial institutions will continue to boost these holdings.

EVERITT The move into higher-yield asset classes has had negligible impact, from what we can see, in primary or secondary. I don't see this changing. I think there will be enough volatility in markets to keep Japanese investors engaged in the higher-rated space.

MCCOLOUGH It is not an allocation out of governments or semis into credit and RMBS per se. Investors are seeking additional yield but not at the expense of their high-grade investments. In fact, Japanese Ministry of Finance data clearly show that sovereign flows are unchanged in the last 12-24 months.

GRICE Some asset classes are benefiting from new money from different investor types – and, as others have said, RMBS is probably the best example. For corporate credit, the marginal dollar is going into longer-dated credit and this is at the expense of the high-grade sector. But credit is still a scarcely available asset out of Australia.

CRAIG So the scale of the impact is minimal, even if there is some adjustment at the edges?

GRICE That's right. These investors have regular cash flows to invest and this doesn't always line up with the availability of long-dated corporate bonds. Corporates aren't very liquid either. It is fair to say that demand is greater than supply in longer-dated credit names for Japanese investors

CRAIG Has the Japanese investor base grown such that there are now different types and sizes of investors, including a range of mandates that can support both high-grade and credit issuance?

EVERITT This is absolutely the case. It has been by name and by supplementary that they have come in. Some of these investors have new mandates which enable them to buy credit, RMBS or other products available in Australia.

These firms probably started off in the high-grade market and they continue to play there – but their mandates have evolved to enable them to participate in other asset classes. This hasn't necessarily been at the expense of the initial asset classes.

"THE MOVE INTO HIGHER-YIELD ASSET CLASSES HAS HAD NEGLIGIBLE IMPACT IN EITHER PRIMARY OR SECONDARY. GOING FORWARD, I DON'T SEE THIS CHANGING. I THINK THERE WILL BE ENOUGH VOLATILITY IN MARKETS TO KEEP JAPANESE INVESTORS ENGAGED IN THE HIGHER-RATED SPACE."

ROD EVERITT DEUTSCHE BANK

Ongoing development at the long end is something the market was hoping for pursuant to the curve-extending ACGB 2047 line in the last quarter of 2016. This evolution of long-end demand and supply is unfolding positively with several of the semi-government issuers now also having issued their own longer-dated bonds.

INVESTOR SPOTLIGHT

Craig Can we drill down into the motivations and outcomes of some of the key international investor groups for high-grade Australian dollars?

WHETTON The motivations are clear for Japanese life-insurance accounts. When the market sold off in absolute terms earlier this year and we saw the generic SSA 10-year yield above 3.25 per cent, this sparked enormous interest from the Japanese buyer base. These investors target 3.25-3.3 per cent yield. Their motivation is simply that it is a profitable product to run so they can sell term life-insurance annuities easily. They will buy so long as the yield is in their bogey.

EVERITT The fact that spreads have affected some of the Japanese life accounts means they are perhaps not as aggressive or as active as they have been – particularly in the longer part of the curve. But we have seen others become more engaged because of the benefit that is currently available from accommodative hedging costs.

We haven't seen a net decrease necessarily. There has been switching by some of the Japanese investors that have been playing in our market for some time.

DONALDSON There are different types of life-insurance investors that we often just lump together. But when we are talking about Japan specifically, some of the very large insurance companies are selling an Australian dollar-specific product to mum-and-dad investors with the retail investor taking the currency risk.

While this appetite continues to grow, it is not doing so quite as fast as it was a year or two ago. It still looks solid but it is a diversification story.

Then there are insurance companies that have liabilities in Australia and need to asset match. They will do this on a periodic basis, according to their liabilities.

MCCOLOUGH The FX hedge returns make Australia marginal for life insurers. While we are unable to predict on a quarter-to-quarter basis, they reserve the right to have less or more of their allocation unhedged. If we get below ¥80 to the Australian dollar it would significantly change the dynamic of life-insurance investment triggers – in a positive way.

Craig How have the motivations or outcomes changed for central banks and sovereign wealth funds as investors in the Australian dollar market? It certainly seems that this particular group of investors is less prominent in Australian dollars than was the case half a decade ago. But is this an accurate reflection of demand patterns?

WHETTON I would argue that central-bank and sovereign-wealth investors remain sidelined. They are not as active as they once were because their accumulation mode has come to an end. Notwithstanding comments around some new central banks appearing at the margin in the Australian Office of Financial Management (AOFM)'s books, broadly speaking the central banks are holding.

For the most part their motivations are around liquidity, so they watch what is happening in repo rates very closely as a big determinant of where on the curve to invest.

DONALDSON It has been reasonably well documented that there was a large build-up of exposures a few years ago but that the sector has been treading water in the last couple of years.

Global data is poor, partly because the International Monetary Fund's currency composition of official foreign exchange reserves data continue gradually to reveal Chinese holdings. Given these holdings are so substantial it appears that the aggregate number is continuing to increase. But in reality we don't think this is what is occurring – it is just a data-reporting issue.

We have seen some central banks lighten up holdings over the past couple of years. This was the type of account we previously described as being more opportunistic. However, we have seen others take the step of including Australian dollars as a benchmark currency. The positive news for Australian issuers is that these accounts are sticky.

The other good news is that there are still further central banks considering entering the Australian market. We expect the data on this to prove to be more robust. Their interest is predominantly for diversification rather than spread.

EVERITT European investors have been a little quieter for a while too, and some of the central banks have moved away from their buy-and-hold nature to be more actively trading securities.

But, by and large, we've seen periodic flows out of Europe, which has been consistent for a year or two now. Again this is yield driven, predominantly focused on longer-dated issuance and probably more engaged and engaging around those liquidity points.

DONALDSON Some global players take decisions on where to invest long-dated money based on currency. These are the investors with which we think there has been good traction in the last 12 months. This reflects the steeper Australian curve and the fact, which I think is crucial, that they can hedge out

"Some investors are focused on spread to treasuries, others on outright yield, and a different set again are more focused on curve shape and relative value. There are clearly diverse motivations and portfolio preferences. However, the overall thematic of duration extension is apparent."

TIM GALT UBS

THE NEXT *MARGINAL BUYER*

Australian high-grade issuers have been very active in seeking out new pockets of investors. Market participants discuss where the next new buyers might come from.

CRAIG Have any new cohorts of investors come into the Australian dollar market in recent months? Where would you advise issuers to concentrate their investor-relations efforts when it comes to finding new money?

DONALDSON One area which has clearly expanded over the last couple of years, out of Japan and Asia broadly, is bank investment in the government bond market and using repo to fund exposures. This plays through to either a collateral swap-type trade or the futures-government trade in Australia.

These trades don't look quite as attractive as they used to. Futures and cash bonds are trading more tightly than they were. We have also seen some pressure from the need for funding come through on repo.

Nevertheless, these players continue to search the globe for opportunities and, we have seen this presence grow as this type of arbitrage trade out of Australia remains relatively attractive. According to recent Reserve Bank of Australia data, the size of the repo book has reached new highs – so this element is clearly growing.

GALT Asian investors are well known for their appetite for duration and this is likely to continue. The ebb and flow of the cross-currency basis may prove advantageous at times for certain locations. However, issuers with consistent marketing and investor-engagement programmes will be well placed to capitalise on these movements over time.

EVERITT Government and semi-government issuers have been very active in seeking out new pockets of investors. It is without question that issuers must keep marketing to accounts in north-east Asia, including Japan and Taiwan, and some of the Hong Kong- and Singapore-based investors. For duration, it is important they keep in front of European buyers. US investors remain very patchy and the Australian market simply doesn't make sense for them in the context of the Australian-US spread differential and currency being where they are.

What may be interesting down the track are potential opportunities arising from inflation-based investors looking for new product. Clearly this is more of an Australian Office of Financial Management (AOFM) story than one that relates to the semis.

But engagement may return over the next couple of years as investors start to get a better handle on understanding global inflation and what this means based on where yields are.

WHETTON I agree that issuers aren't going to uncover multiple new investors. Borrowers appear be looking to term out their debt further, which seems the sensible thing to do given a rise in yield across the board over time from here. They may find some investors don't want duration as yields start to rise – which may make things a little more challenging.

GRICE It is still very much about finding the marginal investor. Unearthing new investors is critical and issuers can never be complacent.

MCCOLOUGH I don't believe issuers need to find a whole new investor subset to be able to fund as their programmes evolve over the coming years. Will Grice and I quite often ask each other who the marginal investor will be – not necessarily in a negative sense but to follow the ebbs and flows.

Marginal relative value is what attracts the marginal investor, and in this context timing becomes all the more important. Australian government-sector issuers are all very good at timing and at targeting appropriate maturities and product types to investor needs. This is more important than uncovering new sources of funding.

"MARGINAL RELATIVE VALUE ATTRACTS THE MARGINAL INVESTOR, AND IN THIS CONTEXT TIMING BECOMES ALL THE MORE IMPORTANT. THE AOFM AND THE SEMIS ARE ALL VERY GOOD AT TIMING, AND AT TARGETING APPROPRIATE MATURITIES AND PRODUCT TYPES TO INVESTOR NEEDS."

DAMIEN MCCOLOUGH WESTPAC INSTITUTIONAL BANK

the currency exposure and still achieve a superior return in the Australian market.

Against this, though, is the fact that the AOFM is not issuing a large quantity of long-dated bonds. One of the reasons the market has performed so well in the last year or two is that it has moved on from the fear that the government funding task would continue to rise and that the AOFM would continue to extend duration, effectively flooding the market with long-dated bonds.

The way it is turning out is that the funding environment has improved materially for the AOFM. It is able to pick and choose according to where demand is. While the AOFM obviously wants to maintain the duration of its portfolio, it is now able to do so on a far more opportunistic basis. Investors can be confident they won't be run over by an excessive volume of supply.

GALT Appetite for duration and increasing comfort in liquidity dynamics at the back end of the curve remain key

"I would argue that central-bank and sovereign-wealth investors remain sidelined. They are not as active as they once were because their accumulation mode has come to an end."

MARTIN WHETTON ANZ

themes. Some investors are focused on spread to UST, others on outright yield and a different set again are more focused on curve shape and relative value. There are clearly diverse motivations and portfolio preferences. However, the overall theme of duration extension is still apparent.

A number of investors are taking views on outright Australian dollar yield while others are swapping into other currencies. There are compelling reasons for both groups to be looking at the back end of the yield curve.

■ **WHETTON** There is one other investor segment I will throw into the discussion. Hedge funds are important in taking down liquidity in syndicated transactions and basket bonds, but they were largely absent from the recent 2039 AOFM syndication. This was driven by the availability, rather than the cost, of repo.

It would no doubt be a concern for the AOFM to lose this buyer base on a regular basis. Hedge funds are no longer in Australia for the Australian-US compression trade, but they do seek the relative-value trade.

■ **GRICE** This is certainly topical in relation to the funding pressures we're observing in the short end of the Australian curve. These funding pressures are a headwind for leveraged participation in our market.

How this plays out remains to be seen. But this has tended to be a quarter- or year-end effect, so everyone is watching to see if this is the new normal or if pressures abate in July. Either way, I believe some of the basis widening we have seen this year is structural.

■ **EVERITT** We saw a bit of disruption over the March quarter end with some of the balance sheet extended to hedge funds being taken away and costs increasing dramatically. This took some of the gloss off our market, and we saw some selling and some accounts not as active as we would expect.

They are still there, though – and we continue to see them looking for relative-value opportunities. This could be either within the market – in other words switching up or down the curve – or playing against other currencies.

What buyers have had to do is be more active around when they lock down their balance sheets. As Will Grice says, it will be interesting to see how this dynamic plays out at the end of Q2.

Craig A theme that has characterised the Australian market for many years is new investors rotating in as others exit. Is this still in play?

■ **EVERITT** Absolutely. As one investor group exits another will come in, either because something has changed for the investor or a relativity has moved and thus brought the market back into focus.

If I think back to the big themes that have grown the Australian market over the last five years, the times when we needed to issue more debt have coincided with demand factors that supported the growth.

Most notably, the allocation of new money to Australian dollars by the central banks and the need for bank balance sheets to build their HQLA books, both of which boosted demand, came at a time when the AOFM and semis needed to issue more.

This phase is ending but other factors are kicking in. Overall, it feels to me that the volume we will need to push through our market is well and truly achieveable within the current investor mix.

RATES OUTLOOK

Craig The outlook for ACGB yield, and the relative yield to USTs, is clearly important. It seems the consensus expectation of Australian rate-hike timing is being pushed back as the perceived risk in the housing market eases and inflationary pressure continues to fail to come through. Should we get used to the idea of Australian rates being lower than the US?

■ **MCCOLOUGH** My perspective is yes, we should – at least for the next 12-18 months. It is too early to say the recent divergence in monetary policy between Australia and the US will switch back in the other direction. This will only occur when the US cycle nears its end, which we are calling for this time next year.

At the moment this debate is going in the other direction with regard to shifts in the Fed Funds dot-plot projections. The 10-year Australian-US bond spread is near record inversion. We expect this trend to continue, to the extent that the differential will reach 40-50 basis points perhaps towards the end of this year. We expect the likely low point to persist into the first quarter of next year.

WHETTON Broadly speaking we expect ACGBs to remain very negative to the US in 10 years, at somewhere around the minus 50 basis points mark and potentially more depending on the pace of the Fed's hiking cycle.

To the second point around the RBA's trajectory, which I think is well-made, the consensus is being pushed back. The further back it goes the more negative the yield and the further out the curve negative yields come into play. Right now, all points out to 15 years are yielding less than the US. One of our forecasts is – eventually – that the 30-year ACGB will go flat to the US.

GRICE Westpac Banking Corporation's chief economist, Bill Evans, is very vocal about his forecast of unchanged RBA policy this year and next, coupled with a view that the Fed will be raising rates up to 2.625 per cent via three more rate hikes, taking the cash differential to minus 112.5 basis points in the middle of next year. This is the backdrop against which Damien McColough is forecasting his ACGB spread target versus the UST. I see no reason why it won't play out.

DONALDSON Expectations for the Fed continue to creep up. As the data hold together and the US economy performs well, rising Fed expectations appear to be intact provided the US dollar doesn't materially strengthen.

Australia is almost at the opposite end of the spectrum, whereby RBA expectations continue to be pushed out. Very importantly, more and more investors are concluding that even when a tightening cycle does happen the ability for the cash rate to move materially above 2 per cent is relatively constrained.

We have a 2.5 per cent peak in our forecast, and we stress that this is a peak. It is well below the estimates the RBA presents as a neutral rate and also well below what looks likely to be the peak in the US.

Looking ahead, this means we will have a negative rate spread in the 10-year part of the curve over a 3-5 year timeframe. With this backdrop it makes sense that bonds further out the curve will also go negative. While we are in this regime we think spread will invert a bit further.

GRICE With rates on hold and no near-term inflationary headwinds, all the volatility is being sourced offshore. Investors, both local and global, like the stability and liquidity that is now available in our market.

MCCOLOUGH In the last decade or so, Australia has benefited from the fact that nothing drastic has occurred to dampen its risk-reward balance. In fact, on a relative basis I'd say Australia is more of a safe-haven play than it has ever been before.

Craig Going back to the global relative-rates story, the macro outlook for the Japanese economy certainly suggests that there is no reason to expect JGB yield to spike. But Europe looks to be on a different trajectory – albeit at a slower pace than most expect in the US. What might a higher euro sovereign bond yield mean for Australian dollar demand?

MCCOLOUGH I am yet to come to a conclusion on this. If we are talking about Australia as a safe haven, the evolution was central banks diversifying their FX reserves into the Australian dollar – and most of this move was a relocation of assets out of the euro.

There is potentially some reversal of these flows coming, to the extent rising euro sovereign yields are a function of stability in growth and geopolitics. But this is not a major concern when I look at the checklist of factors I think will drive Australian bonds over the next six months.

DONALDSON We think the euro is crucial to the outlook. In many ways, the ratcheting up of Fed expectations we saw last year, accompanied by Australian bonds trading below USTs, was a result of the strength of Europe and the synchronised global growth story.

This meant that even though the Fed was raising rates it wasn't seeing the US dollar rise materially. In many ways the strength of the euro unleashed the Fed, providing the ability for the Fed to tighten.

We know now that the European Central Bank (ECB) is drawing a close to QE, but it is also expected to signal that a lift in interest rates is a long way off – and when it does occur it will be a very gradual story.

At the end of the day, the market only has something like a 40 basis point lift in the deposit rate, back to a level of zero, priced in over the next couple of years. If we were to identify something that could shift meaningfully in the globe, it is that our views on this perhaps become a 100 or 150 basis point lift because Europe remains solid and performs well.

If this happens, expectations and yields globally will push up. This would influence Australia but, with the RBA still firmly on the back foot, to a much lesser degree. This would drive our

"With rates on hold and no near-term inflationary headwinds, all the volatility is being sourced offshore and not domestically – and investors both local and global like the stability and liquidity that is now available in our market."

WILL GRICE WESTPAC INSTITUTIONAL BANK bond spreads tighter to Europe, and more negative to the US, unless a part of this process sees the Australian dollar materially weaken.

For other reasons, including our narrow current-account deficit and the appeal of Australia as an investment destination, we don't think the Australian dollar will fall materially even if the previous scenario plays out.

■ **WHETTON** It is not so much the buying of debt that we are cautious around but the liquidity provided by central banks. As liquidity dries up, it may be that risk markets don't perform very well.

We are probably more sanguine in our expectations on Italy, given the talking heads are ex-markets people and they realise Italy losing access to capital markets would be very bad. We are more worried that European QE disappearing will have a negative impact on credit spreads.

HIGH-GRADE VOLUME

Craig How do issuance-volume trends fit into the Australian demand picture? The AOFM's task is easing, having been close to capacity a couple of years ago, while the semis are increasing their issuance – but perhaps not by as much as was once expected. To what extent will lower issuance help keep spreads under control?

■ **EVERITT** Lower issuance volume is really what will contain spreads. The crucial factor is that supply-side challenges seem unlikely as there should be enough demand to meet our supply requirements and, if anything, somewhat more.

There will be sufficient AOFM bonds on offer to keep international investors engaged. For the semis, the new funding year will be about the same as last year, keeping spreads in order. And we may see a fraction less SSA issuance over the next 12 months than we have seen over the past couple of years.

I think there is a good buyer base in Australia for high-quality credit on an ongoing basis. Putting aside volatility-driven events which may have an impact on credit markets, capacity is if anything greater than we think.

If we see a slower Fed from here and the ECB is slow and gradual with no real rate rises, this will be good for credit. In this environment, I can't see the supply-demand dynamic shifting too far from what we've seen over the last couple of years.

■ **WHETTON** Others have made the point that semis aren't massively increasing their issuance, and I agree. But semi issuance is increasing relative to the demand pool and to the level of growth we expect in HQLA demand.

We think semi spreads will widen in this environment. There are homogeneous buying pools but there are also distinct buying pools. There are those that, on the HQLA side, will favour semis for the yield – but they don't have as much capacity. With smaller bank balance sheets, we think the extra marginal dollar will go towards government bonds.

In relative-value terms, we believe ACGBs will perform versus swap because fewer government securities will be issued. Semi issuance will be slightly elevated so we expect semis to widen versus bond and swap, and for the semi curve to steepen.

The AOFM has done a sterling job of completing its issuance over the last few years and its smaller issuance programme coincides with QE starting to be wound down around the world.

■ **MCCOLOUGH** To the extent there is positive net issuance there is clearly some price tension in evidence – although in the out years, if you believe the current state forecasts for borrowing programmes, there will be less and less on a net-issuance basis. Bonds are not so scarce that supply is suppressing liquidity expectations. But we are past peak issuance and this will keep spreads tighter.

I think we have had a bit of an experiment with investors' attitude to supply in the last few months. Just last year, when semis announced borrowing programmes it was negative for spreads – until we saw the demand get taken down after the initial new issuance was delivered in the first quarter of the following financial year. That has not been the case this time around.

The semi-government sector is presenting a different profile, given the fact that Treasury Corporation of Victoria, for example, plans to issue significantly less than it expected this time last year. But the fact that there has been no concession to new supply is reasonably telling.

■ **GRICE** The slightly lower gross issuance from the AOFM this year, at A$75 billion (US$55.8 billion), is more than enough to provide liquidity to all the participants in the market.

The recent post-budget announcement from the AOFM that it will put two new 12-year bonds on the curve for the 10-year basket, a new five-year line that will eventually support the three-year futures, and a new 2041 for the 20-year future reflects a broad-based commitment to providing liquidity across the curve.

The AOFM's recent issue by tender of a new May 2030 line, for A$2.5 billion, is a very good example. The difference between the highest and lowest accepted bid yield issued outright was 1.5 basis points. This is a testament to liquidity in the Australian bond market – in fact I would argue that our bond market has never been more liquid than it is now.

Regarding semis, they have suffered from lack of supply recently. The market was positioning for growth in net supply in 2017/18, and the fact that this did not come through disappointed. We are now heading into 2018/19 looking forward to an uptick in supply.

With A$8 billion programmes already announced by QTC and Western Australian Treasury Corporation, the market is ready for this supply. Spreads, outside of small relative-value changes, will receive the supply with ease. •

EVENT REPORT

Strong ties in a changing world

The **Australian Office of Financial Management** hosted its fourth Australian Government Fixed-Income Forum in Tokyo in June. The event has grown significantly since its debut in 2013, with close to a hundred local investors attending in 2018. *KangaNews* was the only media organisation present, and is pleased to share a flavour of this important investor-relations project.

JOHN FRASER AUSTRALIAN TREASURY

"As the decline in mining investment finally stops dragging on growth in Australia, we expect the pickup in economic indicators to continue. Mining companies will also begin to reinvest to maintain the large capital stock built up through the boom."

"Of current concern in China is risk from the shadow banking sector and the questionable quality of lending in some pockets of the economy. But the somewhat unique features of the Chinese financial system and the powerful role of financial authorities in China provide comfort that these issues can be successfully navigated."

AKIRA TAKEI ASSET MANAGEMENT ONE

"Australia has its ups and downs, but it remains well worth investing in its bond market. Rates may be low, but this continues to be the case everywhere – and we appreciate the regular information updates we get from Australia, which is not the case everywhere."

ROB NICHOLL
AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT

"The number of central banks in the Australian sovereign bond market increased fourfold between 2011 and 2014. After late 2014, the number of new central banks allocating into Australian dollars slowed noticeably, resulting in a decline in the proportion of offshore holdings."

"Changed monetary policy settings globally is potentially a major factor between asset classes, particularly for relative value and the risk outlook. The AOFM remains confident that the careful planning for operational flexibility we have maintained leaves us well placed to deal with a wide range of possibilities as they emerge."

DAVID DEVERALL
NEW SOUTH WALES TREASURY CORPORATION

"We have seen most demand coming in at the long end in the past 12 months. Credit must go to the AOFM for introducing the 30-year sovereign bond, which has created an umbrella effect for the other semi-government issuers."

BILL WHITFORD
TREASURY CORPORATION OF VICTORIA

"As the wave of structural reform rolls around the world there will be opportunities to attract new investors. Collectively, the Australian states have spent a lot of time in Europe and Asia but probably haven't spent as much time in the US. I suspect there is opportunity there over time for TCV when our programme increases in the future."

JOHN COLLINS
WESTERN AUSTRALIAN TREASURY CORPORATION

"The decline in mining investment has had a big impact on state final demand in numerous areas. However, we are near the bottom of this cycle and we are beginning to see the economy rebounding, with a number of new mining projects in the pipeline."

SIMON WARNER AMP CAPITAL

"Australia has been one of the greatest beneficiaries of globalisation and therefore has a vested interest in maintaining the pace of growth in global trade flows. It is up to us to show leadership on this in the region."

"Australia will benefit from an ongoing favourable global cyclical outlook. The base case is positive for commodity prices, exports and benign financial markets. China presents a tail risk as our largest trading partner and primary point of export-price determination, which we need to continue to be cognisant of."

YOSHISADA ISHIDE
DAIWA SB INVESTMENTS

"The driving force of the Australian economy in the recent past has been infrastructure investment from the government sector, and the outlook here remains good. We therefore have no concerns about the trajectory of the Australian economy."

ANTHONY KIRKHAM WESTERN ASSET MANAGEMENT

"For the RBA to tighten monetary policy there needs to be some real growth in wages. The participation rate in 2017 grew at a record-equalling rate which has left some slack in unemployment. It is unlikely that the participation rate can move significantly higher, so we should start seeing a reduction in unemployment and ultimately some pressure on wages."

"The Australian credit market has been affected by Japanese insurers wanting longer-dated assets. This suits issuers in Australia that want to term out debt. The key for an investor in Australia is to understand where these flows are coming from and their investment goals."

CHRIS DALTON AUSTRALIAN SECURITISATION FORUM

"Due to the volume and level of activity in the two largest markets – Melbourne and Sydney – these markets tend to dominate aggregate figures. They have experienced a flattening or a slight decline in prices, but given the significant appreciation between 2015 and 2017 it is not a major concern."

PHILIP NOBLE QUEENSLAND TREASURY CORPORATION

"Climate change will have an impact on our investor base and our business. Whether it takes one year or 10 years, I think you will see people investing in governments and semi-governments that have appropriate climate-change policies."

The role of green bonds in making an impact

To truly understand the value of green bonds – and counter the cynic's objection that they are little more than window dressing – it is necessary to take a historical perspective. By doing so, the nature and context of green-bond impact starts to reveal itself more clearly.

BY ALEX STRUC

It is often the case that the more we are told things are different, the more we find them to be the same if we go back in history far enough. Private debt has more in common with public debt than we are often prepared to admit, similar animal spirits drive investor behaviour in developed and emerging markets, and trading bonds is not all that dissimilar to trading equities – both can be equally liquid or illiquid.

Whether it be positive or negative, all finance has an impact – in the sense that it helps generate outcomes for societies at large. Green bonds are no different.

While it is customary to attribute their birth to the European Investment Bank (EIB)'s first issue in 2007, a cursory look at the history of global capital markets will unveil their much older cousins in the municipal market in the US and agencies in Europe.

US municipals go back to the early 1800s, with the first bond issued for the Erie Canal in 1812. Some of the major infrastructure projects, like San Francisco International Airport and the California State Water Project as well as landmarks like the Bay Bridge, were possible because of money lent by private investors in the form of municipal bonds.

At US$5 trillion in total outstanding volume as of January 2018, the US municipal market is a good example of impact financing. Two main structures dominate: revenue and general-obligation bonds.

Revenue bonds, which comprise approximately 60 per cent of the market, are designed to raise money to finance a particular project. Both the total return and the risk profile of the instrument are solely determined by the viability of the underlying project.

> “BALANCE SHEETS ALWAYS APPEAR IF ASSETS ARE CHEAP ENOUGH, HOWEVER THEY NEVER DO IF PEOPLE HAVE NO KNOWLEDGE OF WHAT THEY ARE BUYING.”

General-obligation bonds could be just as useful in directing funds where they are most needed, but the transparency of use of proceeds is lower than that of revenue bonds as states are able to use the money for a broader range of eligible projects.

Clear structures and robust legislation are key ingredients to facilitate change. In 2009, the then newly authorised Build America Bonds (BABs) grew to a whopping US$181 billion in a year as a result of states providing a direct 35 per cent interest-rate subsidy on taxable bonds.

Europe also has a long history of engaging private capital to support public needs. Two examples are the French agency, Caisse des Dépôts et Consignations, which was established in 1816 to safeguard public funds, and the Netherlands' BNG Bank, which was established in 1914 and exclusively provides financing to semi-public organisations. Similar structures, that facilitate public and private collaboration for impact, exist across most of Europe as well as in countries including Canada, Australia and Japan.

Just like BABs, which were created to help the US deal with the fallout from the financial crisis, green bonds also have a purpose. Initially they were issued to finance renewable-energy projects. However, unlike the US revenue-based structures, green bonds were fully fungible with the rest of the issuer's capital structure including identical default and recovery profiles. In a nutshell, green bonds are *pari passu* with the rest of an issuer's debt. The real benefit lies in an additional level of transparency.

While additional reporting is only a window into the overall activity of the issuer, it is incrementally more helpful than what is offered with a normal bond. It has become common over time for high-grade issuers not to give explicit reasons for their borrowing. Due to the perceived strength of balance sheets, low gearing and easy access to financing, use of proceeds is largely cited as "general corporate purposes".

Even so, if green bonds are just bonds with additional transparency used to finance already existent projects, it is fair to ask how the value they create is additive and how they can help unlock investments needed for the transition to a low-carbon economy.

CONTINUITY OF FINANCING

First and foremost, green bonds offer continuity of financing. Issuers often have to manage the mismatch between assets and liabilities. While at inception green-bond proceeds could be financing projects which already exist, some of these projects could expire before the final maturity of the bond and the remaining proceeds reinvested in other eligible assets.

Here, the strength of a green-bond programme matters most. To draw a parallel with securitised assets, one should favour programmes that ensure greater overcollaterisation. In other words, to maintain integrity of green financing one should ensure that eligible assets are always larger than or equal to the size of liabilities, even if the green-bond programme is unsecured or uncollateralised.

For example, for green bonds issued under the Climate Bonds Initiative (CBI) framework issuers have to earmark new projects they intend to finance when replacing old ones, such that the total value of investments is the same as or higher than the level of financing. To secure continuity, the CBI also allows for a two-year phase-in for eligible assets.

While it may appear that such bonds offer no incremental value at the time of issuance, they secure future financing regardless of market conditions or political rhetoric that may emerge over the life of the transaction. Additionality of impact in a well-structured green bond is achieved over time and is not limited to when the proceeds are first raised.

Growing the issuance of robust green-bond structures today can also help secure necessary funding for future generations. When investing in credit, longer-duration bonds are preferable if fundamentals are strong and valuation is attractive. Similar logic applies to green bonds with respect to impact. If one is committed to the transition and is satisfied with the integrity of the green-bond programme, the longest maturity is always more preferable – all else being equal, of course.

France's issuance of green Treasury bonds, which commenced in 2017 with a €7 billion (US$8.1 billion), 22-year transaction is nothing short of the government's 20-year commitment to support sustainable financing.

ECONOMIES OF SCALE

Green bonds also bring additional investors and could provide economies of scale. Due to the *pari-passu* nature of green bonds, even if every project under the green-bond programme defaults but the issuer remains solvent, investors still receive their money back in full. This feature is extremely valuable for those with lower tolerance for risk but desire to contribute to positive change.

For example, risky project-finance deals in developing countries tend to attract a finite number of investors and thus volume – mainly due to lack of knowledge. However, a large bank or a company with deep experience in the region could draw additional investors if it offers to take the first loss by borrowing money at its own issuer level rather than explicitly linking repayment to the success of an individual project.

Assuming that such a company is well capitalised, it will be able to attract relatively cheap financing and significantly diversify its funding by offering a broader set of investors the chance to facilitate positive change.

Starting a green-bond programme comes at a cost, which is mainly borne by the issuer. This is often overlooked by investors. The cost to the issuer is significant as it includes setting up dedicated teams, developing new protocols for determining eligibility of assets, designing monitoring and compliance systems, hiring an auditor or a third party to verify programme integrity and, finally, developing and producing an annual report containing key performance indicators.

While the final product may not be to every investor's liking, one should always treat the issuance of a green bond as an invitation for engagement by the issuer.

Companies are always looking for additional feedback on how to improve their efforts. Such information is valuable and is especially welcomed if it comes directly from investors. This way issuers could save on fees, which they otherwise have to pay to investment banks.

> "PORTFOLIOS WHICH RELY SOLELY ON GREEN BONDS COULD BE LIMITING AS INVESTORS ARE AT THE MERCY OF THE NEW-ISSUE CALENDAR. SOME COMPANIES ISSUE MORE GREEN BONDS THAN OTHERS, BUT THOSE THAT DO ARE NOT ALWAYS THE BEST OR THE CHEAPEST."

FREE EDUCATION

Drawing on my own experience of creating liquidity in large markets for more than 15 years, I have found that lack of balance sheet is not what ultimately kills liquidity. Lack of knowledge has a more permanent effect. Balance sheets always appear if assets are cheap enough, however they never do if people have no knowledge of what they are buying. The reverse is also true, as education, knowledge and understanding can help unlock vast amounts of capital.

Similar to traditional finance, the benefits of education offered by green-bond disclosures are limitless. To investors, green-bond disclosure can help them understand the effects of the supply chain of individual issuers and their potential vulnerabilities. To public bodies like municipalities, cities and regions, green bonds give a window into best global practices. They are a cheap education, which helps to facilitate the exchange of best ideas.

> WHILE THE FINAL PRODUCT MAY NOT BE TO EVERY INVESTOR'S LIKING, ONE SHOULD ALWAYS TREAT THE ISSUANCE OF A GREEN BOND AS AN INVITATION FOR ENGAGEMENT BY THE ISSUER.

DUE DILIGENCE

While green bonds have many positive features in bringing about social change and helping to combat climate change, they are financial instruments and require the same level of due diligence as any other form of financing. To the end investor, green bonds serve a dual purpose: providing a competitive rate of return and facilitating an impact.

In analysing traditional bonds, investors spend most of their time examining the issuer and the robustness of a bond rating, and reading the small print of the prospectus to protect against unintended consequences. Green bonds require an additional assessment on top of these.

To impact investors, authenticity is equally important as financial performance – if not more so. Examining the integrity of a green-bond programme is key. Issuers must have operational flexibility to issue green bonds. This often involves the creation of an independent internal committee to help identify and monitor eligible assets.

Indication of intent is also very important. Here, issuers could be guided by concrete targets, including science-based projects towards achieving a two-degree world as well as targeting key performance indicators contained in the UN sustainable development goals (SDGs).

More broadly, issuers have flexibility to choose from a variety of actions under the green-bond programme. They could focus on promoting the positives or capturing the effects of their own value chain, or on mitigating the negative effects. The High-Level Expert Group on Sustainable Finance in Europe will play an important role in helping identify the scope for the future of sustainable finance. But, in the absence of robust legislation, the burden of proof regarding the overall quality of green bonds lies with issuers and investors.

While issuers are responsible for selecting the eligible assets to support their green-bond issuance, which includes setting up necessary documentation and seeking third-party verification, investors should play a much more active role in giving issuers feedback on the robustness of their programmes and guiding them with respect to necessary requirements for future issuance.

PORTFOLIO CONSTRUCTION

Green bonds can offer diversification. However, the performance of green bonds is also strongly correlated with the other debt of the issuer.

Portfolios which rely solely on green bonds could be limiting as investors are at the mercy of the new-issue calendar. Some companies issue more green bonds than others, but those that issue most are not always the best or the cheapest, and therefore cannot guarantee the best performance on a portfolio basis. A better approach is to allocate a portion of one's portfolio to green bonds and look to build it up gradually as the market becomes more mature and diversified.

There is an alternative approach for investors that insist on sticking exclusively with green bonds. Once a company has issued at least one green bond, it has the right systems and controls in place to issue more. Investors could construct more robust impact solutions where they are not constrained to green-bond structures but can invest in other debt from the same issuer if it is cheaper.

Regarding purpose, green bonds have the dual objectives of financial performance and impact. While financial performance and associated risk metrics can easily be aggregated on a portfolio basis, impact is a lot more difficult. Use of proceeds can vary greatly, both in content and geographically.

In addition, the ownership of impact is not as straightforward a concept as the ownership of financial performance and risk. Impact is attributed differently to equity investors and debt holders, which adds complexity.

> IN THE ABSENCE OF ROBUST LEGISLATION, THE BURDEN OF PROOF REGARDING THE OVERALL QUALITY OF GREEN BONDS LIES WITH ISSUERS AND INVESTORS.

While aggregation is a challenge, investors could still do more about being intentional in how they seek nonfinancial outcomes. Stating objectives from the outset and measuring the performance of individual projects could go a long way towards securing the authenticity of an impact portfolio.

More should also be done regarding valuation and security selection.

Comparing spreads of green bonds with each other offers limited to no value. It is the same as comparing regular bonds across sectors, geographies, the rating spectrum, currencies and maturities without normalising towards a common factor first.

It is more useful to compare pricing of green bonds with the pricing of other bonds from the same issuer. Analysing their financial cheapness to the curve, volatility profile, basis versus credit-default swaps and new-issue premium is far more informative.

These individual measures versus issuers' non-green twins can then be aggregated across industries, ratings and maturities. Unlike equities, which often mean-revert versus their own history, fixed income mean-reverts versus the pricing of a bond's closest peers. The same is true for green bonds.

FIVE LIVE RECOMMENDATIONS

While one should avoid buying green bonds solely based on their green status, the growth of this market offers exciting opportunities for developing impact solutions and combating the effects of climate change. I would like to share some live recommendations, which could be mutually beneficial to issuers and investors and could help make green bonds more competitive with other capital-market instruments.

For sovereigns, building on the argument of continuity of financing, **it is important not only to issue long-term maturities but also to enrol the largest players to make such commitments**.

Sovereigns could play a significant role in educating the population about impact as well as securing continuity of financing. France's green-bond structure means nothing less than its Treasury's 20-year commitment to financing renewable assets. With the election cycles in most democracies globally ranging between four and 10 years, commitment to long-term green financing means securing a sustainable agenda for longer.

For those issuers that have already gone through the trouble of setting up

their own green-bond infrastructure, **it is important not to stop after issuing one bond**. They should consider setting annual issuance targets as a set portion of their overall issuance.

Spanish utility company, Iberdrola, has been a great example – increasing its portion of green-bond financing to 60 per cent of total debt over the last few years. Banks and supranationals also have large and complex balance sheets with many possibilities to raise green financing. Setting annual targets gives them an opportunity to further diversify their investor bases, become more meaningful in the impact-investing arena and educate the broader public on the important role they play in society and its economic development.

> “GET RID OF TERMS LIKE ‘BROWN’, ‘SHADES OF GREEN’ AND ‘GREENWASHING’. WE ARE MEASURING IMPACT, AFTER ALL – NUMBERS LEND THEMSELVES TO LESS AMBIGUITY AND OFFER BROADER AND MORE PRECISE CHOICES THAN COLOURS.”

The US is the largest issuer of green bonds by size so far. However, many transactions are either bespoke or illiquid. While in some cases small size is warranted by the size of the underlying projects, often it is simply misjudgement of potential investor demand. US banks and companies should consider **issuing more liquid, benchmark-sized deals in green format.**

ESG and capital-markets professionals tend to speak different languages. The longer we continue to do so, the more it creates confusion and trumps market growth. Making something scaleable is often a function of that something being universally understood. Make it simple. Get rid of terms like "brown", "shades of green" and "greenwashing". We are measuring impact, after all – **numbers lend themselves to less ambiguity and offer broader and more precise choices than colours.**

Finally, we should look to **build on green-bond technology to explore more diverse uses of proceeds besides renewables**. This should include using the sustainable-development goals (SDGs) to target a wider range of social outcomes and therefore issuing SDG bonds where possible. •

Alex Struc is a UK-based fund manager with extensive experience as an innovator in the ESG space.

KANGANEWS FIXED-INCOME RESEARCH POLL 2018: **CONSISTENT CONSISTENCY**

The results of the eighth **KangaNews Fixed-Income Research Poll**, the only independent, specialist poll of fixed-income investors' views on research in Australia, are once again supported by a record number of responses. There are some movers within the ranks although the individual category winners continue to show a remarkable degree of consistency.

Commonwealth Bank of Australia (CommBank) dominates the poll results, placing first across seven out of 11 categories including best overall research on Australian fixed income for the fifth year in a row (see chart 1). The bank also retains top spot in the Australian government and semi-government; supranational, sovereign and agency; foreign-exchange; corporations; trade-ideas and relative-value categories.

CommBank also retains second place in the macroeconomic research category behind National Australia Bank (NAB) and returns to the top five in the global markets category in 2018, sharing fourth place with J.P. Morgan.

Scott Rundell, chief credit strategist at CommBank in Sydney, suggests the bank's multiple and repeat successes can be attributed to the team's ability to think like an investor.

"We have our own index and model portfolio in which we aim to achieve the best possible return. The feedback we receive from investor clients is that we are looking at the market in the same way they do. This alternative perspective is of great value to them."

Adam Donaldson, Sydney-based head of fixed-income research at CommBank, believes the bank's approach to coverage of all asset classes is different from that taken by other research providers. CommBank's offering is broad-based, he argues, while others have a more specialised approach to rates or credit, for example, without looking across all asset classes.

Donaldson also suggests that CommBank maintains the same quality and breadth of research even as the research function continues to be under cost pressure at most providers.

"One of our main focuses is on providing views around asset allocation and relative value across asset classes," says Donaldson. "We take a sectoral approach, which appeals to real-money investors who manage funds to a benchmark and who are making these sorts of decisions."

The team at CommBank says its focus in the year ahead will once again be on providing insightful research into regulatory changes. "Investors, issuers and market observers are all looking at regulation, such as total loss-absorbing capacity and changes to bank bill swap rate. These are the areas where we continue to focus and provide guidance," Donaldson says.

POLL METHODOLOGY

The KangaNews Fixed-Income Research Poll provides the Australian domestic fixed-income investor community with the opportunity to acknowledge the best coverage of areas relevant to the Australian debt markets. Voting is conducted through an online platform with only Australian-based institutional-investor votes counting towards final results.

Now in its eighth year, more than 100 qualifying votes were recorded in the 2018 iteration of the poll. The sample represents the majority of key institutional investment funds in the Australian market across the fund-management, insurance and balance-sheet sectors.

KangaNews conducts a rigorous process of vote verification, to ensure that only votes from qualifying institutional fixed-income investors are included in the final count.

Voters were asked to nominate the top-three providers of research in 11 categories: 10 individual sectors and the overall best house.

The best overall category is determined by unique vote rather than as a product of vote totals in other categories.

Westpac reclaims structured finance

Westpac Institutional Bank (Westpac) produced the one top-spot displacement in this year's poll, dethroning CommBank in the structured-finance category (see chart 2). It is a return to the top of the podium in structured finance for Westpac, which won in this category every year until 2016 when CommBank snatched first place.

Martin Jacques, Westpac's Sydney-based head of securitisation and covered-bond strategy, says the result is Westpac's reward for staying on top of "market trends, revised prudential regulation, evolving structures and new asset types being securitised – all while record volumes have been printed in the bank and nonbank sectors".

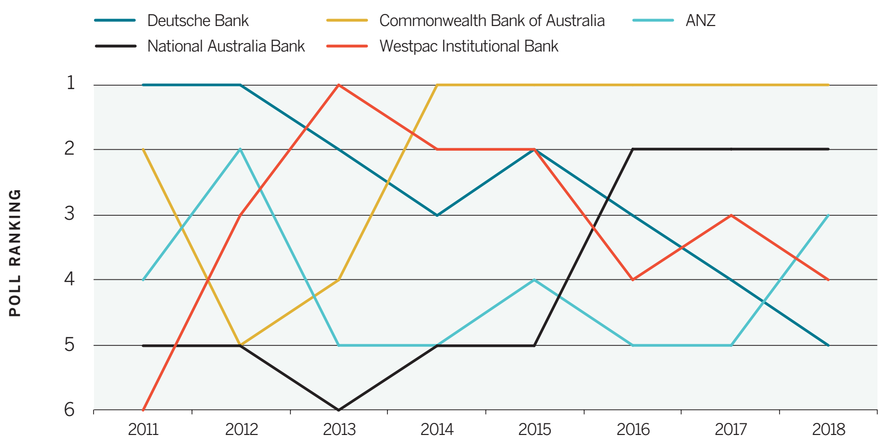
Jacques identifies Westpac's work around the divestment of the Australian Office of Financial Management (AOFM)'s residential mortgage-backed securities portfolio as being particularly noteworthy.

He comments: "This was a unique time in the market. Westpac viewed the AOFM's sell down of the remaining portfolio as a key event and allocated substantial resources and time into providing timely and insightful information. We produced auction previews and sensitivity tables so investors could assess the pools quickly."

Elsewhere in the 2018 KangaNews Fixed-Income Research Poll, Westpac improved its position to third in the foreign-exchange and macroeconomics categories, and broke back into the top five for relative-value research. Westpac also achieved a podium finish for its research on Australian corporations and came fourth in the overall research category.

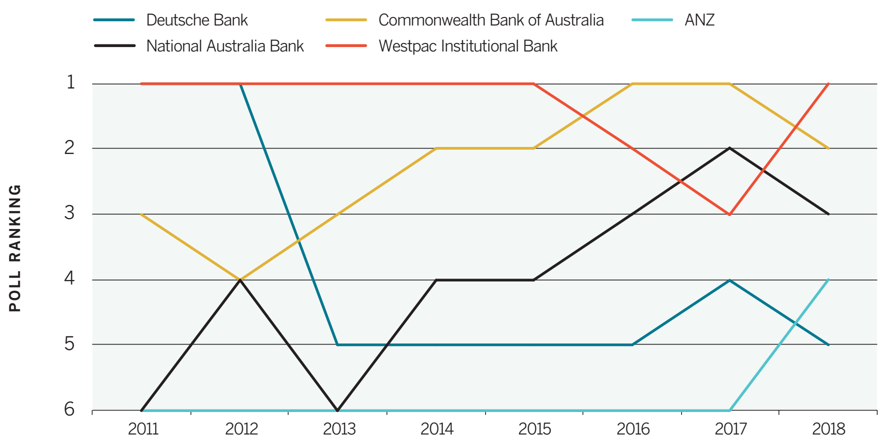
Jacques says Westpac's research team is allocating additional time to understanding the areas in which clients would like to see more research and, as a result, where the bank should continue to focus.

CHART 1. YEAR-ON-YEAR PERFORMANCE: BEST OVERALL



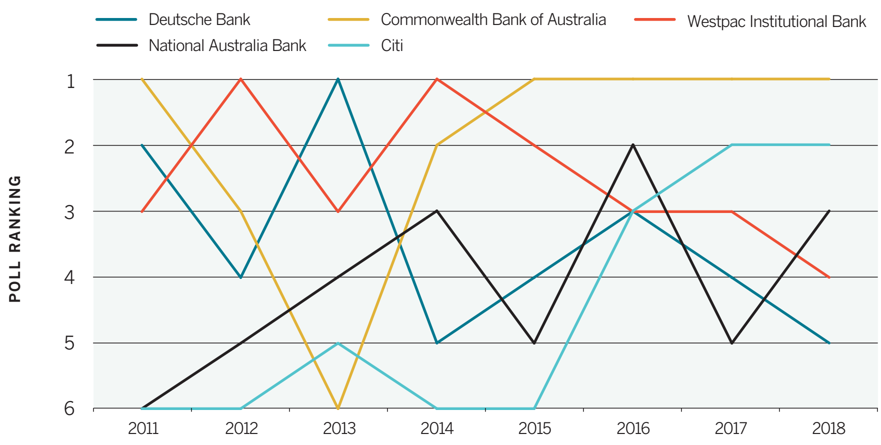
SOURCE: KANGANEWS 18 JUNE 2018

CHART 2. YEAR-ON-YEAR PERFORMANCE: STRUCTURED FINANCE



SOURCE: KANGANEWS 18 JUNE 2018

CHART 3. YEAR-ON-YEAR PERFORMANCE: AUSTRALIAN CORPORATIONS



SOURCE: KANGANEWS 18 JUNE 2018

NAB reigns in macroeconomics

NAB clinched top spot in the macroeconomics research category for the third year in a row, holding out CommBank and Westpac, while also achieving good results in the overall, corporations and structured-finance categories.

Peter Jolly, global head of research at NAB in Sydney, explains how NAB's research and economics functions overlap, suggesting this at least in part explains the bank's success in the macroeconomics category. The macroeconomics team in the markets area, headed by Ivan Colhoun, works closely with Alan Oster's economics team in the main part of the bank. This approach sees NAB produce "a wealth of unique, interesting and relevant data sets, such as the NAB business survey", according to Jolly.

The NAB research team is spending more time and giving more thought to how it can best service its client base for their sell-side research needs, Jolly continues. "We want to give clients information that is relevant to the business decisions they need to make, rather than just spam them with generic research."

NAB also recorded a notable improvement in research on Australian corporations, where the bank rebounded to third having fallen to fifth in 2017 (see chart 3).

"We have put our government-bond and our corporate-credit research under one umbrella, headed by Skye Masters," Jolly explains. "This gives us a more cohesive look across the fixed-income spectrum and replicates the way many of our clients organise their businesses."

NAB finished second in the overall research category for the third year in a row, providing a clear indication of the bank's research penetration in Jolly's view. "NAB is constantly looking at ways to develop new distribution channels, such as through the morning podcast led by Ray Attrill, which has proven to be very popular," he tells *KangaNews*.

KANGANEWS FIXED-INCOME RESEARCH POLL 2018: FULL RESULTS

* Denotes 2017 category winner.

Which team provides the best overall research on Australian fixed income?

RANK	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Adam Donaldson, Philip Brown, Scott Rundell, Chris Walter, Kevin Xie and Tally Dewan
2	National Australia Bank	Peter Jolly, Ivan Colhoun, Alan Oster, Skye Masters, Michael Bush and Ray Attrill
3	ANZ	ANZ research
4	Westpac Institutional Bank	David Goodman, Damien McColough, Martin Jacques and Brendon Cooper
5	Deutsche Bank	Adam Boyton, Ken Crompton, Phil O'Donaghoe, Augusto Medeiros and Jeff Cai

Which team provides the best research and analysis of Australian government and semi-government bonds?

RANK	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Adam Donaldson, Philip Brown and Kevin Xie
2	ANZ	Martin Whetton and Jack Chambers
3	National Australia Bank	Skye Masters and Alex Stanley
4	Westpac Institutional Bank	Damien McColough
5	J.P. Morgan	Sally Auld and Henry St. John

Which team provides the best research and analysis of supranational, sovereign and agency bonds?

RANK	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Kevin Xie and Adam Donaldson
2	ANZ	Martin Whetton and Jack Chambers
3	National Australia Bank	Skye Masters and Alex Stanley
4	Westpac Institutional Bank	Damien McColough
5	Citi	Peter Goves, Steven Mansell and Carl Ang

Which team provides the best research and analysis on foreign exchange?

RANK	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Richard Grace, Joe Capurso, Elias Haddad, Andy Ji and Peter Kinsella
2	National Australia Bank	Ray Attrill and Rodrigo Catril
3	Westpac Institutional Bank	Robert Rennie, Sean Callow and Richard Franulovich
4	J.P. Morgan	Sally Auld and Ben Jarman
5	ANZ	Daniel Been and Giulia Specchia

Which team provides the best research and analysis on structured finance?

RANK	INSTITUTION	TEAM
1	Westpac Institutional Bank	Martin Jacques
2	Commonwealth Bank of Australia*	Tally Dewan
3	National Australia Bank	Ken Hanton
4	ANZ	ANZ research
5	Deutsche Bank	Augusto Medeiros and Jeff Cai

Which team provides the best research and analysis on Australian corporations?

RANK	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Scott Rundell and Chris Walter
2	Citi	Anthony Ip
3	National Australia Bank	Michael Bush and Andrew Jones
4	Westpac Institutional Bank	Brendon Cooper and Martin Jacques
5	Deutsche Bank	Augusto Medeiros and Jeff Cai

Which team provides the best trade ideas?

	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Philip Brown, Kevin Xie, Adam Donaldson, Chris Walter and Scott Rundell
2	ANZ	Martin Whetton, Daniel Been and Giulia Specchia
3	Citi	Steven Mansell, Carl Ang and Anthony Ip
4	National Australia Bank	Skye Masters and Alex Stanley
5	J.P. Morgan	Sally Auld and Henry St. John

Which team provides the best relative-value research in the Australian debt market?

RANK	INSTITUTION	TEAM
1	Commonwealth Bank of Australia*	Philip Brown, Kevin Xie, Adam Donaldson, Chris Walter and Scott Rundell
2	Citi	Steven Mansell, Carl Ang and Anthony Ip
3	ANZ	Martin Whetton and Jack Chambers
4	Westpac Institutional Bank	Damien McColough
5	National Australia Bank	Skye Masters and Alex Stanley

Which team provides the best research on global markets in terms of its value to Australian fixed-income investors?

RANK	INSTITUTION	TEAM
1	Citi*	Willem Buiter, Catherine Mann, Ebrahim Rahbari, Matt King, Jeremy Hale, Harvinder Sian, Jabaz Mathai, Steven Mansell and Carl Ang
2	Deutsche Bank	Deutsche Bank
3	ANZ	Richard Yetsenga, Tom Kenny, Brian Martin, Daniel Been and Martin Whetton
4=	Commonwealth Bank of Australia	Commonwealth Bank of Australia
4=	J.P. Morgan	John Normand and team

Which team provides the best research on Asian markets in terms of its value to Australian fixed-income investors?

RANK	INSTITUTION	TEAM
1	ANZ*	Khoon Goh, Raymond Yeung, Jennifer Kusuma, David Qu, Richard Yetsenga and Martin Whetton
2	Citi	Willem Buiter, Catherine Mann, Li-Gang Liu, Johanna Chua, Kiichi Murashima, Siddharth Mathur, Jeremy Hale, Tomohis Fujiki, Steven Mansell and Carl Ang
3	HSBC	Herald van der Linde
4	Nomura	Nomura
5	Bank of America Merrill Lynch	Bank of America Merrill Lynch

Which team provides the best macroeconomic research and analysis?

RANK	INSTITUTION	TEAM
1	National Australia Bank*	Ivan Colhoun, Peter Jolly, Alan Oster, Tapas Strickland, Kaixin Owyong and David de Garis
2	Commonwealth Bank of Australia	Michael Blythe, Belinda Allen, Michael Workman, John Peters, Kristina Clifton and Gareth Aird
3	Westpac Institutional Bank	Bill Evans and team
4	ANZ	David Plank, Felicity Emmett, Jo Masters, Cherelle Murphy, Daniel Gradwell and Jack Chambers
5	Deutsche Bank	Adam Boyton and Phil O'Donaghoe

Staying ahead abroad

ANZ's dominance in the Asian markets research category of the KangaNews Fixed-Income Research Poll remains firm in 2018. While banks have traded places beneath it, ANZ has finished first in the Asian regional research category every year since it was first included in the poll, in the 2014 iteration.

Richard Yetsenga, Sydney-based chief economist at ANZ, says the fact that the bank operated in 34 markets means it is by its nature highly focused on the opportunities that arise from Australia's place in a globalised world. He also says that ANZ's research on Asian markets fills a large void.

"We have long considered Asia to be a core part of our research offering. The region generates more than 50 per cent of global GDP growth and is by far the most important region for Australia's goods and services exports. Yet news flow in Australia continues to be dominated by the US and Europe," Yetsenga says.

Generally, ANZ performs very strongly in this year's poll, recording a second-place finish in the trade-ideas category and third place in the overall, global-research and macroeconomics categories. ANZ also finished fourth in the structured-finance category, the first time it has finished in the top five in this space.

Yetsenga reveals that ANZ has tried to focus more intently on the areas where clients genuinely value outside opinion, including trade ideas. "Clients value perspective, which requires a breadth of offering. We are continuing to work hard on delivering these products as effectively as we can."

Meanwhile, Citi claimed top spot in research on global markets, which it has won consistently since the category was introduced in 2014.

Steven Mansell, Sydney-based managing director and head of G10 rates strategy, APAC at Citi, says there is an emphasis on global coverage at Citi and that the bank's strong relationships with offshore clients that invest in Australia supports the provision of additional insights to domestic clients.

"Citi's research offering is constantly evolving to meet the fresh challenges faced by an increasingly time-constrained investment community," Mansell says. "We strive to produce high-quality publications with strong thought leadership and value-added content, and look to provide clients with regular access to our global research analysts and experts throughout the year." •

LEADING FROM *THE FRONT*

In the 2018 iteration of the KangaNews Fixed-Income Research Poll, **Commonwealth Bank of Australia** (CommBank) maintained the dominant position it has established in recent years. The CommBank team sat down with *KangaNews* to reflect on the market-shaping factors of the past 12 months and to reveal the main watch points.

COMMBANK PARTICIPANTS
■ **Philip Brown** Senior Fixed Income Strategist ■ **Tally Dewan** Senior Securitisation Strategist ■ **Adam Donaldson** Head of Fixed Income Research
■ **Scott Rundell** Chief Credit Strategist ■ **Chris Walter** Credit Strategist ■ **Kevin Xie** Fixed Income Analyst

The market arguably couldn't be more different than it was 12 months ago. What are the main factors you are focusing on drawing out in your research in this regard?

■ **DONALDSON** It is true we are seeing more bouts of volatility. But while these events appear to lend a slight widening bias to spreads overall, this is in the context of markets that have been performing phenomenally well. We only need to look at equity markets and credit spreads as recently as December or January to see a story that was as good as it has been for more than 10 years.

Broadly, a risk-on environment remains. Yields are still relatively low and clients are not unsettled by risk-off or credit events. They are seeking yield and credit exposure – a situation that has not materially changed from the last couple of years.

■ **RUNDELL** The natural order in Australian fixed income is a general overweight to credit. It is an investment-grade market and historically it is very stable with very low default rates. Talking to clients more recently, however, we have started to perceive a general willingness to dial back on this overweight credit position. This is not a move to being underweight but an organic move towards neutral.

As the European Central Bank (ECB) starts to wind back QE, there is almost a 'high-conviction neutral' view of what the changing environment will mean for spreads in general. We know, when QE was rising, that spreads contracted quite aggressively. We also know, from our own indices, that spreads probably reached their post-crisis tights in February. In this environment, it is easier to identify potential spread-widening catalysts than tightening catalysts.

Ironically, the fundamentals are arguably the strongest they have been for several years. Technicals are also supportive. But sentiment is becoming more cautious, particularly on valuations in the context of elevated geopolitical risk and an evolving monetary-policy environment.

So far, spreads have remained range bound with a very modest widening bias. On a total-return basis, carry remains attractive and there is also pressure among asset managers to stay invested. Credit should still perform well in this environment, short of a systemic shock.

How do you see the fundamental credit story holding up in the corporate sector?

■ **WALTER** In short, very well. But we have seen spreads compress so far that there is very little differentiation across rating bands. We don't see significant spread tightening to come but, by the same token, we don't see extreme widening pressures either. It is more about capital preservation than an alpha trade generating extra spread.

We are not expecting much in the way of corporate issuance volume in the coming months. Not only are maturities light but there is very little stress on maturity profiles, as companies have successfully termed out their debt over the last few years. Nor is growth coming through in swathes.

Overall, the debt-funding requirement just isn't there – and of the instances where there is a requirement, we're once again starting to see international banks actively stepping in through the loan market.

■ **RUNDELL** One point to note is the extent to which the long end of the corporate market has developed in line with the lengthening of the broader Australian market. According to our data, some 30 per cent of local corporate issuance in 2017 was in the 10-year bucket. This is up from 5 per cent in 2014.

Speaking of tenor extension in the Australian market, what effect has the Australian Office of Financial Management (AOFM)'s long bond had on the wider market?

■ **DONALDSON** The Australian dollar curve beyond 10 years was very steep when the AOFM issued its 30-year benchmark. It remains steeper than other jurisdictions, and the huge flattening pressure we've seen on curves elsewhere has driven the long end in Australia to look very attractive.

At the same time, we are seeing robust demand from insurance companies – those from Japan are the most notable, but long-dated appetite is truly global – which is changing the way the market functions to some degree.

For example, we have seen a clear knock-on effect in the supranational, sovereign and agency (SSA) sector during 2018.

XIE Year-to-date SSA issuance has been focused on the long end of the yield curve. The long end accounts for about two-thirds of primary supply in 2018, compared with less than 50 per cent in the few years prior to this. Demand is predominantly being driven by Japanese investors.

Regarding spread performance, the long end of the SSA spread curve remains stable despite sizeable issuance. I expect Japanese accounts to remain cornerstone investors going forward. Domestic demand for long-dated SSAs is relatively soft. In recent years, and given regulatory changes, we have seen demand pockets from other jurisdictions, – such as Taiwan.

DONALDSON I think we would say that any large insurance manager around the world has their eye on our market. Having a relatively steep curve is one factor, but as US rates have lifted and the front end of the curve has flattened the cost of hedging Australian dollar exposures relative to other markets has also diminished.

BROWN The emergence of 20- and 30-year bonds in Australian dollars is also changing the pricing behaviour of the 12-15 year range. Five or more years ago, this sector was illiquid and bonds attracted a significant premium. This is no longer the case – the 12-year point is now very dear. The introduction of the 20-year bond has, effectively, made the 10-year space much wider, since it now extends from eight years through to about 12 or 13.

Let's talk about a sector that has been a particular focus for the CommBank team of late – total loss-absorbing capacity (TLAC).

RUNDELL No Australian bank is classified as globally systemically important by the Financial Stability Board (FSB). Nevertheless, the 2014 financial system inquiry (FSI) recommended the implementation of a TLAC-style framework for domestic systemically important banks

Earlier this year, the Australian Prudential Regulation Authority (APRA) indicated it would begin to engage with local banks on TLAC "later in 2018". We don't think much dialogue has taken place yet between APRA and the banks. My view is that APRA will want to conclude its work on risk-weight changes before engaging with the banks on the issue of TLAC.

APRA has a mandate to implement a TLAC framework and there are various ways it can do this. The most likely option we see is via the development of a new debt or capital class for Australia. Specifically, this would be the senior-preferred and senior-nonpreferred system we've seen implemented in several European jurisdictions like France, Spain and Italy.

The holdco-opco format common with US, UK and Swiss banks is not considered a realistic option for Australia. As we understand it, APRA is not supportive of this structure, notwithstanding it would also be legally complex and financially prohibitive to implement. Another option is statutory bail-in, but after opting for this format in Germany the local regulator discovered that by making all bonds subject to bail-in there are no longer any bank repo-eligible bonds. As a result, Germany is evolving towards the French version.

If we use the FSB's TLAC termsheet to calculate the major banks' potential TLAC requirement, as of March 2018 we estimate there is a A$111 billion (US$82.6 billion) shortfall. At this stage we have no feel or guidance on whether APRA will adhere to this termsheet or come up with its own version.

We also need to keep in mind APRA's more prudent common-equity tier-one calculation methodology, which could influence the final TLAC requirement. Nonetheless, we see A$111 billion as being at the higher end of potential requirements.

If the requirement is this high, we expect a sizeable proportion to be funded offshore. Senior nonpreferred has been extensively issued offshore and the market is becoming increasingly seasoned. Accordingly, if Australia goes down this path for TLAC we think it likely that the bulk of the TLAC requirement will be funded offshore in markets which are more familiar with the type of bond being issued.

> "Ironically the fundamentals are arguably the strongest they have been for several years. But sentiment is becoming more cautious, particularly on valuations in the context of elevated geopolitical risk and an evolving monetary policy environment."
>
> SCOTT RUNDELL

Is the Australian market of sufficient size to sustain liquidity in senior-unsecured and senior-nonpreferred products?

RUNDELL We believe there is room for both, but offshore markets will continue to dominate major-bank wholesale-funding needs. Major-bank senior-unsecured issuance in Australian dollars has averaged around A$25 billion for each bank per annum since the crisis. Our data show there is currently A$104 billion of senior-unsecured bonds outstanding across fixed- and floating-rate formats. Offshore issuance has averaged about twice the volume of local issuance, including covered bonds.

A consideration for local demand for nonpreferred bond issuance is the fact that it will not be repo-eligible. Major-bank issuance, particularly benchmark deals, is typically well supported by other bank balance sheets for its repo-eligibility. Anecdotally, we see balance-sheet participation in local senior-unsecured major-bank paper at 30-50 per cent.

Moving on to securitisation, a theme in the residential mortgage-backed securities (RMBS) sector has been the re-emergence of offshore bank balance sheets. To what extent is this influencing deal flow?

■ **DEWAN** This reflects in part earlier regulatory changes in relation to the liquidity coverage ratio (LCR), but beyond this is appetite from Asian banks to search the globe to put money to work.

Over the last couple of years, Asian investors have completed their paperwork and begun allocating to major-bank RMBS. We have also seen them move gradually into the nonbank space.

We are now seeing Asian investor interest move from the senior tranches down the capital stack. Interest from these investors is solid and their share of outstanding RMBS has increased significantly – particularly in the last 12 months.

This interest is particularly noteworthy in nonbank spreads, which have outperformed in 2018 relative to major and regional banks despite the nonbanks issuing significant volume.

Another topic of widespread market interest is the bank bill swap rate (BBSW). There seem to be several factors at play.

■ **BROWN** We have seen very pronounced widening in BBSW and repo spreads near the quarter end for the past few quarters. Here we are near the end of June and spreads are widening again. Unlike December and March, this is not a global phenomenon: BBSW has been widening even though US Libor has been tightening.

We don't attribute this to the recent change in methodology for calculating BBSW to volume-weighted-average price. In fact, we expect to see liquidity hold together reasonably well over time given the new approach encourages funds to participate in the window when the product is trading.

But the widening does raise several issues. On the repo side, it is very clear that offshore banks are pulling back on their exposures as we near quarter end. So there is an element of window dressing, which appears to be manifesting itself as something of a squeeze on funding markets generally.

Of course, if you have been on the wrong side of widening cost in the last couple of quarters you are keen to ensure you have funding locked away to avoid widening pressure late in the quarter. This means widening spreads have come through in June a little earlier than in December and March.

It is difficult to pin down exactly whether any particular change in domestic regulation is contributing. We believe it relates more to the increasing presence of a larger number of banks in the Australian market either seeking arbitrage opportunities in bonds versus futures or the Japanese collateral trade which feeds through to the FX basis. We are seeing considerable tension emerge in these areas of the market. Related to this is the more structural change in relation to Libor offshore.

While we have put measures in place domestically that should protect three- and six-month BBSW, one-month BBSW has more of a question mark around it. •

"On the repo side, it is very clear that offshore banks are pulling back on their exposures as we near quarter end. So there is an element of window dressing, which appears to be manifesting itself as something of a squeeze on funding markets generally."

PHILIP BROWN

London call-in

Engagement with international investors is a significant – and growing – focus for Australian securitisers. The **Australian Securitisation Forum**'s annual showcase returned to London on 4 June, giving Australian issuers and intermediaries a chance to discuss the state of the local product and market with European investors.

CHRIS GREEN
AUSTRALIAN SECURITISATION FORUM

"The UK, and Europe more broadly, are important markets which have been and continue to be very supportive of Australian issuers."

TAPAS STRICKLAND
NATIONAL AUSTRALIA BANK

"Strong population growth, of around 1.6 per cent, is driving dwelling demand. Melbourne's population has grown by 23 per cent in the last 10 years while Sydney's has grown by 18 per cent. So it is no surprise that house-price growth accelerated there in recent years."

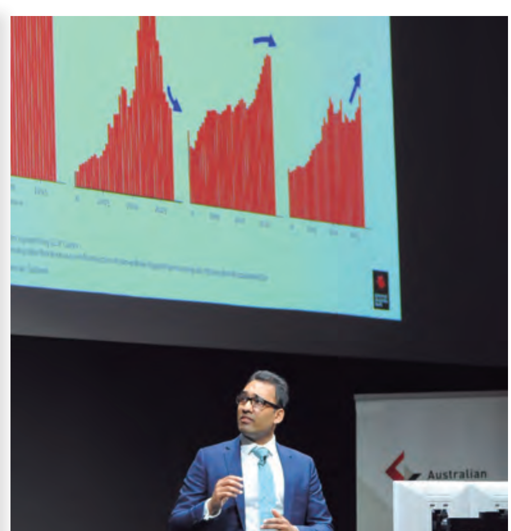
EVA ZILELI
NATIONAL AUSTRALIA BANK

"NAB has targets around financing the transition to a low-carbon economy and being the first Australian bank to issue a green RMBS tranche contributes to these. It is also a very positive way for group funding and treasury to align with the bank's direct objectives and be seen to provide positive guidance to the community."

CEDRIC TCHABAN HSBC

"Australia is up against structured finance from any other jurisdiction for our allocation. We like Australian RMBS for the yield pickup but also for the diversity on offer. In Australia we can find a broad range of issuers offering full capital structures backed by prime and nonconforming collateral, which is rare."

"One area in which we see a difference between Australia and elsewhere is in investor loans. In the UK, the yield from the investment property has to be sufficient to support the servicing of the loan. This isn't always the case in Australia."



JEAN-SEBASTIEN PALEY
INTERNATIONAL FINANCE CORPORATION

"Australia's royal commission is a double-edged sword for investors. It brings out some themes we don't want to see but on the other hand it is positive to see the regulator being proactively involved in addressing concerns rather than letting the situation deteriorate further."

"Australia is one of the few active securitisation markets which is not completely cannibalised by QE at the moment, so there is naturally more value there. There are further reasons for the additional value, including lack of relative liquidity and the high proportion of domestic investors, so at the margin Australia remains attractive."

JENNIFER HELLERUD RBC CAPITAL MARKETS

"It isn't hard to see why private-equity firms are attracted to Australian nonbank originators. With the backing of private equity, nonbanks should continue to take market share from the bank lenders. This will likely lead to more frequent and larger securitisation transactions."

KEVIN LEE MACQUARIE BANK

"Australia is slightly behind in issuance volume compared with 2017, but there has been good variety of issuance so far this year. There have been deals backed by credit cards, auto loans and consumer loans as well as a couple of green tranches, so diversity is very positive."

"Typically, Australian ABS deals aren't as large as RMBS deals – which makes it difficult to include a foreign-currency tranche that is large enough to be justified. Even so, I think the cross-currency piece is still something ABS issuers would consider if swap spreads become more attractive."

JONATHAN STREET THINKTANK COMMERCIAL PROPERTY FINANCE

"Small-ticket CMBS has more similarities than it does dissimilarities with RMBS. Where we diverge is that there is more credit support than in residential loans and CMBS prints slightly wide of prime and near-prime RMBS. We compete with the major banks for loans, though – which gives a good idea of where we sit in credit quality, which is backed by performance."

MATTHEW O'HARE PEPPER GROUP

"Australia has always had very strong loan-servicing standards. A robust legislative requirement is imposed on lenders, which predates the financial crisis and has subsequently been strengthened, whereby we are compelled to ensure customers can service their loans without any undue hardship."

MARY PLOUGHMAN RESIMAC

"We are excited about the demand we are seeing coming out of Europe, which is really the last area to show strong interest in Australian RMBS. More offshore investors are coming into our programmes in Australian dollars and we continue to look at euro and sterling as options to augment our US dollar funding."

AUSGRID KEEPS AHEAD OF THE RUN RATE

Ausgrid Finance (Ausgrid) added to its landmark US private placement (USPP) and Australian domestic deals from 2017 in April, with a €650 million (US$752.5 million) and a dual-tranche, US$1 billion 144A/Reg S transaction. **Michael Bradburn**, chief financial officer at Ausgrid in Sydney, shares views on pricing objectives, market selection and sentiment as the company continues its mammoth term-out task.

What is your read on credit-market issuance conditions compared with the second half of last year when Ausgrid was last active? How much weaker was sentiment in April this year compared with 6-9 months previously?

Having undertaken a global roadshow ahead of the April deals, my impression when talking to market participants, whether they are banks or investors, is that sentiment has certainly changed. Last year was a golden age for issuers and now it is beginning to shift. We are still in a reasonably good position as issuers, but it is nowhere near as good as the second half of last year.

What was the process and rationale behind doing the latest deals in quick succession?

We had to prepare documents for 144A, euro and Reg S transactions. We are a small team, so once we completed the Australian domestic deal we turned our minds to preparing the documentation for the big public markets. We finished those and quickly got on the road.

My view was that if we waited – which we could have done as our funding task wasn't urgent – we would be sitting back in six months' time wishing we had gone in the first half.

The plan was to meet investors, listen to feedback and execute a deal if it was conducive. If it wasn't we were happy to wait until it was.

As for priorities, we did the Asian leg first visiting Singapore and Hong Kong. We then did the European leg – London, Amsterdam, Paris, Munich and Frankfurt – followed by the US. European and Asian investors had more time than those in the US: while we were doing the US leg the others had time to do their credit work. This meant it made sense for us to issue there first.

We told investors we would do a deal in both markets if the timing worked and pricing was appropriate. US investors saw us do the euro deal and knew it was consistent with what we said we would do. We thought we should wait over a weekend just for some space between the deals, and here we are now with two deals achieved at a good price.

After the domestic deal Ausgrid priced last year the company had termed out roughly A$3.5 billion (US$2.6 billion) of a target of approximately A$9 billion of its A$13 billion bank facilities. The latest transactions knock out roughly a further A$2.4 billion. What is the plan of action in capital markets from here?

Ahead of the latest deals, we had approximately A$917 million of drawn debt due in June 2020. We also had a A$6 billion tower due in December 2021, so the funding task we had ahead was still reasonably substantial.

We wanted to get to the end of this year having established a beachhead in the Australian dollar, USPP, 144A/Reg S and euro markets. We have now achieved this, so the plan going forward is to build on the diversity we have established. We can then start to build a curve across the three public markets over time.

With A$7 billion due to expire in the next three years or so we need around A$2-2.5 billion per year of refinancing. Last year we got ahead of the curve, with an equivalent A$3.5 billion across our USPP and Australian domestic deals. This meant we didn't need to achieve huge volume in the latest deals. We were more focused on getting a presence in these markets at a good price.

Now we have done this we can go back to these public markets and others for A$2-2.5 billion per year. We can then begin to term out some of our shorter-term bonds and also start to issue new debt to fund capex, which will grow over time.

The plan remains to have around a quarter of Ausgrid's A$12 billion debt in bank debt and the remaining three-quarters spread across debt capital markets.

Will the three public markets be Ausgrid's predominant funding sources going forward?

This is certainly the preference. We are agnostic to currency in the sense that we are indifferent to funding in euros or US dollars. We are an Australian business with Australian dollar revenue. The only factor there is that we want to be able to build a curve so we have markets to go back to over time.

These will be the main markets, but we will also be opportunistic in looking at other currencies and other markets. If the landed cost is attractive in other currencies we will consider them.

We understand the euro deal swapped back to Australian dollars in the low 140s basis points over swap, which looks pretty competitive with the 122 basis points over swap Ausgrid paid in the domestic market last year – especially considering the price action in credit spreads between then and now. What was your view on the outcome?

We were very happy with pricing. Looking at the comps, it was consistent with what an electricity utility would struck a balance between giving us the price we wanted and achieving volume equivalent to the entire June 2020 refinancing task. It also satisfies investors and gives them the right balance between price and trading in the secondary market.

Did you pay anything in the way of a new-issuer or offshore-issuer premium for the euro deal?

We probably paid a new-issue premium, but it was relatively modest. In good times you might pay a 1 basis point new-issuer premium and in bad markets you might pay 10 or so.

We hit a fairly sweet spot in the market. It certainly isn't the spot that markets were in last year, where issuers could essentially get whatever they wanted, but it is still a reasonable market for issuers.

We could have issued at another tenor, though. Next time around, once we have an established name, we may issue in another tenor. But we wanted the first deal to be in the deepest part of the curve.

The Reg S market has emerged as a consistent option for Australian corporate borrowers in the last 12-18 months. What was your thinking around the format of Ausgrid's public US dollar debut?

We opened the deal in both the Reg S and 144A markets. We prioritised the order by starting the execution process in Asia, via the Reg S market, which we have seen produce consistent results in for Australian corporates in the last 18 months.

We launched the transaction at US$500 million volume and with

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achieve at triple-B plus rating – which was pleasing given we have a split rating with a triple-B baseline.

Again, volume was not a huge consideration. We launched at €500 million and upsized to €650 million given genuine demand at this price.

Some companies seek small volume cap deal size at launch so they end up with a massively oversized book. When investors know you are going with a small deal they will oversubscribe because they know they will be scaled – they will put an absurd number in as a bid because they know they will only receive a fraction of their allocation.

Our dynamics are different given the nature of our funding task. Investors know we have the capability to issue large volume, so the books we see are genuine. From the joint lead managers' feedback, upsizing to €650 million

The maturity of the euro deal is relatively close to that of the domestic transaction Ausgrid completed last year. What was your thinking on tenor when you came back to the market, and specifically why did you decide not to pursue the 10-year option in euros?

We knew we wanted to keep the five- and 10-year space for the 144A/Reg S deal and the deepest part of the euro market was at seven years. There are two investor bases that converge at seven years so that tends to have the most liquidity.

When we did the European roadshow, we had genuine feedback from investors on their preferences when it came to duration. We have a relatively open fairway for our issuance and investors were eager for a seven-year deal.

five- and 10.25-year tranches. We had no target around increasing volume, but ended up achieving a price in both tranches that allowed us to take US$1 billion.

Both the US dollar tranches tightened significantly from initial guidance during the transaction process, and as you have said the deal was upsized. Can you give some colour around the demand and pricing for this deal?

We are a new name in the 144A market and are very happy with the following we now have with investors. The deal was upsized due to demand and competitive pricing. Volume was not a driver for us as I said, given the jumbo USPP and Australian MTN deals last year as well as the €650 million we did a few days before the 144A. •