

**RBNZ:** EXCLUSIVE  
INSIGHTS INTO NEW  
CAPITAL APPROACH

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AUSTRALIAN MARKET  
LOOKS TO THE FUTURE

**USPP:** CORPORATE  
AUSTRALIA'S FAVOURITE  
STAYS ONE STEP AHEAD

# KangaNews

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AUSTRALASIAN FIXED INCOME: GLOBAL REACH, LOCAL EXPERTISE



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NEW ZEALAND RATES HOUSE OF THE YEAR  
NEW ZEALAND CREDIT HOUSE OF THE YEAR



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Proposed new capital requirements for New Zealand's banking sector are causing consternation in the local debt market as participants grapple with a raft of potential implications. The consequences for the fixed-income sector – intended and unintended – are potentially game-changing.

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- Transaction analysis: **Australian major banks** return to domestic issuance.
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### COLUMN

#### A new licence

It is extraordinarily hard to unpick the issues around governance, ethics and social licence to operate in the financial sector. Banks – especially the majors – clearly have a lot of work to do to re-establish public trust in the wake of the royal commission. Data from the US's increasingly partisan political environment calls into question whether there is even an audience for bank rehabilitation.

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### COPUBLISHED ROUNDTABLE AUSTRALIA STILL IN VOGUE FOR USPP INVESTORS

In January, *KangaNews* hosted – with **MUFG** – its annual roundtable discussion with US private placement investors and Australian issuers in Miami. Investors remain positive about credits from the Australasian region and see no reason for supply to decline.



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#### Activity review

KangaNews's transaction data and intermediary league tables show some interesting trends from Australasian bond issuance in 2018. Outright volume was robust, including several issuance records. But while the New Zealand market added breadth, Australia struggled for issuance diversity.

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#### SSA sustainability trail blazers

Global supranational, sovereign and agency issuers continue to strike new ground in the Australian dollar sustainability-bond sector. A trio of deals printed in January highlight

the sector's leadership position, offering Australia its largest-ever SSA green bond, further supply to the nascent social-bond space and a rare renewable-energy bond.

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### Q+A

#### RBNZ ADDS COLOUR TO A DEVELOPING PICTURE

Local market participants are thinking through the likely knock-on effects of increased capital ratios for banks proposed by the **Reserve Bank of New Zealand** at the end of 2018. In an exclusive interview with *KangaNews*, **Geoff Bascand**, the RBNZ's Wellington-based deputy governor and general manager, financial stability, says any wider market consequences are a necessary step in ensuring the long-term stability of New Zealand's financial system.

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### COPUBLISHED ROUNDTABLE

#### THE REFERENCE-RATE CONUNDRUM

The impending likely demise of global interbank offered rates has sparked many questions for the Australian market. *KangaNews* and **Commonwealth Bank of Australia** brought together key market participants in late January to discuss the way forward.



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

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## ISSUER INSIGHTS

## Mining capex and GST review driving WA recovery

Western Australia (WA)'s economy is continuing an upward trajectory, with increased mining revenues and a favourable reallocation of goods and services tax (GST) among the main drivers of fiscal improvement. The state is now forecasting a fiscal surplus in 2019/20, a year earlier than expected.

The state's bottom line suffered when the mining and construction boom ended in 2012. After an extended period of negative or negligible economic growth and simultaneous budget repair, the mining industry is once again driving the WA economy – though the latest capex wave will not reach the peaks of the last boom.

At a presentation to dealers and investors in Sydney on 17 January, Michael Barnes, WA's under treasurer and chairman of Western Australian Treasury Corporation (WATC), explained that a recent spate of project approvals – principally in iron ore and lithium mining – is driving investment, jobs and revenue.

Lithium and iron-ore projects, as well as stage two of Chevron's behemoth Gorgon LNG project, are expected to bring an estimated A\$17.1 billion (US\$12.4 billion) in capex to the WA economy.

"Employment growth has rebounded strongly since its trough in early 2017 and the amount of full-time employment that has been generated by these projects has been particularly pleasing," Barnes said.

While iron ore is still the dominant mineral in WA's economy – it accounts for 90 per cent of mining royalties – the state is placing great hopes on its potential to become a powerhouse in the export of lithium as global demand for battery-storage technology heats up.

WA already accounts for 41 per cent of the world's lithium production and aims to increase that share to 50 per cent over the next three years. WA's lithium revenues in 2017/18 were A\$1.6 billion and the state expects this to more than double by 2021/22.

Projects are in the pipeline to allow WA to be a processor of lithium as well as a miner and exporter. While the industry is still relatively small, this may give the state more insulation to the kind of commodity-price swings which have determined its fortunes in the past.

Exports have taken an increasingly important role in WA's economy, with the yawning gap between gross state product (GSP) and state final demand growing since 2012. Barnes said, however, as the state's economy improves the domestic component is expected to overtake exports as the main source of growth.

**GST RELIEF**

GST has long been a sticking point for WA's politicians and public, with the state receiving as little as 30 per cent of its GST contribution even as its economy struggled. But with changes to the way GST is distributed passing through the federal parliament late in 2018 there is some long-awaited relief en route.

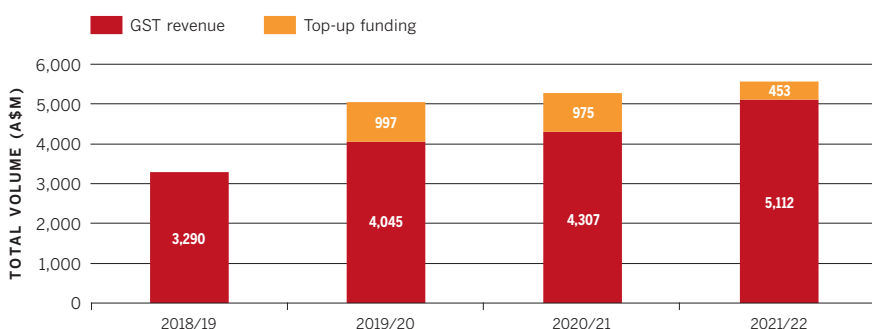
An effective 70 per cent GST floor to be implemented from the 2019/20 financial year is forecast to produce A\$2.4 billion in top-up payments for WA from the federal government by 2021/22 (see chart). These payments are to be solely allocated to debt reduction.

The revision to GST distribution was a key reason for S&P Global Ratings revising its outlook for WA's AA+ rating to stable from negative in October 2018.

GST relief and the strong performance of the state's mining sector, as well as meaningful reduction of the state's expense growth, have WA's economy well positioned with public sector net debt and net debt as a share of GSP set to decline over the forward estimates. General-government revenue has been revised up by A\$3.3 billion since the 2018/19 budget.

The result of the state's budget improvement is a lower forecast borrowing requirement, according to outgoing WATC chief executive, John Collins. WATC's new-money requirement for 2018/19 was revised to A\$1.4 billion from A\$2.7 billion at the mid-year budget review.

Collins says: "Plans are still in place to introduce a new floating-rate note, likely to be with a 2024 maturity. We may also introduce a long-dated line, with client demand currently suggesting a 2029 maturity. But the upside in revenue could affect these plans."

**WESTERN AUSTRALIA FORECAST GST RECEIPTS AND TOP-UP FUNDING**

SOURCE: WESTERN AUSTRALIAN TREASURY CORPORATION 18 JANUARY 2019





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TRANSACTION ANALYSIS

# Major-bank domestic deals give volume at a price

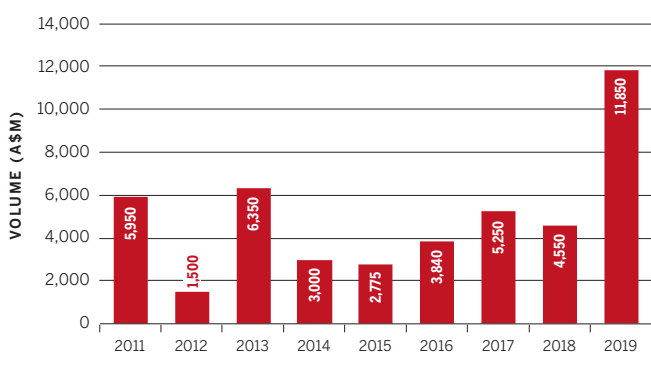
All Australia's big-four banks had printed domestic senior-unsecured benchmarks in 2019 by mid-February. The consistent theme to emerge was ample liquidity (see table 1 and chart 1) but noticeably wider margins than equivalent transactions from recent prior years (see chart 2).

**TABLE 1. LARGEST-EVER BIG-FOUR BANK DOMESTIC SENIOR BENCHMARKS (EX. GOVERNMENT-GUARANTEED)**

PRICING DATE	ISSUER	TOTAL VOLUME (A\$M)	TENOR (YEARS)	MARGIN (BP/SWAP)
9 Nov 18	Westpac Banking Corporation	4,250	3 & 5	73 & 95
30 Jan 19	ANZ Banking Group	4,100	3 & 5	88 & 110
10 Aug 18	Commonwealth Bank of Australia	3,500	3 & 5	73 & 93
27 Nov 18	ANZ Banking Group	3,250	3 & 5	82 & 103
6 May 16	National Australia Bank	3,200	5	117
14 Feb 14	Westpac Banking Corporation	3,000	5	94
9 Jan 18	ANZ Banking Group	3,000	3 & 5	58 & 77
15 Feb 19	National Australia Bank	3,000	5	104
17 Jul 15	Westpac Banking Corporation	2,900	5	90
15 Jan 15	Westpac Banking Corporation	2,775	5	90
8 May 18	National Australia Bank	2,700	3 & 5	70 & 90

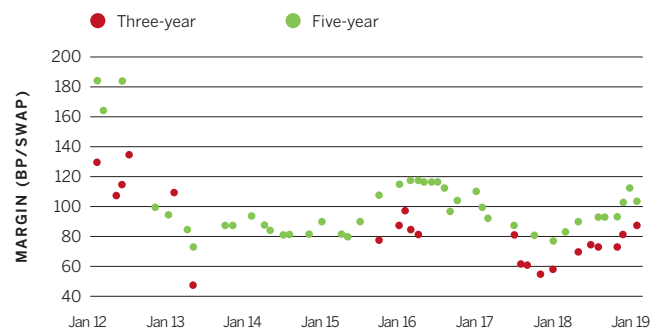
SOURCE: KANGANEWS 15 FEBRUARY 2019

**CHART 1. BIG-FOUR BANK DOMESTIC SENIOR ISSUANCE, 1 JAN - 15 FEB**



SOURCE: KANGANEWS 15 FEBRUARY 2019

**CHART 2. BIG-FOUR BANK DOMESTIC SENIOR BENCHMARK PRIMARY PRICING**



Points represent the tightest primary-market margin achieved by a bank benchmark in each month.

SOURCE: KANGANEWS 15 FEBRUARY 2019

Issuer: **Commonwealth Bank of Australia (CommBank)**

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

Pricing date: **8 January 2019**

Maturity date: **11 January 2024**

Volume: **A\$2.2 billion & A\$300 million**

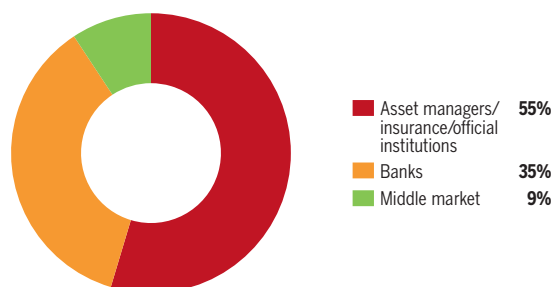
Margin: **113bp/3m BBSW & 113bp/s-q swap**

Geographic distribution: **Australia 86%, Asia 14%**

Distribution by investor type: **see chart 3**

Lead manager: **CommBank**

**CHART 3. COMMBANK DEAL DISTRIBUTION BY INVESTOR TYPE**



SOURCE: COMMONWEALTH BANK OF AUSTRALIA 10 JANUARY 2019





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Issuer: **Westpac Banking Corporation**

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

Pricing date: **17 January 2019**

Maturity date: **24 April 2024**

Volume: **A\$1.9 billion & A\$350 million**

Margin: **114bp/3m BBSW  
& 114bp/s-q swap**

Lead manager: **Westpac Institutional Bank**



Issuer: **National Australia Bank (NAB)**

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

Pricing date: **15 February 2019**

Maturity date: **26 February 2024**

Volume: **A\$2.6 billion & A\$400 million**

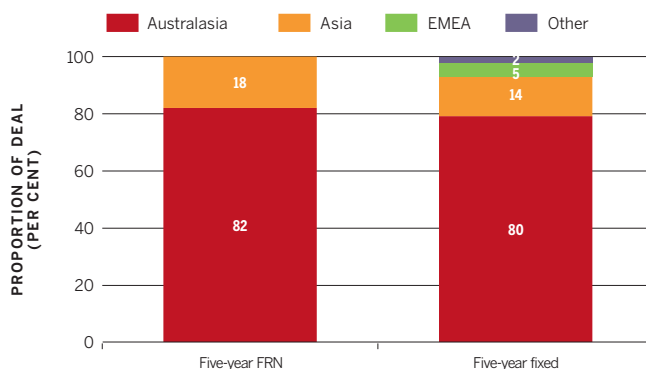
Margin: **104bp/3m BBSW  
& 104bp/s-q swap**

Geographic distribution: **see chart 4**

Distribution by investor type: **see chart 5**

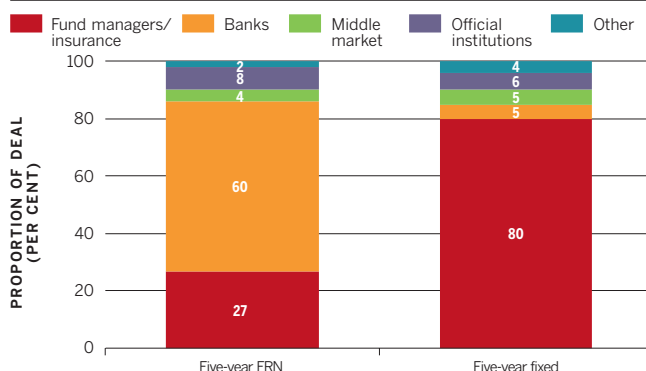
Lead manager: **NAB**

**CHART 4. NAB DEAL GEOGRAPHIC DISTRIBUTION**



SOURCE: NATIONAL AUSTRALIA BANK 20 FEBRUARY 2019

**CHART 5. NAB DEAL DISTRIBUTION BY INVESTOR TYPE**



SOURCE: NATIONAL AUSTRALIA BANK 20 FEBRUARY 2019

Issuer: **ANZ Banking Group**

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

Pricing date: **30 January 2019**

Maturity date, volume and margin: **see table 2**

Geographic distribution: **see chart 6**

Distribution by investor type: **see chart 7**

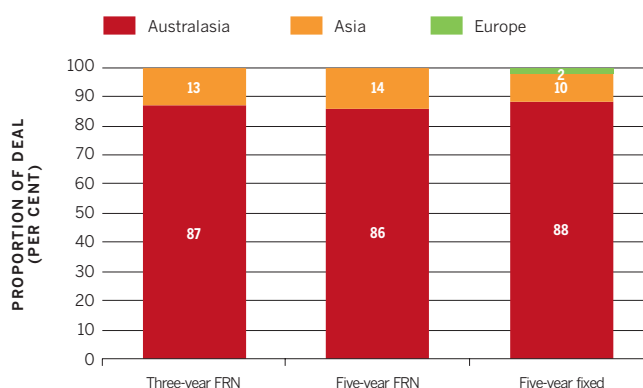
Lead manager: **ANZ**

**TABLE 2. ANZ DEAL STRUCTURE**

MATURITY DATE	COUPON TYPE	FINAL VOLUME (A\$M)	BOOK VOLUME (A\$M)	MARGIN
8 Feb 22	FRN	1,500	>1,750	88bp/3m BBSW
8 Feb 24	FRN	2,200	>2,700	110bp/3m BBSW
8 Feb 24	Fixed	400	>500	110bp/s-q swap

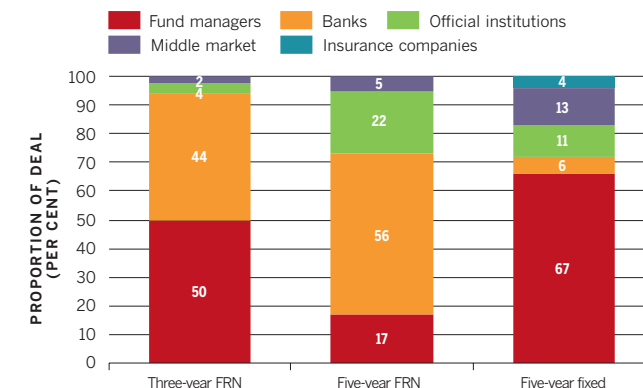
SOURCE: ANZ 30 JANUARY 2019

**CHART 6. ANZ DEAL GEOGRAPHIC DISTRIBUTION**



SOURCE: ANZ 12 FEBRUARY 2019

**CHART 7. ANZ DEAL DISTRIBUTION BY INVESTOR TYPE**



SOURCE: ANZ 12 FEBRUARY 2019





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## TRANSACTION INSIGHTS

ANZ deepens ties with SONIA  
in sterling covered-bond return

ANZ Banking Group (ANZ) became the first non-UK bank to execute a sterling covered bond referencing an alternative benchmark rate on 11 January. The deal also takes Australian-issuer engagement with alternative reference rates a step further, as the longest maturity – and, at £750 million (US\$980.6 million) by far the largest – deal to reference an alternative benchmark to be printed by an Australian issuer.

Issuer: **ANZ Banking Group**

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

Issuer rating: **NR/Aaa/AAA**

Pricing date: **12 January 2019**

Maturity date: **24 January 2022 (soft bullet)**

Volume: **£750 million (US\$980.6 million)**

Margin: **68bp/floating, compounded daily SONIA**

Geographic distribution: **80% UK/Ireland, 20% rest of Europe**

Distribution by investor type: **64% fund managers/pension funds, 36% other**

Lead managers: **ANZ, Barclays, HSBC, Lloyds, RBC Capital Markets**

ANZ's deal follows a £125 million, one-year senior-unsecured deal priced in December by Commonwealth Bank of Australia, which was the first from an Australian bank to reference SONIA – or any other alternative reference rate.

ANZ opted for covered rather than senior-unsecured format based on demand, market conditions and pricing. Simon Reid, director, group funding at ANZ in Melbourne, explains: "Covered-bond pricing worked well compared with senior-unsecured funding across markets. While markets are in much better shape than the end of 2018, pricing remains elevated, particularly in senior-unsecured."

A range of SONIA covered transactions have been executed in the sterling market since the product's inception in public syndicated benchmark format late last year. But they have all been issued by UK financial institutions that are repo eligible with the Bank of England. According to Gerard Perrignon, Sydney-based managing director, debt capital markets at RBC Capital Markets, this makes ANZ's volume outcome particularly noteworthy.

Among the notable covered-bond transactions to have SONIA as a reference rate are a £750 million three-year from Lloyds Banking Group and a £1 billion five-year from Nationwide Building Society. Reid says the robust

outcomes in these deals gave confidence that ANZ's long-term relationship with the sterling market would ensure it could attract sufficient demand despite lacking local repo eligibility. The eventual £840 million book supported a final print of £750 million for ANZ, exceeding the issuer's benchmark-volume aspirations.

According to Reid, some accounts that were sizeable investors into ANZ's previous sterling covered bond declined to participate. In fact, only two of the top-five sterling investors were common between the two trades. However, Reid argues that this was largely based on the cash or limit position of these investors – not because of a pricing convention. "Of those that declined to invest, there were only a few that declined to do so on the basis that they could not buy off a SONIA benchmark," says Reid.

"I don't believe the benchmark convention was the factor that caused the top of the book to be different," adds Paul White, global head of capital markets at ANZ in Sydney. "We did get some investor feedback that they are still getting up to date with the new benchmark. But my sense is all the main, large investors are comfortable with it. It was more other factors which changed the composition of the book – including market dynamics at the time, flight to quality and other supply."

The sterling market has evolved to a position where the investor bases for LIBOR and SONIA product are very similar. Perrignon explains: "We believe a significant majority of key volume and value-defining investors in traditional three-month sterling LIBOR product have approvals to invest in SONIA-related product."

Going forward, ANZ will exclusively use SONIA for its floating covered-bond issuance in sterling. "The senior market remains largely LIBOR-based and for the time being SONIA and LIBOR will operate side by side," says Reid. "But it is likely that LIBOR will be discontinued within three years. For deals with longer maturities than this, issuers need to be confident that their fallbacks take this into account – and we are."



"Of those that declined to invest, there were only a few that declined to do so on the basis that they could not buy off a SONIA benchmark."

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TRANSACTION ANALYSIS

# GM gets Australian corporate market in gear for 2019

A debut Kangaroo transaction from General Motors Financial Company (GM) kick-started Australian corporate issuance, from domestic and international credits, in 2019. Deal sources say the tenor and volume GM achieved were a good result for this segment of the corporate market and lay a good platform for an issuer that has also established a domestic subsidiary.

Issuer: **General Motors Financial Company**

Issuer rating: **BBB/Baa3/BBB**

Pricing date: **14 February 2019**

Maturity date: **21 February 2023**

Volume: **A\$400 million (US\$289.3 million)**

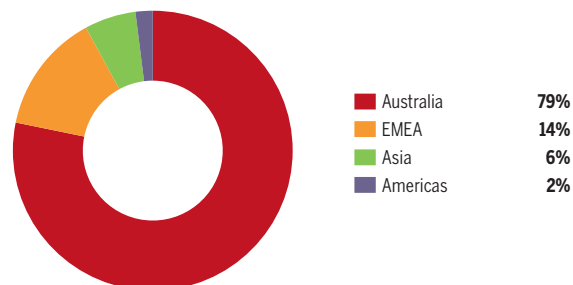
Margin: **205bp/s-q swap**

Geographic distribution: **see chart 1**

Distribution by investor type: **see chart 2**

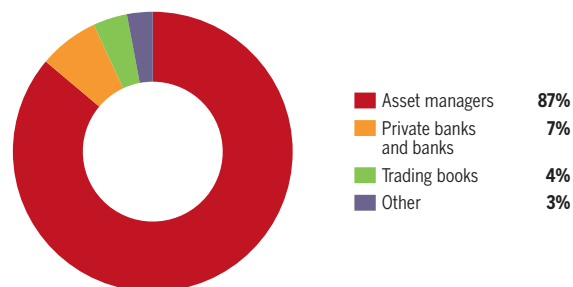
Lead managers: **Deutsche Bank, TD Securities, Westpac Institutional Bank**

CHART 1. GM DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: WESTPAC INSTITUTIONAL BANK 15 FEBRUARY 2019

CHART 2. GM DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: WESTPAC INSTITUTIONAL BANK 15 FEBRUARY 2019

ISSUER INSIGHTS



**Susan Sheffield**  
Executive Vice  
President and Chief  
Financial Officer  
General Motors  
Financial Company

**GM roadshowed in Australia and Singapore in September last year, waiting until February 2019 to issue. What led to the timing of deal execution and what were your volume aspirations?**

We had been monitoring the market for an optimal issuance window. Having recently reported strong full-year 2018 results, the timing was right for us to

execute. The final transaction size was within our expectations.

**Will you issue in Australia again?**

Establishing a domestic [Australian] MTN programme was very efficient for us. We view the Australian market and investor base as deep and diverse. We are very pleased with the level of investor engagement we have seen and we expect to maintain a market presence going forward.

While this inaugural issuance was for our US entity and represents a source of funding diversification, we have established a dual-issuer programme that includes GM Financial

Australia – a wholly owned subsidiary which began operations in late 2018.

**How did pricing compare with what you could achieve in your home market?**

While investor diversification was the primary objective, final pricing was very much in line with equivalent US dollar funding levels.

We are very pleased with the final outcome and pricing. In addition to this issuance, we have also accessed the US and European markets in 2019. Similar to those transactions, we believe we were able to achieve the most optimal outcome available to us [in Australia].



# ICPF green portfolio and loan could point the way to market evolution

Investa Commercial Property Fund (ICPF) has closed a A\$170 million (US\$123 million) green loan having tagged its entire asset portfolio against the Climate Bonds Initiative (CBI) low-carbon-building criteria emission thresholds. The facility is bilateral with ANZ, but the borrower says green loans should be able to find new liquidity and pave the way for more downline green-bond issuance.

**T**he ICPF portfolio comprises 15 investments and A\$5.1 billion in assets under management. The CBI criteria the fund has benchmarked its assets against require portfolio assets to perform in the top 15 per cent of buildings in their city for carbon intensity.

Taking a portfolio approach rather than tagging specific assets as suitable for green issuance gives ICPF significant scope to issue further labelled green debt. Jason Leong, ICPF's Sydney-based fund manager, explains: "The entire portfolio has been tagged against the criteria in order to maximise flexibility in issuing future green debt and clarification of use of proceeds from debt funding. Technically this does mean an increasing portion of ICPF debt could be certified in the future."

The fund is not making firm commitments in this respect, though. Leong tells *KangaNews* there is no target for green debt as a proportion of the overall book – only that it is "open to pursuing green-debt opportunities in the future". Neither, the fund says, was there a pricing benefit to signing a labelled green loan.

## BORROWER BENEFITS

For the borrower, there are two reasons for certifying bank debt. First, says Nina James, general manager, corporate sustainability at Investa Property Group (Investa) in Sydney: "The benefits for Investa are certainly about industry leadership and demonstrating our full commitment to a net-zero carbon

transition. Pursuing green debt is very much about aligning our values and business practices."

The other potential benefit is incremental liquidity. James says having a green debt portfolio gives ICPF "the ability to tap into new green-loan financiers", and the company expects other banks to follow ANZ's lead by making funds available specifically for green-labelled debt in Australia.

Ivan Gorridge, Investa's Sydney-based chief financial officer, explains: "Investa aims to prompt and support the

**"While this transaction is a bilateral, we know there is increasing appetite among banks for the finance of 'green' assets – take the demand for finance of grid-scale renewables, for instance."**

IVAN GORRIDGE INVESTA PROPERTY GROUP

development of financial innovation that helps the transition to a lower-carbon economy. While this transaction is a bilateral, we know there is increasing appetite among banks for the finance of green assets – take the demand for finance of grid-scale renewables, for instance."

Gorridge says Investa "strongly expects" other banks will follow ANZ, to the benefit of his company and other businesses with green assets.

The ICPF facility is Australia's first green use-of-proceeds loan. In December last year, Adelaide Airport closed a A\$50 million sustainability performance loan – also with ANZ as the lender – that offers the borrower a pricing incentive to meet sustainability performance targets measured by Sustainalytics.

Katharine Tapley, head of sustainable finance at ANZ in Sydney, explains that a key difference between the two facilities is that Adelaide Airport's is a general corporate purposes loan tied to corporate sustainability performance, while ICPF's requires proceeds to be used to fund verified green assets.

"[The ICPF loan] is the first time an Australian borrower has executed this kind of labelled and certified green loan," Tapley confirms. "It is also the first borrower to have done both a labelled and certified green bond and a green loan. It expanded its existing green-bond framework to cover green loans to do this, which will also give it the ability to fund the entire ICPF business via the green bond and loan markets going forward."

James confirms that the same process applies to asset approval for green loans as it does for bonds. She adds that the CBI certification programme for commercial buildings is "clear and simple to use".

This enabled ICPF to take the next step from its existing position as the pioneer of corporate issuance in the Australian green-bond market. Investa Office Fund was the first such issuer, printing A\$150 million of seven-year green bonds in March 2017. These notes were later bought back in the course of a takeover transaction.

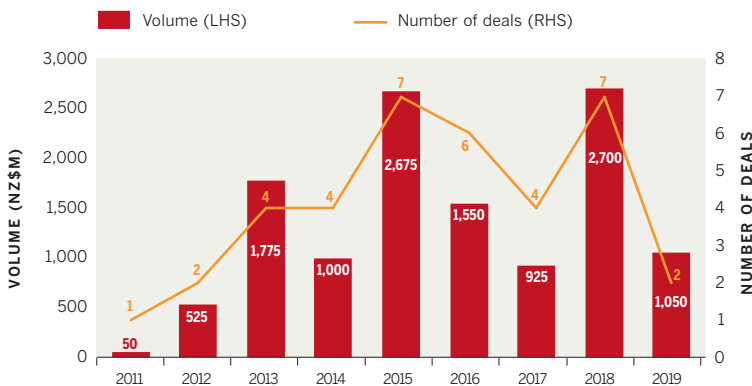
ICPF has also printed a green bond: A\$100 million of 10-year notes priced in April 2017. Leong confirms that the fund is open to returning to this market in future.

TRANSACTION ANALYSIS

# Kauri deal flow commences but new year starts slowly

A brace of Kauri transactions came to market in January 2019, but even though both were relatively large in volume they were not sufficient to prevent the market from experiencing a relatively slow start to the year (see chart). Market sources say Kauri economics have been challenging.

## KAURI ISSUANCE, 1 JANUARY – 15 FEBRUARY



SOURCE: KANGANEWS 15 FEBRUARY 2019

Issuer: **World Bank**

Issuer rating: **AAA/Aaa**

Pricing date: **16 January 2019**

Maturity date: **24 January 2024**

Volume: **NZ\$400 million (US\$275.6 million)**

Margin: **41bp/mid-swap, 74bp/NZGB**

Geographic distribution: **70% New Zealand, 30% offshore**

Lead managers: **ANZ, BNZ, Commonwealth Bank (CommBank)**

★

Issuer: **Export Development Canada**

Issuer rating: **AAA/Aaa**

Pricing date: **14 January 2019**

Maturity date: **30 November 2023**

Volume: **NZ\$650 million**

Margin: **42bp/mid-swap, 75bp/NZGB**

Geographic distribution: **55% Australasia, 38% Asia, 7% other**

Lead managers: **ANZ, BNZ, CommBank**

TRANSACTION INSIGHTS



**BRAD PEEL**  
DIRECTOR, DCM  
ORIGINATION  
COMMONWEALTH BANK

**“EDC benefited from several large offshore investors deciding to**

**participate. This was spurred in part by the Kauri market presenting a good relative-value proposition compared with transactions in other global markets at the time of issuance, as well as some name-specific factors.”**



**GLEN SORESEN**  
DIRECTOR, SYNDICATE  
ANZ

**“Sharply narrowing US dollar swap spreads through December pushed**

**supranational, sovereign and agency spreads wider. Combined with widening New Zealand dollar basis levels, the gap between New Zealand and US dollar economics closed. US dollar spreads have recently begun to widen, though – which could make conditions more challenging again for Kauri issuance.”**



**MIKE FAVILLE**  
HEAD OF DEBT CAPITAL  
MARKETS  
BNZ

**“There have been successful transactions with spreads as low as 55-60 basis**

**points over government bonds and it is rare to see a spread higher than 80, so World Bank’s Kauri was at the upper end of the range.”**



# NZFMA opens consultation on BKBM fallback

The New Zealand Financial Markets Association (NZFMA) has opened a consultation on the idea of supplementing – though not replacing – the existing bank-bill reference rate (BKBM) with an overnight risk-free rate (RFR).

The goal is better to align the New Zealand market with evolving global norms, specifically the International Organization of Securities Commissions (IOSCO)'s principles for financial benchmarks. "The implications of global developments have had an influence on the options...proposed in this consultation," the NZFMA reveals. "Namely, in order to transact derivative products against US dollars, euros, yen, sterling and Swiss francs, a New Zealand dollar overnight risk-free rate will be required."

The NZFMA says its planned approach is similar to that being taken in Australia. Unlike many global jurisdictions, Australia is not anticipating the imminent demise of its local interbank offered rate (IBOR) – in this case, the bank-bill swap rate (BBSW). Instead, it has worked to solidify the existing rate while implementing what the NZFMA calls a "robust fallback benchmark interest rate to meet IOSCO principles and satisfy EU benchmark reform regulation equivalence requirements".

## FALLBACK OPTIONS

Three options for a fallback rate are under consideration in New Zealand. These are the Reserve Bank of New Zealand (RBNZ) official cash rate or a variant thereof – likely the interest rate paid on reserves in RBNZ accounts – the overnight interbank cash rate and overnight indexed swaps. The NZFMA is inviting market feedback on all three.

The regulator notes that none of the three options, in its opinion, meets all the IOSCO criteria though all of them meet "a high proportion". It has rejected a clutch of other options, including the term repo and Treasury bills rates.

The consultation document invites market participants to respond to specific questions about the validity of the three preferred options. However, comments are also invited in support of the explicitly discarded options or any alternative not discussed in the consultation document.

None of the three preferred options provide both a term and credit rate which can be used as a fallback for BKBM. Instead, they will require the derivation of such from rates that are either or both of overnight and near risk-free. The NZFMA's working group on a fallback rate is proposing that "international developments in this space be monitored and adopted".

**"The implications of global developments have had an influence on the options...proposed in this consultation. Namely, in order to transact derivative products against US dollars, euros, yen, sterling and Swiss francs, a New Zealand dollar overnight risk-free rate will be required."**

NEW ZEALAND FINANCIAL MARKETS ASSOCIATION

Its reference point is a consultation conducted by the International Swaps and Derivatives Association (ISDA) that closed in October 2018. ISDA expects to update documentation in the second half of 2019 to set a standard for extrapolating alternative reference rates for term and credit. The NZFMA notes that an "overwhelming majority" of respondents to ISDA's consultation favoured compound setting in arrears for a term rate while a "significant majority" favoured a historical mean or median approach for determining credit-spread adjustment.

New Zealand market participants are asked whether they agree with the approach of following ISDA's lead as a

general principle, as well as for specific views on the most appropriate method of extrapolating a fallback reference rate for term and credit locally.

## BENCHMARK ADMINISTRATION

One area where the NZFMA does not expect New Zealand to follow the approach taken in Australia is on benchmark administration. The Australian Financial Markets Association handed over responsibility for BBSW administration to the Australian Securities Exchange in 2018 as the precursor to a methodology overhaul that market participants hope will set up BBSW to survive even as global IBORs wither.

While the NZFMA appears committed to supporting BKBM even as it works to develop a fallback rate, it is not proposing a change in administrator for the rate. "It is the NZFMA's intention to remain the benchmark administrator," the consultation paper states.

The regulator is conducting a self-assessment and obtaining an external audit of BKBM in light of the IOSCO principles, to ensure the rate remains fit for purpose. Implementing a fallback is another aspect of this drive to ensure New Zealand's reference-rate setup is robust.

The consultation document asks market participants if they support this retention of the BKBM administrator role, whether they believe the fallback rate they prefer should have an administrator and, if so, whether the NZFMA should take that role as well.

The NZFMA consultation was open until 1 March. An anonymised summary of responses will be published "as soon as possible after the closing date".



LAURENCE DAVISON  
LDAVISON@KANGANEWS.COM

# A new licence

It is extraordinarily hard to unpick the issues around governance, ethics and social licence to operate in the financial sector. Banks – especially the majors – clearly have a lot of work to do to re-establish public trust in the wake of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Data from the US's increasingly partisan political environment makes me wonder if there is even an audience for bank rehabilitation.

First of all, the obligatory disclaimer. The royal commission uncovered some grotesque abuses in the banking sector. The perpetrators and the management structures that enabled them deserve appropriate punishment – right up to board level, if necessary – if for no other reason than that the healing process cannot begin until the wound has been thoroughly cleaned. A quick wash under the cold tap and a plaster is not going to do the trick in this case.

On the other hand, I assume readers of this publication generally reject the narrative that banks are inherently evil and that the bigger they become the more evil they get.

The problem, as I have written before, is that it has been too easy to cede the narrative. In a world where the people controlling the levers of power understood the value and purpose of a healthy banking sector there never seemed to be a pressing need to explain, in any depth, that story to the wider public.

But the world has changed. The rise of populism demonstrates that low-information viewpoints are now being given as much weight in the political realm as any others. We can no longer rely on sane voices to prevail, and just because something makes sense doesn't mean it is immune to populist wrath. A bad time for a poorly understood, highly profitable industry's dirty linen to get aired in public.

What the banks are finding now is that their branding and marketing efforts are built on sand. Consumers don't care if you sponsor cricket teams or rescue helicopters, or sell the *Big Issue* for a day a

year, if they don't have any conception of what value you bring to society in the first place but have plenty of evidence of your profiteering.

There are echoes here of the campaign leading up to the UK's Brexit referendum. Pro-remain campaigners were astonished to find that, facilitated by 40 years of almost exclusively negative media coverage of the EU, a large swathe of the British public could not be convinced in six weeks that being part of the European project was a positive thing.

There simply weren't any foundations of understanding on which to build a coherent case for remaining, so the remain campaign had to base its arguments on vague economic threats. These were likely accurate but were too easily labelled "project fear" by leavers.

When much of the general public's baseline case is that something provides them no value and in fact is probably out

to rip them off, it is quite hard to convince them of its value.

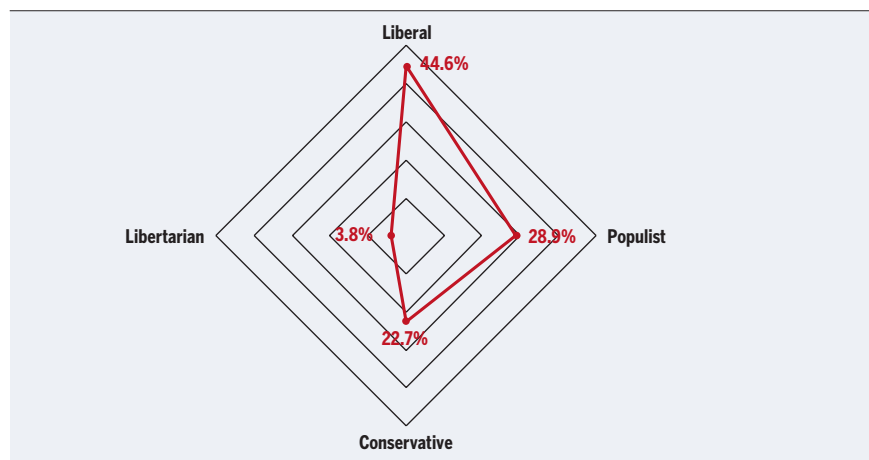
In some ways, Australia's banks have a less critical PR task: they are not facing a binary public decision about whether to abandon them entirely. On the other hand, the UK never conducted a public inquiry that uncovered seemingly endless tales of corruption and greed throughout the customer-facing aspects of the EU (it had the *Daily Mail* to concoct those).

### DIFFICULT NARRATIVES

A theme I keep returning to in this column is the content and standard of public discourse. In this case, the critical aspect is how poorly understood are the purpose of banking and the service it provides to a modern mixed-model democracy.

I am prepared to bet that in the wake of the royal commission the banks initiate substantial, highly budgeted and

### 2016 US ELECTORATE



SOURCE: DEMOCRACY FUND VOTER STUDY GROUP JUNE 2017



beautifully conceived PR campaigns to rehabilitate their images. We will hear and see more resignations, profuse apologies, assurances that hard lessons have been learned and commitments to do better in future. At no point will any of this materially attempt to explain what banks are there for or why we need them.

Some might say making this case insults the intelligence of the audience. I disagree. I tend to think that most people are broadly capable of understanding more than they are often given credit for. It's just that public discourse has been dumbed down so far that most people are chronically information-starved.

I can only think of three reasons why banks wouldn't try to explain to their customers what the purpose and value of a bank is. Either they think the general public already knows, the banks aren't confident in their own *raison d'être*, or they don't think the public is capable of or willing to understand it.

None of these speak particularly highly of the banks' self-awareness. All the available evidence suggests financial literacy is low. In a country where most people can't consistently answer extremely basic questions about interest and inflation (see box), it would be extraordinarily arrogant for the financial sector to assume inherent value is being ascribed to the provision of housing credit, investment services and the like.

I'll move swiftly past banks' own sense of self-worth. Presumably major financial institutions believe they have a purpose in society, so we can safely assume this is not why they don't try to explain it to their customers.

### THE SUPPORTIVE COHORT

This leaves the possibility that the general public is deaf to a message about the purpose of financial services and banking, either because people are not capable of understanding it or because they actively reject it. Capability is one question, but I'd be tempted to suggest that it is unproven specifically because no-one is trying to educate people about more complex concepts.

## AUSTRALIAN FINANCIAL LITERACY

The annual Household, Income and Labour Dynamics in Australia survey, funded by the Australian government and conducted by the Melbourne Institute, suggests the state of financial understanding in Australia is shaky at best.

### The survey asks five basic financial questions:

1. [Numeracy] Suppose you put A\$100 into a no-fee savings account with a guaranteed interest rate of 2% per year. You don't make any further payments into this account and you don't withdraw any money. How much would be in the account at the end of the first year, once the interest payment is made?
2. [Inflation] Imagine now that the interest rate on your savings account was 1% per year and inflation was 2% per year. After one year, would you be able to buy more than today, exactly the same as today, or less than today with the money in this account?
3. [Diversification] Do you think that the following statement is true or false? "Buying shares in a single company usually provides a safer return than buying shares in a number of different companies."

4. [Risk–return] Again, please tell me whether you think the following statement is true or false: "An investment with a high return is likely to be high risk."

5. [Money illusion] Suppose that by the year 2020 your income has doubled, but the prices of all of the things you buy have also doubled. In 2020, will you be able to buy more than today, exactly the same as today, or less than today with your income?

In 2016 – the most recent data set – just 42.5 per cent of respondents got all five right. The mean score was 3.9. Some cohorts scored particularly poorly: a quarter of 15-24 year olds got two or fewer answers correct while less than 40 per cent of all female respondents and of all respondents over 65 got all five correct.

It is hard to imagine that a population with this shaky a grasp of finance inherently understands the purpose of banking.

Take the debate on mortgage finance. People want their houses to retain and gain value. They also want their children to be able to afford to get on the housing ladder. The only way we have found to make both these things possible is through relatively free access to credit. And yet people also want to see banks punished and have their government support withdrawn.

There is a dissonance here that extends beyond just cleaning up dodgy practice at the front end. Some US polling data gave me a clue as to why this might be. A survey of the 2016 US electorate by the Democracy Fund Voter Study Group found that while many voters combine social conservatism and economic liberalism, hardly any have the opposite view (see chart).

In other words, the audience for the kind of 'friendly capitalism' that I would

argue makes up the core of major banks' marketing message – supporting socially progressive causes while at the same time being pillars of the free market – basically doesn't exist.

I acknowledge that the link between banks and socially progressive causes may not be strong, but I would contend that this is the 'friendly face' the banks have tried to present. There is an audience for it, too – just not one that is comfortable with the fundamentally pro-market position banks require.

Banks have long been able to bypass the fundamental nature of what they do in their retail marketing, because there was a consensus – at least in the political realm – in support of their role. That consensus is under threat, and the banks can either start re-digging their social-licence foundations now or risk taking much more damaging blows to their positions in future. •

# Activity review

KangaNews's transaction data and intermediary league tables show some interesting trends from Australasian bond issuance in 2018. Outright volume was robust, including several issuance records. But while the New Zealand market got broader, Australia struggled for issuance diversity.

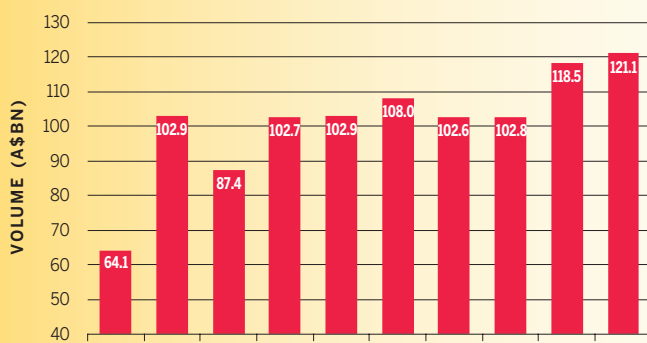
BY LAURENCE DAVISON

**S**yndicated Australian market issuance reached a record level in 2018, with more than A\$121 billion (US\$87.5 billion) priced (see chart 1). This figure includes domestic and offshore issuers' deal flow but excludes sovereign-bond syndications – which have a distortionary effect given the Australian

Office of Financial Management's ability to flex in and out of the syndicated market depending on supply of new bond lines in any given year.

The large majority of Australian dollar supply continued to come from domestic issuers in 2018 as Kangaroo volume fell slightly year-on-year (see chart 2). Kangaroo issuance has been range-bound in recent years, never adding less than A\$24 billion of annual volume to the Australian market in the past decade but never adding as much as A\$39 billion either. Supranational, sovereign and agency names dominated this space in 2018.

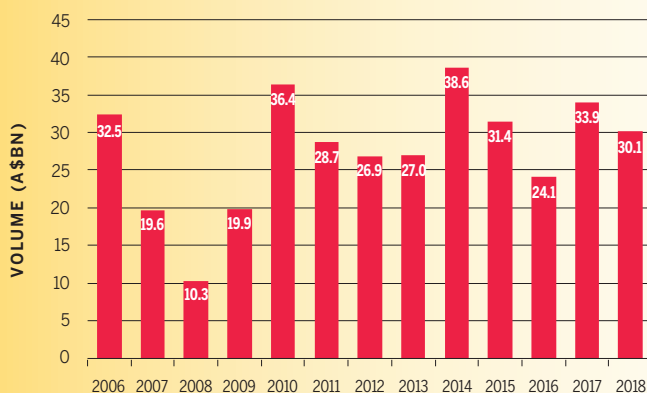
**CHART 1. ALL AUSTRALIAN MARKET SYNDICATED ISSUANCE\***



\* Excludes Australian Office of Financial Management syndications and government-guaranteed bank issuance.

SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 2. KANGAROO ISSUANCE**



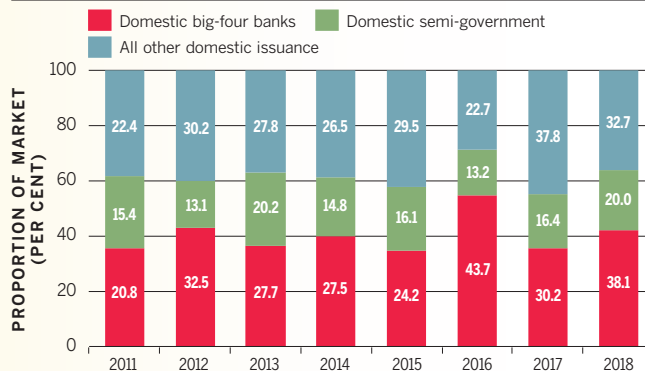
SOURCE: KANGANEWS 14 FEBRUARY 2019

## DIVERSITY SUFFERS

**W**hile volume was up in Australia in 2018, the sources of supply were relatively narrower. In 2017, A\$37.8 billion of domestic-issuer supply came from names outside the big-four banks and local semi-governments (see chart 3). At nearly 45 per cent, this was the largest contribution to total domestic-market supply from less frequent issuers this decade.

In 2018, just 36 per cent of total syndicated supply came from issuers outside the major banks and semi-governments. Other than 2016 – a year of particularly narrow issuance diversity – 2018 had the greatest concentration of domestic Australian dollar

**CHART 3. COMPOSITION OF AUSTRALIAN DOMESTIC ISSUER LOCAL SYNDICATED ISSUANCE\***



\* Excludes Australian Office of Financial Management syndications and government-guaranteed bank issuance. Note: Numbers on the bars are A\$bn

SOURCE: KANGANEWS 14 FEBRUARY 2019

supply from the market's most programmatic issuers – albeit only marginally so.

The story of limited diversity is cast in even sharper relief by corporate issuance volume. With just A\$9.6 billion of true corporate issuance, 2018 was the second-slowest year for this sector since 2011 (see chart 4). As a proportion of the total market, 2018 was the worst year for true corporate volume in Australian dollars since 2010 (see chart 5). At less than 8 per cent, the corporate component was less than half that of 2017.

The drop-off cannot be blamed exclusively on a thin domestic supply pipeline. Previous poor years for issuance by Australian corporates saw total volume propped up to some degree by corporate Kangaroos – at least A\$3 billion of this flow came to market in each of 2015 and 2016. In 2018, international corporate issuance into the Australian market declined to just A\$1.9 billion – the lowest figure since 2014.

One reason for the decline in corporate supply could be the Australian dollar market's reduced willingness to offer corporate credits extended tenor in 2018. Following an apparent breakthrough in 2017, when more than A\$6 billion of corporate deals with tenor of 10 years or longer came to market, just A\$2.4 billion of such deal flow printed in 2018 (see chart 6).

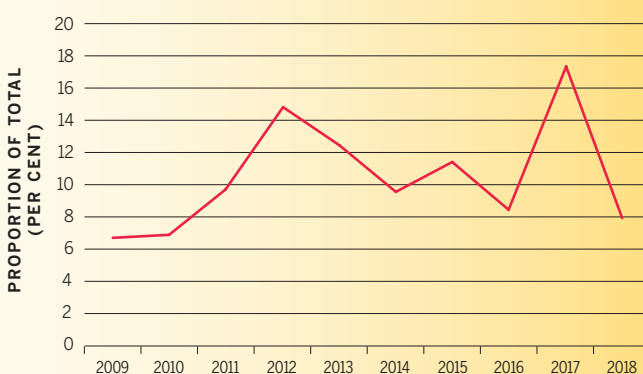
Completing the picture of an uninspiring year for Australian dollar corporate issuance, 2018 saw the momentum for triple-B, subinvestment-grade and unrated deal flow that built in 2017 evaporate. The A\$4.7 billion of such supply to price in 2018 was more than came to market than in 2015 or 2016 but barely reached half the level seen in 2017 and was less than the equivalent figures from 2013 and 2014 (see chart 7).

Another fixed-income asset class – securitisation – also took a step back in 2018 after a bumper preceding year (see chart 8). In both cases, though, it may prove to be the case that 2017 was an outlier in which unusually benign issuance conditions enabled issuers to find liquidity in Australian dollars more consistently and in greater volume than a more typical backdrop would allow.

One clear upward trend in the Australian dollar securitisation market is the prominence of nonbank issuers. Nonbanks

provided more than half the total supply in 2018, the third consecutive year that saw significant growth in proportional nonbank issuance (see chart 9).

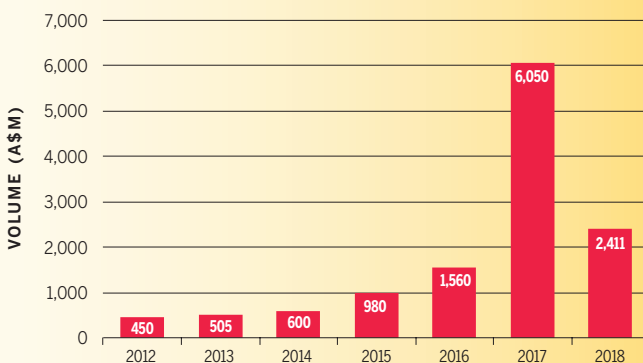
**CHART 5. TRUE CORPORATE PROPORTION OF TOTAL AUSTRALIAN MARKET SYNDICATED ISSUANCE\***



\* Excludes Australian Office of Financial Management syndications and government-guaranteed bank issuance.

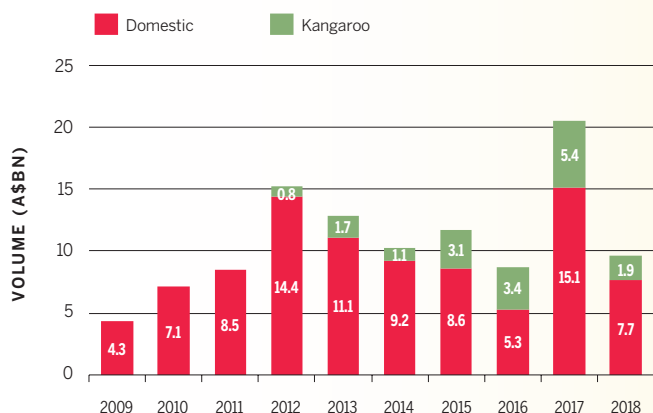
SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 6. AUSTRALIAN MARKET TRUE CORPORATE ISSUANCE, 10+ YEAR TENOR**



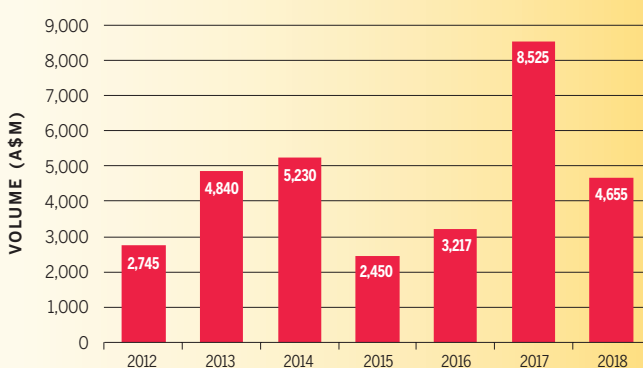
SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 4. AUSTRALIAN MARKET TRUE CORPORATE ISSUANCE**



SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 7. AUSTRALIAN MARKET TRIPLE-B, SUBINVESTMENT-GRADE AND UNRATED TRUE CORPORATE ISSUANCE**



SOURCE: KANGANEWS 14 FEBRUARY 2019



## NEW ZEALAND VOLUME

The New Zealand dollar market presents a number of contrasts to the Australian issuance story. Most Australian sectors saw an issuance boost in 2017 before returning to earth in 2018. In New Zealand, 2017 was the disappointing year and 2018 seems to have re-established some more positive trends that appeared to be developing earlier this decade.

Overall issuance had been on a gradual upwards trend from 2010 before dropping precipitously in 2017. The final figure for New Zealand dollar bookbuilt issuance in the local market in 2018 – again excluding sovereign-bond syndications – recovered all the previous year's lost ground and set a new record (see chart 10).

Total issuance fell by more than A\$5 billion (US\$3.4 billion) from 2016 to 2017, and A\$3 billion of that drop can be attributed to a particularly slow year in the Kauri market (see chart 11). The subsequent rebound in Kauri issuance last year – to a near-record level – also delivered more than half the overall issuance recovery in New Zealand.

Unlike Australia, the New Zealand domestic market actually delivered a greater level of diversity beyond the major banks in

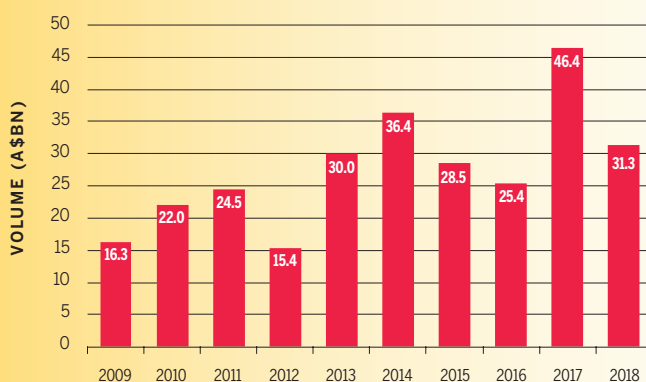
2018. Big-four bank domestic issuance volume in New Zealand fell to its lowest outright volume since 2014 – NZ\$2.9 billion – which represented less than 40 per cent of the total domestic market for the first time (see chart 12).

Without recording exponential growth, the local corporate market had a robust year in 2018 and finished with record issuance volume of NZ\$3.2 billion (see chart 13). The second-largest year for New Zealand corporate issuance – 2012 – is also something of an outlier as NZ\$1.4 billion of the NZ\$2.6 billion printed that year came from just two jumbo transactions.

The New Zealand market has established additional diversity despite losing the bulk of what used to provide a significant component of the local syndicated market: own-name deals from local authorities.

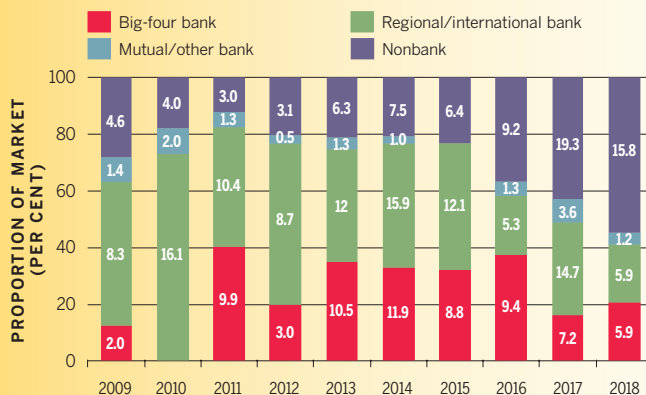
The local-government sector used to provide around NZ\$1 billion of deal flow each year, but the introduction of the New Zealand Local Government Funding Agency – which issues exclusively by tender – in 2012 has seen much of that deal flow transition out of the bookbuilt space (see chart 14). The return of Housing New Zealand in 2018 added NZ\$800 million to the agency sector, however.

CHART 8. AUSTRALIAN MARKET SECURITISATION ISSUANCE



SOURCE: KANGANEWS 14 FEBRUARY 2019

CHART 9. COMPOSITION OF AUD SECURITISATION MARKET



Note: Numbers on the bars are A\$bn

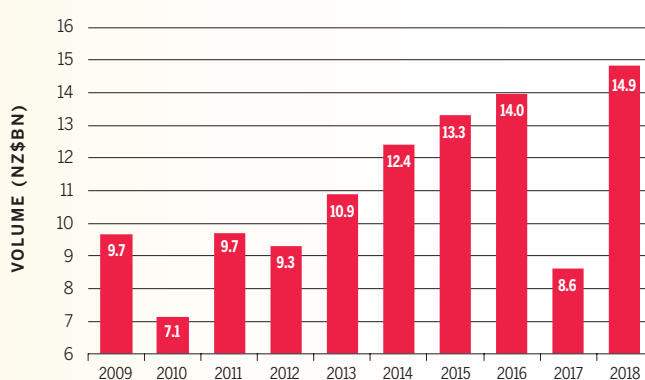
SOURCE: KANGANEWS 14 FEBRUARY 2019

## LEAGUE-TABLE POSITIONS

The Australian big-four banks retained a near-monopoly at the top of KangaNews's intermediary league tables in 2018. In the all-Australian dollar league table – which includes all domestic syndicated deals including sovereign issuance as well as the whole Kangaroo market but excludes self-led deals – ANZ maintained its hold on the top lead-manager position. National Australia Bank (NAB) and Commonwealth Bank of Australia (CommBank) took the next two spots while UBS's strength in the local sovereign and semi-government space allowed it to break up the majors with a fourth-place finish.

The KangaNews league table for all domestic Australian dollar issuance – in other words excluding Kangaroo volume – looked very similar in 2018. The top three from the all-Australian

CHART 10. ALL NEW ZEALAND MARKET SYNDICATED ISSUANCE\*



\* Excludes New Zealand Debt Management syndications.

SOURCE: KANGANEWS 14 FEBRUARY 2019

dollar league table take the same places for domestic deals only, though Westpac Institutional Bank (Westpac) leapfrogs UBS into fourth place.

Meanwhile, ANZ also finished top of an all-big-four lineup in the Australian dollar credit league table, which mainly comprises local financial-institution and corporate issuance. NAB finished second with Westpac third and CommBank fourth. UBS again took the top spot for an international bank in fifth.

It was a different story in the Kangaroo league table, where international banks dominated. TD Securities (TD) finished 2018 with a dominant lead over the field, having accounted for A\$5.4 billion (US\$3.8 billion) of league-table Kangaroo volume compared with A\$3.2 billion for its nearest competitor, Nomura. RBC Capital Markets finished narrowly behind in third place, with Deutsche Bank and ANZ rounding out the top five.

The top five of the KangaNews securitisation league table for 2018 was another domestic affair. In this case NAB took top spot relatively comfortably over Westpac, with A\$5.7 billion of league-table volume to A\$4 billion. CommBank, ANZ and Macquarie Bank rounded out the top five and Deutsche Bank was the best-placed international name in sixth.

In New Zealand, ANZ was also top dog in the 2018 whole-market league table which includes sovereign syndications, all other domestic bookbuilt issuance and Kauri transactions. BNZ took second place, Westpac third and CommBank fourth. TD was the top international finisher thanks exclusively to its Kauri franchise.

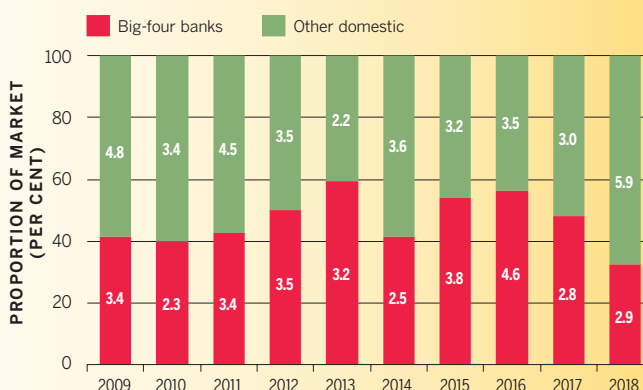
ANZ also took out top spot in the New Zealand league tables for individual sectors – in both cases ahead of BNZ. In the league table for New Zealand domestic deals Westpac also performed strongly, pipped for second place by BNZ in volume terms by less than NZ\$70 million (US\$48.2 million) and actually ahead – by 20 transactions to 13 – in number of deals led. ANZ retained a solid advantage in both aspects, however.

The finishing order in the 2018 Kauri league table could hardly have been closer. ANZ was responsible for NZ\$1.9 billion from 10 transactions while BNZ wrote NZ\$1.8 billion of Kauri

league-table volume in 11 deals. TD placed third, with NZ\$1.1 billion of league-table volume, while CommBank and Deutsche Bank rounded out the top five. •

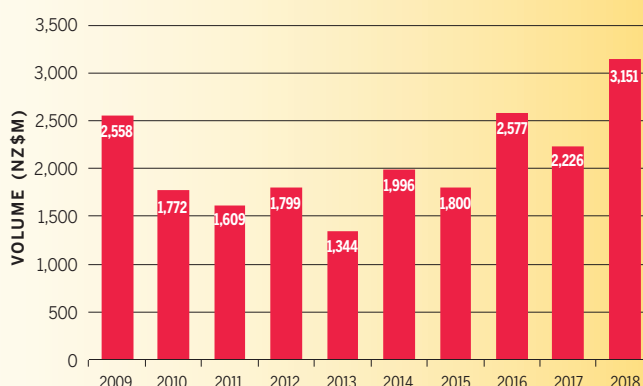
\* All KangaNews league tables can be viewed at [www.kanganews.com/league-tables](http://www.kanganews.com/league-tables)

**CHART 12. COMPOSITION OF NEW ZEALAND DOMESTIC ISSUER LOCAL SYNDICATED ISSUANCE**



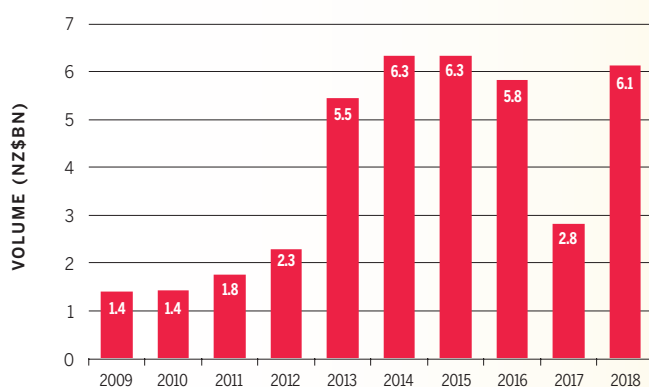
SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 13. NEW ZEALAND MARKET TRUE CORPORATE ISSUANCE**



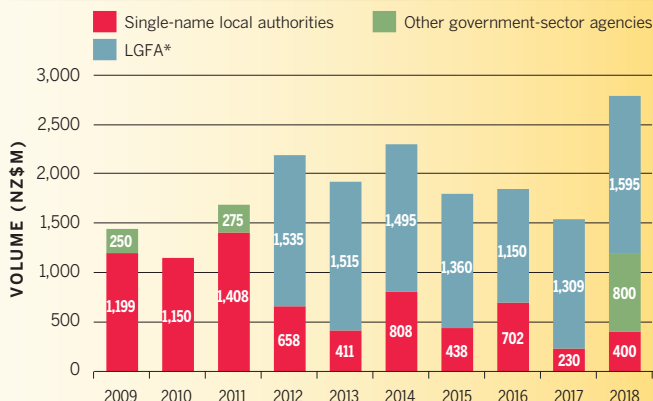
SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 11. KAURI ISSUANCE**



SOURCE: KANGANEWS 14 FEBRUARY 2019

**CHART 14. NEW ZEALAND DOMESTIC SEMI-GOVERNMENT ISSUANCE**



\* LGFA issuance conducted via tender. All other data is for syndicated deals.

SOURCE: KANGANEWS, NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY 14 FEBRUARY 2019

# SSA sustainability trail blazers

Global supranational, sovereign and agency (SSA) issuers continue to strike new ground in the Australian dollar sustainability-bond sector. A trio of deals printed in January highlight the sector's leadership position, offering Australia its largest-ever SSA green bond, further supply to the nascent social-bond space and a rare renewable-energy bond.

BY MATT ZAUNMAYR

**S**SA issuers were among the first to price green bonds in Australia, supplied almost half 2018's record sustainable-bond issuance and have seen the new year off to a flying start (see chart 1).

Most of the early volume in 2019 was provided by a brace of trades: a A\$1 billion (US\$723.3 million) new green bond from Asian Development Bank (ADB) and a A\$400 million social-bond tap from International Finance Corporation (IFC). The first Australian dollar print off BNG Bank's renewable-energy-bond programme was much smaller, at A\$25 million, but still added further innovation to the Australian market (see box on facing page).

## ADB DEMAND BOOST

**A**DB's transaction, led by Deutsche Bank, Nomura and TD Securities (TD), is the largest-ever SSA Kangaroo green bond – surpassing European Investment Bank's A\$750 million, five-year climate-awareness bond – and the second-largest in Australian dollars from any issuer.

The deal was also the largest single-tranche SSA Kangaroo transaction since World Bank's A\$1 billion five-year deal in June

2014 and ADB's equal largest single-tranche Australian dollar deal – ADB achieved this volume in transactions in 1998, 2010, 2011 and 2014, according to KangaNews data.

The transaction is ADB's first green bond in Kangaroo format. The supranational has previously issued around US\$5 billion equivalent under the programme in currencies including US dollars, euros, Swedish krona, Hong Kong dollars and Indian rupee. The programme focuses on funding projects which support mitigation of greenhouse-gas emissions and adaptation to the consequences of climate change.

Lead managers reveal that the transaction launched with minimum volume of A\$300 million. However, they were always confident the final print would be larger.

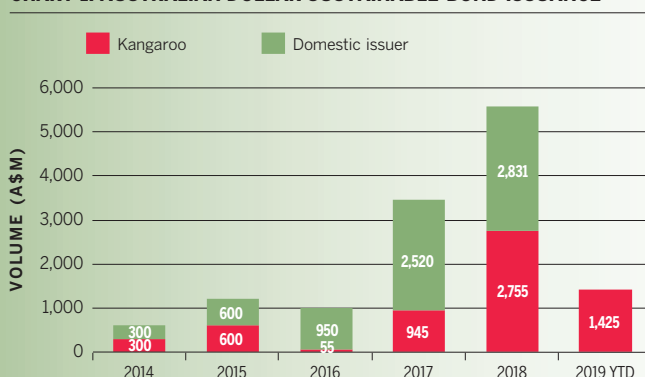
The first transactions of a calendar year typically derive a benefit from the demand that builds up over the Christmas and New Year break, but ADB and its leads suggest that in this case the green overlay provided an additional volume boost.

Anthony Ruschpler, Manila-based treasury specialist at ADB, says much of the interest surrounding the transaction was because of the green label. "We do not think we would have achieved the same outcome for a regular outing. Not only did most of the key domestic SRI [socially responsible investment] buyers participate, but so did several offshore accounts which have been absent from the Kangaroo market for a number of years."

Yuriy Popovych, Singapore-based director, international fixed income, origination and syndication at TD, says the transaction developed a positive feedback loop once it was announced to the market that it would be upsized. "At A\$300 million some accounts were waiting on the sidelines because green-bond transactions typically are less liquid in secondary markets as accounts tend to buy and hold," he explains. "But as the transaction grew, first to A\$500 million and eventually to A\$1 billion, most of these accounts came in to the deal and a lot of others increased their orders."

Craig Johnston, Sydney-based director, Australian and New Zealand dollar syndicate at Deutsche Bank, says it is difficult to pinpoint the level of additional demand coming from the green

CHART 1. AUSTRALIAN DOLLAR SUSTAINABLE-BOND ISSUANCE



SOURCE: KANGANEWS 8 FEBRUARY 2019



# BNG Bank's renewable-energy bond draws out long-end demand

BNG Bank priced its first-ever renewable-energy Kangaroo bond on 23 January, based on reverse enquiry from a Japanese investor. Deal sources say the specific use of proceeds from the deal strikes a chord with a particular type of investor and gives the issuer access to long-dated Australian dollar funding.

The A\$25 million (US\$18.1 million), 10.5-year transaction, led by Daiwa Capital Markets (Daiwa), raised funds to be “earmarked and allocated to finance a wind-energy project based in the Netherlands”, according to the deal’s launch announcement.

Bart van Dooren, head of funding and investor relations at BNG Bank in The Hague, says the issuer did a A\$36 million private placement linked to renewable-energy projects in 2018, but this is the first such deal under the agency’s Kangaroo programme.

The Kangaroo deal is not large but van Dooren says this is typical for the programme and BNG Bank has financed

several projects through this type of issuance. The agency’s larger sustainability-bond programme is linked to the Dutch municipalities and housing associations, but funds raised under that programme are not project-related.

“The demand for renewable-energy bonds comes because they fund specific projects. Some investors are unable to participate in our sustainability-bond deals because they are not project-related transactions,” says van Dooren.

The nature of a use-of-proceeds deal means the scope for increasing the size of this bond may be limited. Van Dooren says it would depend

on the pool and scale of BNG Bank’s renewable-energy projects, with investor appetite a secondary consideration.

James Holian, Singapore-based executive director and head of Asian syndicate and MTN at Daiwa, says the thematic bond product also helps access Japanese demand at the long end of the curve.

According to KangaNews data, the total volume of 10-year plus Kangaroo deals from supranational, sovereign and agency issuers in the second half of 2018 was lower than any recent year.

“Long-end Japanese demand waned last year due to hedging costs

becoming more expensive for Japanese investors and the inversion of rates between US and Australian dollars prompting a reallocation of funds,” says Holian.

He adds, though, that there is growing demand in Japan for socially responsible investment product. The type of assets BNG Bank has are well-suited to long-dated issuance, so this type of transaction can help secure the long-term bid.

Van Dooren says there are currently not many currencies outside of euros where long-dated funding is available. To be able to price a long-dated transaction in Australian dollars was a good opportunity for diversification.

overlay. However, he adds that investors are eager to buy the product for more reasons than a simple desire to add to their green portfolios. “Some are buying on the expectation that their dedicated green funds will grow or because they expect the product to perform well,” he tells *KangaNews*.

Oliver Holt, head of Australian dollar syndicate at Nomura in Singapore, says ADB’s deal gave investors the best of both worlds. “The funds are purely focused on the darkest-green projects which is the preference for ESG [environmental, social and governance] investors, while also allowing traditional investors into the order book,” Holt says. “This resulted in a materially larger deal than ADB’s peers have printed. As such, this is likely the most liquid green Australian dollar SSA to date and it will help cultivate further interest.”

Since the beginning of 2018, three of the four largest-volume, five-year SSA Kangaroo deals have been in green format (see chart 2). Jeff Grow, executive director at UBS Asset Management in Sydney, tells *KangaNews* it is encouraging for the market to see large-volume deals being printed.

“We are not particularly worried about liquidity as there is always a bid for green bonds in the secondary market,” says Grow. “But we would prefer to get set in the primary market so

that we can fulfil the wishes of our clients, rather than having to chase the bonds in secondary.”

## SOCIAL-BOND EVOLUTION

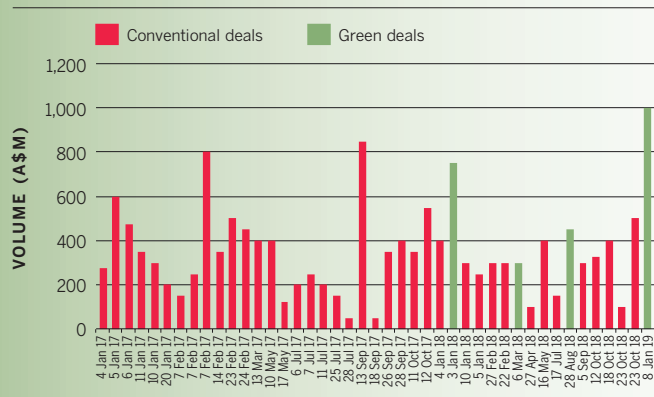
Increased product recognition helped IFC more than double the outstanding volume of its Kangaroo social bond via a first tap, which priced on 10 January. The A\$400 million increase was led by Commonwealth Bank of Australia (CommBank), Deutsche Bank and J.P. Morgan.

Deal sources say social bonds are starting to be viewed under the same socially responsible investment (SRI) criteria as green bonds, thus attracting a broader range of investors.

Marcin Bill, Washington-based senior financial officer at IFC, says the ADB deal paved the way for IFC’s social-bond tap. “There is clearly strong demand for themed product at the moment and market conditions have been quite conducive. This helped with execution,” he tells *KangaNews*.

Simon Rutz, director, European DCM origination at CommBank in London, adds: “Recent roadshows with SSA borrowers in Australia have been characterised by a clear emerging theme that SRI is a major growth area for much of the domestic-investor universe.”

CHART 2. FIVE-YEAR SSA KANGAROO DEALS, 2017-2019



SOURCE: KANGANEWS 11 JANUARY 2018

This is only part of the story, though. Johnston also highlights a high volume of redemptions in January and SSAs trading at favourable levels to Australian sovereign and semi-government bonds. In other words, he says, the demand picture is conducive for SSAs looking at vanilla deals as well as labelled issuance.

The Australian dollar investor base appears to be getting more comfortable with social bonds specifically. When IFC came to the Australian dollar market with its debut Kangaroo social bond in March 2018, the issuer told *KangaNews* that execution was more challenging than in a vanilla or green bond due to the emerging nature of the social-bond product and lack of clarity around qualifying assets.

Bill says investors now have greater understanding and recognition of social and sustainability bonds. Less work was needed on the issuer's part to educate investors around the deal's framework, use of proceeds and documentation.

However, Ryan Chamberlain, Australia syndicate at J.P. Morgan in Sydney, adds a cautious note. "We are seeing increasing interest in social bonds as a standalone category but this is more of a global story than being specific to Australia. With limited supply it is difficult to set up dedicated social-bond funds in Australia. However, with continued support from issuers the market should continue to grow."

Distribution of IFC's deal supports a global-demand story, as 70 per cent of the transaction was allocated to accounts in Asia. Of the rest, 26 per cent went to Australian investors and the balance to US-based buyers.

Johnston identifies two main factors which helped with IFC's second Kangaroo social-bond transaction. "Additional liquidity helps attract a deeper pool of investors. There is also continued development in the way investors are making decisions. Increasingly they have an ESG overlay, which includes social as well as green bonds. This helps with demand for the product."

The transaction was initially intended not to exceed A\$300 million, according to Bill. Demand facilitated an upsize and the final book totalled A\$520 million.

IFC's social-bond programme, which lends to "banking on women and inclusive business-eligible projects", has grown to nearly US\$1.5 billion from 25 transactions including its latest

Kangaroo deal. At the time of its inaugural Kangaroo deal, 10 months ago, the programme had less than A\$700 million on issue.

Despite the greater traction gained in Australia and globally, Bill says spreading awareness of the product is an ongoing task. "We would like to see the asset class grow including more engagement from ESG accounts. In Europe and North America these accounts are investing more heavily in public trades and it would be good to see this develop in Australia. The other side is that the market likely needs more supply for this development to occur," Bill tells *KangaNews*.

## TECHNICALS SUPPORTIVE

The success of the sustainable-bond transactions from ADB and IFC comes despite a more challenging year-on-year environment for SSA Kangaroo issuance. The Australian market proved to be challenging for SSA issuance in the second half of 2018, with unfavourable basis-swap levels curtailing supply.

Ruschpler reveals that pressure on Australian dollar spreads towards the end of 2018, owing to selling and a tightening bias in the US dollar market, made new mid-curve Kangaroo issuance very challenging. The opportunity for ADB's new Kangaroo deal came from the fact that Australian spreads had stabilised while US dollar spreads had moved wider.

Johnston says the market may not be as conducive in early 2019 as it was in the first months of 2018, when a whopping A\$4.8 billion of SSA issuance was priced according to *KangaNews* data. However, he adds that SSAs looked attractive compared with semi-government paper at the start of the year and were pricing historically wide on an asset-swapped basis.

According to Holt, the ADB deal also represented good long-term relative value against Commonwealth government bonds – a function once again of the opposing moves in US and Australian swap spreads.

This dynamic led to a larger-than-expected participation in the ADB deal from Asian accounts. Typically, mid-curve SSA Kangaroos – particularly green bonds – are favoured by domestic investors, and leads say these were the initial focus of the transaction. However, deal statistics provided by TD show that the majority of the book was allocated to Asian-based investors.

Bill, meanwhile, says the IFC deal attracted a good level of support from central banks and official institutions, some of which have expressed explicit support for the ESG asset class. He adds that the favourable spread to government bonds also encouraged participation from this investor segment.

Despite these improving technical factors, challenges remain for the SSA Kangaroo market. Holt points out that sterling and euro were particularly competitive for global borrowers at the start of the year, with some deals in sterling saving issuers 6-8 basis points compared with other global options.

According to Popovych, the Kangaroo market is open for borrowers that are prepared to take a strategic view. "The pipeline of the usual suspects is there, but some are struggling to get to their funding-cost targets at the moment." •

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# AUSTRALIA STILL IN VOGUE FOR **USPP INVESTORS**

**I**n late January, *KangaNews* hosted – with **MUFG** – its annual roundtable discussion with US private placement (USPP) investors and Australian issuers in Miami. Investors remain positive about credits from the Australasian region and see no reason for the record supply pipeline from Australian and New Zealand issuers in the last two years to decrease. In fact, the buy side points to its flexibility to structure deals to attract more issuance from the Antipodes. Issuers, meanwhile, emphasise the positive experiences they have had in issuing USPPs.

## PARTICIPANTS

■ **Alex Alston** Co-Head of Private Placements MACQUARIE INVESTMENT MANAGEMENT ■ **Jeff Behring** Director NORTHWESTERN MUTUAL  
■ **Frederick Echeverria** Managing Director and Head of Private Placement Group MUFG ■ **Paul Italiano** Chief Executive Officer TRANSGRID  
■ **Paul Lewis** Chief Financial Officer QUBE ■ **Lenny Mazlish** Managing Director, Fixed Income Securities CIGNA INVESTMENT MANAGEMENT  
■ **Ben Nolan** Head of Treasury and Financial Control PACIFIC NATIONAL ■ **Drew Riethmuller** Managing Director and Head of Corporate and Institutional Banking, Oceania MUFG ■ **Luke Stifflear** Senior Managing Director, Private Placements PPM AMERICA

## MODERATORS

■ **Peter Brooks** Director, Capital Markets Group, Private Placements MUFG ■ **Matthew Carr** Managing Director and Head of DCM Australia and New Zealand MUFG ■ **Samantha Swiss** Chief Executive KANGANEWS



## FERTILE GROUND

**Swiss** From an outside perspective, the USPP market did not seem to miss a beat in 2018. What was the tone like in the US?

■ **BROOKS** Last year was excellent for the USPP market. While official figures haven't yet been published, we're tracking total volume of around US\$80 billion – which is on par with the record year in 2017. From a geographical standpoint, US issuers made up roughly 50 per cent of total volume with issuers from the UK and Australia following at 15 and 13 per cent. Both these figures are broadly in line with the 2017 split.

Average deal size ticked up in 2018, to US\$280 million from US\$250 million the previous year. One of the trends we have been seeing is more 'mega deals' of US\$1 billion or more. There were eight such deals last year and more than 35 transactions that were larger than US\$500 million.

The market also saw a record month in June, which featured more than US\$12 billion of issuance via more than 40 transactions. This illustrates that a large number and volume of deals can be digested in a short amount of time.

■ **CARR** To add a further Australian perspective, in 2018 corporate Australasia issued US\$25 billion equivalent across capital markets – domestic and offshore, public and private. This was similar to 2017 from a volume perspective – slightly up from US\$23.4 billion. But what is noteworthy is that close to US\$10 billion of the total – just on 40 per cent – was done in the USPP market.

**Swiss** There is more interest than ever, in Australia and elsewhere, in the political and economic situation in the US. As of late 2018, there is arguably as much uncertainty as there has been for a decade. What is the local investor view?

■ **ALSTON** The world is a bit of a mess and the US is no exception. We are dealing with a host of things from geopolitical risk to trade tensions, and Brexit on the other side of the pond.

One thing that's true about the USPP market, and it's certainly true of our shop, is that we take a bottom-up approach to credit. We look at all the things going on in the context of each individual credit. As a result, our strategy doesn't really change.



■ **BEHRING** We are cautious but optimistic about the way the world is moving. We have been about 18 months away from a recession for five years now – it seems always just a year and a half in the future.

While we're cautious, we continue to build our portfolio from the bottom up with good businesses which have solid capital structures that can weather the cycle. We then work to build long-term relationships with our investments.

**Lewis** The bottom-up approach makes sense, but do you think the pricing or terms you'd accept for a credit would be different in a more favourable global environment?

■ **ALSTON** Pricing certainly ebbs and flows with the economic cycle. But one thing investors love about this market is that structure tends to hold pretty consistently. This is largely driven by the fact that the market is mostly comprised of life-insurance companies and pension funds that have pretty steady liability streams they are looking to match. Investors have a similar risk tolerance. As a result, the market is pretty disciplined with respect to structure.

■ **STIFFLEAR** I would offer a counterpoint. I think when we talk about pricing ebbing and flowing, this is much less volatile in the private market than what we see in the public market.

For example, at the end of November and beginning of December last year we saw credit spreads widen tremendously

"The allocation issue is certainly more challenging these days because the traditional life companies have increased their allocation to PPs. A lot of third-party money is also coming into the market through the traditional investor base."

**ALEX ALSTON** MACQUARIE INVESTMENT MANAGEMENT



in the public market, on a day-to-day basis. In the past two weeks we were buying a Baa1/A- rated brewer at 205 basis points over while a triple-B US domestic office-furniture manufacturer issued at 250 basis points over. If the furniture manufacturer had come in the private market, with a debt-to-EBITDA covenant, it probably would have got a margin of around 225 basis points.

We try to hold a steadier view of what relative value looks like over the longer term, rather than on a day-to-day basis. In the public market you see spreads widen and tighten much faster than what you see in our market. This is an advantage to issuers.

■ **MAZLISH** Economic conditions are clearly weaker than in 2018. The reality is, however, that we are 15-20 years away from what we would consider a normal downturn. When market participants see any economic weakness nowadays they are all trying to figure out whether this is the next crisis. This can create excellent buying opportunities, as was the case in Q4 2018 when pricing reached extreme levels that were vastly beyond what the fundamentals would justify.

While we are cautious on the macro outlook for 2019, even with recent spread tightening we're quite constructive because we think we're getting paid very well for what is a modestly weaker outlook.

We don't avoid risk, we manage it. Despite the weaker economic environment, our risk appetite has actually grown because we're going to invest through the cycle and right now we are getting paid better than we have in quite some time. Importantly, we saw no pressure on terms during the past up cycle. With the right structure – which we view as a foundational aspect of what we do – we will invest in the companies we choose in good times and bad.

■ **STIFFLEAR** The terms and structure aspect is definitely worth highlighting. This is the primary base we look at as a USPP investor. If I talked to our CIO or our clients a decade ago, I would have discussed pricing as the element that drove investors. Today, we are talking about three primary criteria for why we invest in the USPP market.

The first is structure. Second, credit diversification. Pricing is third – it is not the primary driver for us anymore. We don't have a budget under which we have to put a certain amount of money to work every year. Rather, our CIO tells us to invest if we can find good deals. If not, sit on the sidelines and we'll make it up in the public market.

■ **ALSTON** We are the same way. Relative value or price is not the driving factor – although it is a factor. As Luke Stifflear says, these assets diversify the portfolio and they offer covenant protection and structural benefits that are not available in the investment-grade public market.

However, when we look at each credit, the distinction we make is that structure is important but so is credit. We don't put structure ahead of the underlying credit because I don't think it's possible to structure away a bad company. We look at credit first, structure second. Price and relative value are typically the third consideration.

## US-AUSTRALIA MACRO VIEW

**Swiss** The most recent Federal Reserve (Fed) pronouncements certainly suggest a more cautious tone. What are investors' rate views and how do they influence strategy?

■ **MAZLISH** We will be surprised if there's any move on the front end because the outlook has clearly deteriorated. It's much harder to predict what will happen on the long end.

But honestly it does not affect our business very much – the 50-basis-point move down in US Treasuries took some of the wind out of our sails, but this was really at the margin.

We are assuming we will be range-bound but there's not a strong conviction and, as I say, it doesn't affect our strategy. We are flow investors. We have cash flow coming in that needs to be invested and while a declining base rate may tweak what we do on a single deal, it won't fundamentally alter our investing strategy for 2019.

■ **ALSTON** From the interest-rate perspective, our clients – the life-insurance companies – are looking to match assets against their liabilities. Those liabilities will move in the same direction as the assets, however rates move. This is the real driver for our shop. Yes, lower rates will affect how much yield we get in different deals, but job one is to make sure the assets and liabilities are matched.

■ **BEHRING** We are all doing something relatively similar, though perhaps for different reasons. Lenny Mazlish's comment that we are flow investors is consistent with our profile. While we would prefer higher interest rates, our goal is to generate outperformance relative to the public asset class alternatives via structure, credit selection and pricing.



"We build assets that go through multiple cycles and we know USPP investors want to invest through the cycles. There's a strong alignment. This allows us to build a story, a relationship and a strategy so investors understand what the business is doing over the longer term."

PAUL ITALIANO TRANSGRID



■ **ECHEVERRIA** MUFG's strategist was the first to call that the Fed should be more hawkish in hiking rates. He's also suggested that it shouldn't have hiked in December. His outlook is a little softer at macro level. He thinks the Fed will be cutting instead of hiking rates and he anticipates one or two cuts this year.

**Swiss** What about the macro view on Australia? How does this play into investment appetite?

■ **RIETHMULLER** The Australian economy is in a reasonably solid state. Underlying economic indicators – such as consistent GDP growth, historically low interest rates and continuing improving unemployment and participation rates – have helped deliver a stronger economy over the last five years.

We have also seen corporate balance sheets consistently deleveraging over the last three to five years through improved profitability off the back of a more robust economy.

We have seen a consistent level of M&A activity over the last few years which has been supported by a robust and broader debt capital market.

Another positive feature has been the significant privatisation programme of the New South Wales government over recent years. A significant quantity of proceeds from this process has been recycled by investing in new infrastructure assets like roads and rail. This investment has also helped deliver further job creation and fuelled further business investment.

Australia has a federal election coming up in the first half of 2019 and it is expected that there will be a change in government. There could be a dampening effect on forward M&A activity and certain boardroom decision-making until there is clarity on this front.

With regard to property, the residential market has cooled off over the last year or two. The commercial-property market, especially on the eastern side of Australia, has remained quite strong. This is reflected by historically high occupancy rates and low cap rates.

The commodity sector in general has also seen improvement over the last few years with falling mining investment coming to an end and price recovery across core sectors such as oil, gas, coal and iron ore. Overall, the Australian economy is in a strong position.



**Stifflear** What's your outlook on Australia's housing market, especially on the east coast where the decline has been greatest?

■ **RIETHMULLER** The view is that there is still a bit to come off on the eastern seaboard. This is different from the western part of Australia, where housing has been depressed for some time due to the mining downturn.

There has been a level of regulatory and government intervention nationally around foreign investment and limiting the level of investor lending. This has had a cooling effect on the housing market. The major banks have also tightened their lending criteria. There has been a range of interventions to control asset prices and credit availability.

"The Australian economy is in a reasonably solid state. Underlying economic indicators have helped deliver a stronger economy over the last five years. We have also seen corporate balance sheets consistently deleveraging over the last three to five years."

**DREW RIETHMULLER** MUFG



# USPP VERSUS **LOAN FUNDING**

If US private placements (USPPs) are Australian corporates' preferred bond format, their core debt-funding option remains bank debt. The loan market is changing but continues to provide ample liquidity and attractive pricing.

■ **CARR** We've talked about USPPs versus other debt capital markets. How does relative value stack up in comparison with the bank-loan option?

**RIETHMULLER** Last year the loan market was about four times the issuance volume of all debt capital markets for Australian issuers. Loan volume was up close to 20 per cent year-on-year. We have seen a broadening of the bank-loan market in the sense of increased appetite from foreign lenders in Australia, as well as more activity from Asian banks offshore.

There is also an increasing level of interest offshore for longer tenor. The local bank market is predominantly a five-year market, going up to seven years. But we've seen a growing level of appetite in Japan, which can see tenors out to 15 years with similar pricing to the USPP market. The Japanese investor base, primarily of banks and insurers, continues to grow and is broadening the range of sectors it will invest in.

The loan-market product is also reasonably straightforward and consistent to existing documentation with certain structural advantages.

■ **SWISS** Is the Japanese loan market providing strong competition to the USPP market for Australian corporate borrowers?

**RIETHMULLER** Yes, although size is an issue in Japan. Issuers won't get the same size of funding out of the Japanese loan market as they can get in the USPP market. There is definitely a greater level of liquidity in longer tenors in the USPP market and also broader investor appetite across different sectors.

Having said this, the market is evolving and the Japanese

regional banks and insurers are receiving greater investment allocations particularly into Australian dollars. This will help support future issuance.

■ **CARR** All the issuers here today have conducted refinancings in the bank market in the last 12 months. What are issuer observations on bank versus bond financing, especially around cost, tenor and availability of liquidity?

**LEWIS** There's still very attractive pricing in the bank-loan market. We recently saw – for the first time – multiple offers for seven-year bank funding at margins well within those of the USPP market, with all the flexibility of bank debt.

We're not sure whether this is now a permanent feature of the market or whether it just reflects the cycle we're



**"THERE'S STILL VERY ATTRACTIVE PRICING IN THE BANK-LOAN MARKET. WE RECENTLY SAW – FOR THE FIRST TIME – MULTIPLE OFFERS FOR SEVEN-YEAR BANK FUNDING AT MARGINS WELL WITHIN THOSE OF THE USPP MARKET, WITH ALL THE FLEXIBILITY OF BANK DEBT."**

**PAUL LEWIS** QUBE

## USPP MARKET OUTLOOK

**Swiss** Back to the US, what has been the impact of corporate tax cuts on local companies' debt profiles? We understand that windfalls have been used to retire debt and, even if this hasn't happened, presumably tax cuts reduce the marginal draw on credit markets. Has the tax situation curbed domestic supply in the USPP market and thus caused issues like tighter spreads and bidding down terms and conditions?

■ **BROOKS** Tax changes have affected US-based multinational issuance, especially in the healthcare and industrial sectors. The primary driver is that these companies were able to bring back cash that was trapped overseas so they are generally in debt-paydown mode. We have seen a slight decline in US corporate issuance as a result.

■ **STIFFLEAR** I was in favour of the corporate tax cuts. But I have been a little disappointed in domestic US corporate issuance in the private market. I thought there would have been more expenditure on M&A activity and capital expenditure for equipment. My feeling is that most of the money went to share buybacks and then to wages. This of course doesn't help corporate-debt issuance.

The equity-market spike we saw last year will be difficult to replicate in the next few years. I think it will be steady sailing for the foreseeable future.

■ **MAZLISH** I agree, which is why I think we're facing a weaker outlook. Last year saw double-digit growth in earnings that was mostly tax-driven and supported by very aggressive stock-buyback activity. On the other hand, there hasn't been any noticeable impact on deal structures – certainly less than I expected given the very robust level of issuance.

■ **ECHEVERRIA** I agree with Peter Brooks – we've seen fewer deals due to companies being in debt-paydown mode. But it is

in. The seven-year bank-loan market is certainly not as deep as the USPP market and therefore only makes up a relatively small part of our overall financing mix.

What we have seen is a big change with our domestic banks, which are trying to reduce their funding and have put up their pricing. Asian banks, on the other hand, are being quite aggressive on pricing.

There's still plenty of liquidity at attractive pricing for the right credits, and it hasn't been affected yet by global dynamics. Everyone is talking about funding pressures and therefore pricing increasing, but from our perspective it hasn't happened so far.

**RIETHMULLER** Looking at the big-four Australian banks, the return metrics for their retail businesses are at a premium to their institutional businesses. We're seeing a level of capital move from institutional books into retail books.

The other thing that has happened locally is the Royal Commission into Misconduct in the Banking, Superannuation and Financial-

services Industry. This has taken a lot of management time from the big four.

Most have been rationalising different parts of their wealth and banking businesses to focus on more traditional retail businesses and leaner institutional businesses. These dynamics will raise opportunities for offshore funding and foreign funders.

**NOLAN** We did a bank refinancing at the back end of last year. We got very good pricing and we were able to refresh our liquidity lines completely. This is great as it gives us plenty of flexibility in the short term – particularly for capex and acquisition.

However, as a long-dated infrastructure asset we still see the need for long-dated debt. I'm not seeing the bank market as competing. It's complementary.

**ITALIANO** We also refinanced in the bank market at competitive rates last year. This gave us a breather as we are three years into a privatisation. However, like Pacific National, ultimately tenor will always be important for us.

just transaction volume that has been affected – deal structure hasn't weakened or changed. Having said this, despite the record volume in the PP market last year, we would like to do more volume – the constraint is on supply rather than demand.

■ **ALSTON** The difference between a buyers' and a sellers' market in USPPs is spread. As we've said, spread ebbs and flows over the cycle. But the investor base remains pretty adamant about structure.

■ **ECHEVERRIA** Having said this, investor response in the private market is different from the US public market. PP investors never say they are not buying deals. The worst they will say is that spreads are elevated and this is what they need for relative value. On the other hand, in the public market there are go and no-go calls and issuers might decide not to venture into the market based on pricing or other factors.

Private investors take a longer view on relative value. In the 15 years I've been working in this market, I've never heard an investor say they are not open for business.

■ **BEHRING** Part of the reason for this is that we are buy-and-hold investors with a long-term horizon afforded by our extremely long liability structure made up primarily of participating whole-life insurance policies.

We do rather rigorous analysis prior to making a new investment because we can't expect to be able to sell the investment prior to maturity if the original thesis does not hold. We have to complete solid due diligence and make the right credit call so the portfolio can perform well without the expectation of trading activity to drive returns. The bulk of the relative value we provide our policyowners is from the upfront analysis that drives our credit selection.

This is why, when a deal comes to market, we initially look at the combination of business profile and structure. We would often rather take the right business and structure combination over extra basis points for a weaker credit with limited structure, because doing so provides downside protection.

This is one of the reasons we're open for business through the cycle. As long as a company's competitive position and the management team in which we have invested remains intact, we should be comfortable having made the investment regardless of the point in the economic cycle.

■ **ALSTON** It's basically the difference between our market and a total-return portfolio where prices are getting marked every day. Insurance companies don't have to do this.

■ **STIFFLEAR** That's right. It's about how the performance of the investment manager is measured. We are primarily a capital-base performance manager with total return coming second. This is different from some colleagues that run total-return public funds that won't buy a bond if it is not in the index, no matter how good the company or the structure is. I think this makes a big difference.

As Jeff Behring says, the public desk has a lot of inflows and outflows. Our total-return guys can have a lot of money

“Investment-grade debt returns don't justify taking unhedged currency risk. Earning a 3-5 per cent coupon on an investment while facing potential negative currency moves of 10 per cent or more is a poor investment decision.”

**JEFF BEHRING** NORTHWESTERN MUTUAL





# ISSUER PLANS IN DEBT MARKETS

Australian corporate issuers are spoiled for choice in global debt markets. With limited capex needs, issuance is likely to be sporadic – but borrowers say a fair share at least will be in US private placement (USPP) format.

■ **CARR** What are Australian corporates' issuance plans for 2019 and which markets do they expect to be in the running for any debt issuance that eventuates?

**NOLAN** Our next capital-markets maturity is not until September 2020. With the liquidity we have, the next 12-18 months look pretty comfortable. This won't stop us looking around and trying to open up markets. But our approach in the next 12 months will be opportunistic.

**ITALIANO** We unapologetically have two

futures. We have a business-as-usual (BAU) future while at the same time the Australian energy market is undergoing quite a significant period of transformation. If it continues this journey, we have the potential for A\$5 billion (US\$3.6 billion) of capital expansion in the near future. This will throw our existing capital plans up in the air – we will need to restructure and take a different course.

If that doesn't take place, it will be BAU for us. There's quite a significant fork in the road ahead that's dependent on energy-market policy. With a

New South Wales state and a federal election coming up in the next six months, policy could make a really big difference to our plans.

What we like about the USPP market is that we can come and talk to investors about this, and be upfront about it. If we do hit the market it won't be a surprise.

**LEWIS** We have plenty of liquidity at the moment. In the medium term, as our Moorebank major development progresses and we build warehouses with 10-year-plus leases, it will

make sense to have longer-term funding in the capital markets to match these assets and income streams. As a result, we will look at capital-markets options including further USPP issuance.

Our associate, Patrick, which we own 50 per cent of with Brookfield, is a nearer-term possibility for capital-markets financing. Patrick is currently going through the process of refinancing its bank debt – a process which should be complete early this year.

Once this is done and Patrick has the right pricing and terms in the bank market, shareholders and management will assess whether capital markets make sense to establish longer-term funding. As an investment-grade-equivalent credit that's not rated, the USPP market will be front of mind for consideration.

to invest one day and be dry the next. This inconsistent flow of investable cash would be difficult for the PP market where marketing and circles can be two or three weeks.

I also think the PP market is very efficient for issuers. It is barbelled by the public market on one side and, to a lesser extent, the bank loan and 144A markets on the other. We have a niche between the two, for deals of between US\$200 million and US\$1 billion or somewhat larger.

Some telecom borrowers issue US\$50-60 billion at spreads 50-60 basis points behind where their current public bonds are trading. This is because they have to raise so much money. We don't necessarily see this in our market, because generally our issuers don't have the same hurdles to meet.

■ **BROOKS** That's a good point. If you think about what could potentially characterise a market as a buyers' or sellers' one – especially on the public side – it is the new-issue concession required. This is extremely volatile in choppy market conditions. It's something we see less of in the USPP market,

which generally offers a relatively consistent concession over a company's public bonds – or the public bonds of similarly rated companies.

■ **MAZLISH** If you think about the two distinguishing characteristics of our market, one is non-US dollar funding – which is a big deal for Australian issuers – and the other is delayed funding. Both aspects are not interesting for investors – we have no natural reason for either.

The reason these options have evolved to become as common as they are is because investors have been willing to meet issuer needs in order to induce them to access our market. This has driven significant growth and is of material benefit to issuers and investors.

**Swiss** Does this suggest its difficult to get allocations?

■ **STIFFLEAR** Yes. It's what I was talking about before with the barbell concept. If a company needs to issue several billion



"We were one of a handful of issuers to access the Reg S market in 2018, but for 10-year issuance that market is for all intents and purposes closed at the moment. The flexibility of the USPP market and the fact that price doesn't move much day-to-day are hard for issuers to ignore."

**BEN NOLAN** PACIFIC NATIONAL

“We have seen more 20-30 year Australian dollar issuance as a growing number of investors have the ability to lock in very long-dated cross-currency swaps. Flexibility from investors on long-dated tenors has opened up a new part of the Australian dollar curve.”

PETER BROOKS MUFG



dollars or more at one time, our market is not the greatest and the company will probably need to look at alternative markets. This is what makes allocations on our end more difficult.

■ **MAZLISH** Allocations for plain-vanilla transactions are worse than ever. What we have done is offer structures like non-US dollar funding to gain a competitive advantage. We use this type of structure as a competitive tool and receive significantly better allocations when we do.

We are also an off-the-run investor and are willing to do things other investors might not. For example, NAIC-3s – noninvestment-grade companies – are a big part of what we do. Last year these comprised about 25 per cent of our volume. We are a very consistent player in this market and it has been a steady source of attractive yield for our portfolios.

■ **ALSTON** The allocation issue is certainly more challenging these days because the traditional life companies have increased their allocation to PPs. There’s greater demand and a lot of third-party money is also coming into the market through the traditional investor base.

On the supply side, agents consistently tell us it’s constrained because we are unwilling to give up our requirement for covenants. But that just is what it is. There is a squeeze, though – allocations are challenging.

What we try to do is find additional allocation from complexity. We will quite happily dig into a deal that’s far more complex. I don’t want to say it’s riskier – I want to say more complex. This is an area where we can sometimes get better allocations and pricing.

■ **ECHEVERRIA** On the allocation side, for a US borrower that is a registered company and needs US\$300 million or more, the public market can do this very efficiently without any structure. That market’s volume has been north of US\$1 trillion over the last two years. The companies that access the PP market are non-US borrowers that don’t want to register with the

Securities and Exchange Commission. They are infrequent issuers or US companies that don’t need such big volume. Each investor in the room today could buy US\$200 million in any one transaction, so the deals are typically well oversubscribed.

As a result, allocations are challenging. But Alex Alston is right – investors who roll up their sleeves and dig into the more complex transactions are able to find extra allocations and extra relative value.

## RELATIVE PRICING

**Carr** Let’s look at relative-value pricing comparisons to public markets, particularly as some global markets have become dislocated from a pricing perspective. How does this figure into investment decisions?

■ **ALSTON** This gets into the art part of relative value and comparables. There’s no shortage of ways to look at it. We can look at public companies that have debt in the UK and US markets, get a basket of these companies, see what the pricing differential is and apply it to the issuers’ public bonds. It’s all about finding a way to normalise it.

■ **MAZLISH** We buy 144As as well as PPs. One of the things I push very hard on internally is that we need to have some view of the comps and how we feel about them. Very often the analyst will put together a bid sheet with four comps but we don’t own bonds in any of the comps. It’s not very helpful to say we are getting 20 basis points over deals we would never own.

On the other hand, we might see a deal with four comps where we own US\$50 million of each. We might feel very good if we are getting 10-15 basis points over those comps. The bottom line is there’s more nuance around relative value than a snapshot number might suggest.

“I think when we talk about pricing ebbing and flowing, this is much less volatile in the private market than what we see in the public market. We try to hold a steadier view of what relative value looks like over the longer term, rather than on a day-to-day basis.”

LUKE STIFFLEAR PPM AMERICA



## USPP AND **SUSTAINABLE FINANCE**

The US private placement (USPP) market has seen some activity in green-bond format, including deal flow from Australia. Investors say sustainability is moving up the agenda, but suggest it is yet to become a formalised aspect of the buy-side process.

■ **SWISS** Can the investors give some insights into the degree of interest in and uptake of sustainable or environmental, social and governance (ESG) investing in the USPP market, in their experience? The insurance sector in Australia is one of the industry leaders in applying long-term sustainability overlays to investment mandates – is the same true in the US?

**ALSTON** Macquarie Investment Management has a big focus on ESG. It's also implicit to our process within the PP platform. The reason I say this is there's a large part of ESG – especially

the 'G' – that is part of any decent credit underwriting.

The 'G' part covers management governance, integrity and how 'good' companies are. On the 'E' and 'S' side, it varies from company to company. But we would always be concerned about any environmental-health liability exposure.

The approach is not formalised within the PP group. But we recognise that ESG is becoming increasingly important to some investors in Europe and Australia. My suspicion is that it will become a more overt part of our process.

**BEHRING** ESG is not currently an actively-managed KPI for us. We have invested in green bonds, we like the good they do and we have done quite a bit of sustainable-energy investing. However, it's not a formal part of our decision parameters.

I agree with Alex Alston, though – looking at ESG factors is part of good underwriting, even if it's not formalised.

**ECHEVERRIA** The whole issue of ESG is definitely something that is getting more prominence. We haven't seen enough green demand to change market dynamics – it's still the marginal

dollar from USPP investors that is driving pricing. Having said this, sustainable financing has accelerated a lot more than I would have thought. We do a lot of renewable project financing. It will get to the point where there are dedicated funds with a mandate to invest in socially responsible credits.

But with the size of the USPP market at US\$80 billion and the public market at US\$1 trillion, we will need a lot of socially responsible funds to start influencing the relative-value decision.

■ **CARR** Renewable energy is a hot topic in Australia.



**"WE HAVEN'T SEEN ENOUGH GREEN DEMAND TO CHANGE MARKET DYNAMICS – IT'S STILL THE MARGINAL DOLLAR FROM USPP INVESTORS THAT IS DRIVING PRICING. HAVING SAID THIS, SUSTAINABLE FINANCING HAS ACCELERATED A LOT MORE THAN I WOULD HAVE THOUGHT."**

**FREDERICK ECHEVERRIA** MUFG

■ **STIFFLEAR** Our investment strategy is similar. We are about relative value. We will buy the right credit down to levels over public deals, but only for public deals we own and like.

I believe it detracts from the process when an issuer has a 144A bond outstanding that is not included in the comp sheet from agents. Bankers will make a fair point by saying it's not on there because you can't buy it. But we will go and do the exercise about whether we can buy the bond. We may only be able to accumulate US\$7-8 million a week. But if it's 50 basis points behind where the PP is coming we will buy the public bond.

Relative value and identifying a good comp set are more an art than an exact science. In any event, comparable bond sets need to include bonds we own or would buy and not bonds we have passed on because we do not like the credit or pricing.

**Brooks** That's a good point for the US 144A market. But do investors ever look at the US

dollar Reg S market in Asia as comparable for relative value?

■ **BEHRING** We do not.

■ **MAZLISH** I struggle to understand why issuers would do Reg S deals rather than 144As. We buy 144As but we can't look at Reg S bonds because we don't have an overseas office. The Reg S market has been so dislocated since 2017 that it has made relative value very challenging to use those bonds as PP comps.

■ **STIFFLEAR** It's tough for an issuer that has a stranded 144A out there, that may have been done seven or eight years ago and the mark on it is 50 basis points wider than it should be. But we will look through this when we can't actually buy the bonds.

■ **MAZLISH** In circumstances where there are orphaned 144As, it helps when the issuer offers a structure that is in line with what they offer their banks. This means we can differentiate the bond in a way that allows us to justify some level of tightening inside the theoretical offer level of the orphaned public bond.



## Paul Italiano, what is driving sustainable generation in Australia?

**ITALIANO** The fundamentals of the Australian energy market are vastly in favour of renewables. We are one of the few, if only, markets in the world where offshore wind makes no sense because the opportunity cost for onshore is so positive. We have a lot of land space, sun and wind, along with very low peak demand.

The ability to service our energy needs from renewable generation is naturally quite strong. When you couple this with investors' general wariness about the longevity of coal, you have all the ingredients for a preference for renewable generation in the Australian market.

We are looking at this already, even in our organisation. We recover our capital cost over a 50-year period. When we make an investment on a connection asset, we need to make sure the asset will be required in 50 years' time. This is a very different question when you're looking at a coal-fired generator versus a renewable one. The investor appetite, while not

huge, is driving a small price difference for capital. It's also already driving some of the investment decisions in the Australian energy market.

## ■ SWISS Have you got to the point where your treasury is involved with sustainability teams?

**ITALIANO** We include sustainability but not from a philosophical position. We deal with it from a fundamental risk position – particularly the 'G' part of ESG. We look at whether an asset will be able to wash its face over its life. We deal with this through the investment committee rather than through treasury.

**LEWIS** We raised A\$150 million (US\$108.5 million) through the Clean Energy Finance Corporation (CEFC) based on the environmentally friendly aspect of Moorebank. I understand this was the first corporate lending the CEFC did.

As an organisation, we try to be environmentally friendly in how we manage our business, and as an Australian Securities Exchange top-100 company there's increasing focus on ESG. But it doesn't drive our treasury policies.

■ **NOLAN** The reason an issuer would do a Reg S only deal is that it can be done off an existing EMTN programme, and the cost and time to do so is far superior to doing a 144A transaction. Ease of execution and cost were huge drivers for Pacific National to do a Reg S only transaction last year.

You can say the same positive things about the USPP market, though. The cost and ease of execution to do a USPP deal is far superior to doing 144A.

■ **STIFFLEAR** Talking about time and effort in the USPP market, I want to bring up the point that Australia is a long distance from us. If we only get financials every six months, it's more difficult to monitor than quarterly financials. I think investors' monitoring for an Australian issuer is much more important than it is for a US-based issuer.

Australian issuers generally do a good job of keeping US investors informed. They stay in front of us – and many of us also stay in front of them. This is because there's a heightened level of sensitivity when we invest in an Australian issuer.

■ **NOLAN** I'm very conscious of this. Whichever market I've been in, I've always made the effort to keep in contact with investors regularly. Taking the time and effort to keep in touch is not that difficult and it should be bread and butter for most Australian issuers.

■ **ALSTON** Like other investors, we value company updates. Although, being headquartered in Sydney, we may enjoy a marginal advantage on the rare occasion when company updates are less frequent.

■ **BEHRING** We greatly appreciate management teams' efforts to keep us in the loop. Australian and New Zealand management teams are better than average, which helps build relationships for a longer period of time. It also provides easier access for issuers, particularly when markets are more difficult. The USPP market is more open for issuers that have had more frequent and regular conversations because investors understand their businesses and have an ongoing relationship.

■ **ECHEVERRIA** From the agents' perspective, when we talk to an issuer for the first time we lay out four steps for accessing the USPP market. First is preparing the offering documents, followed by marketing the transaction. Then it's pricing and closing the documentation. Finally, optional for issuers, is to stay in touch with investors.

The fact that issuers are being proactive to stay in touch is much appreciated by investors. It also makes it much easier for investors and issuers if there's a technical amendment to be made.

■ **ALSTON** I would add that sometimes there may be few investors on an update call, but most are probably interested in the update. It would be great if a replay is always offered for investors who can't make the call.

■ **MAZLISH** Issuers should view investor updates as an act of self-interest, since 80 per cent of our volume is repeat issuance. A repeat issuer will have a much easier go of a follow-up transaction if the last update we had from them was six months ago as opposed to six years ago when they did the last deal.

## ISSUER PREFERENCES

**Carr** The characteristics of the USPP market that have been described fit very well with the profile of many or even most Australian issuers. Only a handful of Australian companies have capital-markets requirements north of A\$1 billion (US\$723.3 million) a year. The great majority have funding requirements of between A\$200 million and A\$1 billion. A lot of conversations we have are with issuers that are weighing up the Australian domestic option versus USPP. What are the issuers' views on the relative benefits of these two markets?

■ **NOLAN** This conversation has been great. Although Pacific National hasn't been in the USPP market, with the positive



factors mentioned today it's hard to ignore this market. There are good reasons the USPP market was the most accessed option by Australian issuers last year.

We were one of a handful of issuers to access the Reg S market in 2018, but for 10-year issuance that market is for all intents and purposes closed at the moment. The flexibility of the USPP market and the fact that price doesn't move much day-to-day are hard for issuers to ignore.

The thing we would need to get our heads around if we decided to issue in the USPP market is what structure the deal would need to have.

■ **LEWIS** We accessed the USPP market recently and one of the key things we were looking for when thinking about diversifying our funding sources away from bank debt was to have confidence that the market would be there for repeat issuance or refinancing in the future.

In our experience, I don't think the domestic market has yet proved that it will be there in challenging cycles. With the USPP market, while pricing may change in challenging times, at least we know it will be possible to issue.

We have done some opportunistic funding – such as an Australian Securities Exchange-listed subordinated note. At the time this was the right opportunity to take advantage of low interest rates and investors' desire for yield. But we didn't do that deal thinking the same market would necessarily be there for us at the time of refinancing.

By contrast, the USPP market was a core part of our financing structure and certainty of issuance was a key driver in our decision to choose this market.

■ **NOLAN** I'm not one to bag the domestic market. But it comes down to total issuance size. Most companies will find their cap in the domestic market well before they reach a limit in the USPP market. As a treasurer you couldn't recommend going back to the domestic market only.

The diversification play often comes first when choosing to issue in a market like USPP, but it's well grounded in the sense that companies have a far bigger cap in this market.

It's also a big advantage that the USPP market is now offering Australian dollar funding – it's probably the only other market in the world that will do this.

■ **ITALIANO** From our point of view it is the availability of longer-tenor debt and the continuity of investors in the USPP market that appeal. We build assets that go through multiple cycles and we know USPP investors want to invest through the cycles. There's a strong alignment. This allows us to build a story, a relationship and a strategy so investors understand what the business is doing over the longer term.

We do also support our domestic market, but by its nature it is shorter-term focused and it's harder to build those stories over time.

■ **NOLAN** I agree. Corporates can issue up to 10 years in the Australian domestic market, but the sweet spot is 5-7 years. In the USPP market you're starting at 10 years.

**Carr** Non-US dollar currencies including Australian dollars have been available from USPP investors for several years. The number of Australian-origin deals that take advantage of this facility – and the proportion of Australian dollars in multicurrency deals – has increased markedly in the past couple of years. How do investors manage this internally, given most of them don't have natural need for Australian dollars?

■ **MAZLISH** When we buy Australian dollar bonds, our funding currency isn't the same as how we view our investment. This creates internal reporting and accounting issues that need to be dealt with.

However, it is a relatively seamless process once the systems are in place. At this point the only issue is when our portfolio



"Non-US dollar currencies including Australian dollars have been available from USPP investors for several years, but the number of Australian-origin deals that take advantage of this facility has increased markedly in the past couple of years."

**MATTHEW CARR** MUFG

group gets worried about swap exposure. To date, this has not been an issue despite very significant growth in these exposures since 2015.

■ **BEHRING** I agree with this to a certain extent, in that we have also been rather active in the non-US dollar market. We do this synthetically and we charge a bit more due to the costs and even higher illiquidity – you can't trade these bonds easily.

We are active investors and have a measured view taking into consideration multiple factors including our level of exposure, the availability of swap counterparties and other regulatory considerations.

■ **STIFFLEAR** PPM America's strategy is twofold. First, it was about putting the systems in place – which was more difficult than I thought it would be. It took almost a year to put everything into place, because we are a total-return manager and we measure each security on a daily basis. Having the swap and the security measured daily for total-return performance was difficult.

Second, when I asked for approvals to do cross-currency swaps we acknowledged that there is less liquidity for currency-swapped bonds. As such, our strategy is to manage a position such that we'll have half our targeted hold size for a company in US dollars and the remainder in other currencies to allow us to get better allocations.

Since I originally developed this thesis, we've seen more and more issuers borrowing just in their local currency with no US dollar tranche. This is different from the multicurrency deals that were being done even 18 months ago. The market has become deeper such that issuers don't need to do anything in US dollars.

Due to the liquidity of the bonds, with synthetic bonds we're still looking for a hold size of around 50-60 per cent of what it would be if it were a straight US dollar bond.

**Carr** For the issuers, what's your decision-making process about how to allocate a deal when you have both Australian and US dollars on the table?

■ **LEWIS** For us it's pretty simple. The majority of our earnings are in Australian dollars so, ultimately, we are looking for the most cost-effective way of getting back to Australian dollar funding on the terms we want. All things being equal, our preference would be natural Australian dollar funding, but we do look at the all-in cost.

■ **NOLAN** I agree – it's about looking at the all-in costs. We can do the maths on paying a little more for local-currency funding relative to a US dollar transaction. I don't tend to think swap-breakage language is concerning – I think issuers should view this as if they have done the swap themselves. It's just that someone else has done it for you – and at a potentially cheaper cost than you could do it.

■ **BROOKS** We have also seen more 20-30 year Australian dollar issuance as a growing number of investors have the ability to lock in very long-dated cross-currency swaps. This is evidenced by recent transactions from Sydney Airport, Adelaide Airport and New South Wales Ports. Most of these issuers are unable efficiently to execute swaps beyond 15 years, so flexibility from investors on long-dated tenors has opened up a new part of the Australian dollar curve.

■ **ALSTON** This is a perfect snapshot of the background. Initially companies would do deals in US dollars and swap the funds themselves. But institutions in the private market realised they could provide swaps more cheaply and for longer tenor than the issuers could. We offered to do this as a courtesy in exchange for the issuers paying us the swap fee. The most recent evolution has been that the fee has started disappearing.

Now we're being asked to keep the interest-rate risk as well. We want to work with issuers but we don't have natural sterling or euros. It will be interesting to see how this shakes out, because some shops are willing to take on the interest-rate risk as well.

■ **ECHEVERRIA** It's a valid point. But our observation is that some investors see this as a competitive advantage and a means to differentiate themselves – by doing transactions without swap breakage.

■ **BEHRING** Investment-grade debt returns don't justify taking unhedged currency risk. Earning a 3-5 per cent coupon on an investment while facing potential negative currency moves of 10 per cent or more is a poor investment decision.

Indemnification for swap-breakage costs is important to protect investors from costs that are outside their control. For instance, if a company repays its debt due to a change-of-control event and investors are forced to pay the resulting swap-breakage costs, we've just eliminated a meaningful portion of our original return.

While some issuers would prefer not to provide swap breakage, taking this approach leads to a smaller potential investor base and is likely to result in a higher overall coupon. •

"While we are cautious on the macro outlook for 2019, we're quite constructive because we think we're getting paid very well for what is a modestly weaker outlook. We don't avoid risk, we manage it. With the right structure we will invest in the companies we choose in good times and bad. "

**LENNY MAZLISH** CIGNA INVESTMENT MANAGEMENT





[COVER STORY]



**NEW**  
**ZEALAND**  
DEBT MARKET  
EYES A  
**SHAKE-UP**

Proposed new capital requirements for New Zealand's banking sector are causing consternation in the local debt market as participants grapple with a raft of potential implications. The consequences for the fixed-income sector – intended and unintended – are potentially game-changing and are relevant to sectors as diverse as the high-grade Kauri market and corporate debt.

BY MATT ZAUNMAYR

**O**n 14 December 2018, the Reserve Bank of New Zealand (RBNZ) released a consultation paper reviewing the capital-adequacy framework for registered banks. This recommends increasing the required tier-one capital ratio for local domestic systemically important banks (D-SIBs) to 16 per cent from 8.5 per cent and for other registered banks to 15 per cent (see chart 1).

The proposals also recommend changes to the calculation of risk-weighted assets. Banks that are internal-ratings based (IRB) accredited – the New Zealand majors – will also be required to use the standardised approach methodology for credit exposures that have an external rating. This includes exposures to other banks, sovereigns and large corporates.

The RBNZ proposals set out a floor of 85 per cent applied to outputs from IRB models. The reserve bank estimates that this will result in a 15.5 per cent lift in risk-weighted assets (RWAs) for IRB banks. The already increased capital-ratio requirements would be against this likely higher calculation of RWAs.

The RBNZ says the changes are first and foremost designed to ensure stability in the local banking system, while levelling the RWA playing field between the major banks and the rest of the sector is another consideration (see p45).

According to the RBNZ's consultation paper, the 16 per cent capital ratio is the point identified where “there is enough capital in the system as a whole to cover losses that are so large they might only occur very infrequently”.

This is clearly the outer frontier for capital requirements. The RBNZ also states that “at a tier-one capital ratio of 16 per cent there would be little room to increase stability further without some impact on expected output”.

There can be no doubt that, if implemented, the RBNZ proposals would put New Zealand's banks at the top of any global capital comparison. A report prepared by PwC for the New Zealand Bankers' Association in October 2017 estimated “large, internationally active banks” to be running average total-capital ratios of 14.7 per cent. New Zealand's big four were at levels in the range 12.5-13.5 per cent, but stricter local rules led PwC to estimate that around 6 per cent could be added to the New Zealand totals on an internationally comparable basis.

Extrapolating to the latest RBNZ proposals, while the New Zealand banks might have to add just a few percentage points of capital, this could place them at more than 20 per cent total capital when internationally harmonised – especially given the further ramping up of RWA standards.

There are a myriad of implications that such a capital raising might have for New Zealand's banks as well as the wider debt capital markets and economy.

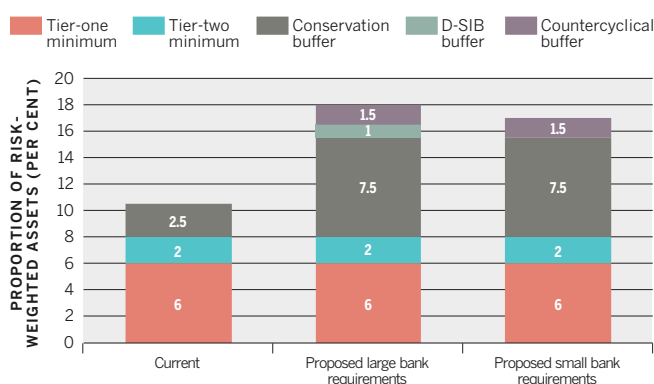
BNZ's Wellington-based head of research, Stephen Toplis, tells *KangaNews*: “Capital requirements have been consistently raised since the financial crisis so we have an understanding of what the possible implications are. But we do not really have a working understanding of what the consequences might be from the degree of shift being proposed.”

Furthermore, the RBNZ is insisting that new capital come in the form of common-equity tier-one (CET1) rather than any form of additional capital – which the reserve bank believes does not contribute to the safety of a bank.

How exactly New Zealand's major banks would raise the equity required under the proposed changes is one of the key aspects of the debate, given the banks themselves are owned by Australia's big four and therefore do not have the capacity to issue their own shares.

Ross Pennington, Auckland-based partner at Chapman Tripp, says there are a few ways the banks could meet

**CHART 1. RBNZ PROPOSED CAPITAL REQUIREMENTS**



SOURCE: RESERVE BANK OF NEW ZEALAND 14 DECEMBER 2018

## IN LOCO PARENTIS: AUSTRALIAN MAJORS AND KIWI CAPITAL

Increased capital requirements on the New Zealand majors could affect their Australian parents. Whether the Australian banks will subsidise incremental capital accumulation in New Zealand is unknown, however – as is any changed impact of more capitalised subsidiaries at group level.

Specifically, it is unclear how the Australian Prudential Regulation Authority (APRA) would view increased capital in the New Zealand banking system. Under current Australian regulation, more heavily capitalised New Zealand subsidiaries would not contribute to an improved group capital position.

A Westpac Institutional Bank (Westpac) research note states that “at this point, capital held at subsidiaries does not [affect] level-two bank reporting with the banks’ exposure to their subsidiaries recognised through a 400 per cent risk weighting. Therefore, the increased New Zealand capital has no benefit for the parent”.

APRA is playing its cards close to its chest. A spokesperson declined to comment to

*KangaNews* beyond saying the regulator is still determining how the proposed changes in New Zealand will be treated under the Australian capital framework.

A range of proposals for consultation on capital are currently in process, meaning plenty of potential moving pieces. The Australian regulator says the possible New Zealand changes will be considered as the Australian capital framework is finalised in the coming years.

Some analysts are prepared to predict a negative response should the Australian majors seek further to support their subsidiaries’ capital positions. A UBS research note says: “APRA is likely to be uncomfortable with substantial amounts of capital being transferred out of Australia

and into New Zealand. This would reduce the amount of capital available in the level-one businesses which is available to protect Australian depositors.” It adds that this may place compliance with APRA’s “unquestionably strong” requirement at risk.

Higher capital requirements in New Zealand could have a wider impact on the value of the subsidiary businesses to the Australian big-four bank groups. The Westpac note suggests: “The sharp lift in capital requirements will result in a significant erosion of return on equity across all [affected] business lines and the bank more broadly and therefore the parent is likely to review existing capital allocation.”

In something of a lose-lose situation, the Westpac note

also predicts that greater capitalisation in New Zealand will not prompt a cost-of-funds benefit for those issuers in wholesale debt markets.

The Westpac research note concludes: “The ownership structure of the banks has a direct impact on ratings and provides benchmark pricing for the New Zealand D-SIBs [domestic systemically important banks] which is likely to prevent any significant repricing of the New Zealand bank curve as a result of the increase in capital. Any decrease in supply may see some scarcity value attached to D-SIB bonds moving forward, however it is unlikely that the New Zealand banks would price through their parents’ spread levels, or even flat, despite holding considerably higher capital ratios.”

the requirement. “They could shrink lending, change the composition of lending or raise equity. It will likely end up being a combination of methods.”

The RBNZ suggests that the banks could raise the capital over a period of five years through retained earnings. This may be possible – if painful to shareholders. Jack Do, director, financial institutions at Fitch Ratings in Sydney, estimates that meeting the increased capital requirement would account for 70 per cent of banks’ profit over the five-year period.

But he adds: “The major banks in New Zealand have large market share, pricing power and earning capacity so we think they can make the requirements with retained earnings. It is likely, though, that the dividend they return to Australia will be significantly reduced during this period.”

The scale of the majors’ balance sheets and those of their Australian parents at least give them capital-raising options – although the extent to which they can rely on their parents is an open question (see box on this page). Martien Lubberink, associate professor, accounting and capital at Victoria University of Wellington, says the smaller banks may face a greater struggle in raising further common equity.

“If the proposals are brought in, there will likely be a race to the top and the banks that can will begin raising the capital immediately. Some of the smaller banks, which will have fewer options to meet the requirements, may struggle to keep up,” Lubberink tells *KangaNews*.

Market participants say there is clearly less capacity to generate capital from profits in the smaller-bank sector. Do says it is likely some smaller and cooperative banks will need to go to their shareholders or rely on new capital instruments – to the extent these are allowed – to meet at least some of the requirement.

### CREDIT CONSEQUENCES

**S**uch a significant increase in bank capital requirements will inevitably have an impact on banks’ all-in cost of funds, as so much more of the total funding stack will have to come from the equity market rather than cheaper debt funds.

The RBNZ is confident this will only be a marginal factor. It estimates that a 1 per cent increase in a banking system’s tier-one capital ratio from current levels “may lead to a 6 basis point increase in the price of bank credit”.



“Capital requirements have been consistently raised since the financial crisis so we have an understanding of what the possible implications are. But we do not really have a working understanding of what the consequences might be from the degree of shift being proposed.”

STEPHEN TOPLIS BNZ



The RBNZ estimates its proposal will lead to the major banks needing to raise NZ\$12.8 billion (US\$8.8 billion) of additional tier-one capital to meet the proposed regulatory minimum. However, market estimates are higher in many cases given banks tend to hold a voluntary buffer over the regulatory minimum.

Assuming a 2 per cent buffer over the regulatory minimum, a BNZ research note estimates the big four will need to raise an extra NZ\$18.6 billion of equity with a consequent 40 basis point increment to the aggregate cost of funds. ANZ research estimates the figure to be NZ\$22 billion, taking into account a 3 per cent buffer, and a 50 basis point cost-of-funds increment.

This will inevitably lead to more expensive or less readily available credit in New Zealand. Either or both are possible, with the weight of market opinion perhaps leaning towards more expensive credit rather than less of it.

As one senior New Zealand bank funder says: “New Zealand is just one place where investors can put their money to work. The reality is if the return opportunity is greater elsewhere, they will take that opportunity. The only way to attract the extra capital will be to ensure shareholders receive an appropriate return, which means higher lending margins.”

Do agrees that it is likely the New Zealand major banks will be able to pass on the cost of the capital requirements through higher lending rates. “The New Zealand major banks are rated where they are because of the strength of the franchises and their overwhelming control of market share. If they can pass on price increases, we don’t see any scenario where they wouldn’t opt to do so,” he tells *KangaNews*.

However, David Tripe, professor and head of the school of economics and finance at Palmerston North’s Massey University, believes it is more likely that there will be a reduction in lending rather than a material increase in the price of credit.

“Reducing lending is one way of decreasing the amount of equity that needs to be raised. Furthermore, with a downward

shift in the return on bank equity, the market value of banks will be undermined. This could also lead to banks cutting back on their lending exposure,” Tripe tells *KangaNews*.

ANZ’s research draws a similar conclusion, stating that the move to build a higher capital buffer affirms the bank analysts’ call that the next move for the official cash rate (OCR) will be a cut rather than a hike.

The note states: “Conceptually, a higher cost of funds, whether temporary or permanent, would need to be offset by a lower OCR. . . . Another reason the OCR may need to be lower during the transition period is that banks can meet the new ratios not only by raising capital but also by reducing their balance sheet.”

Dominick Stephens, Auckland-based chief economist at Westpac Banking Corporation New Zealand Branch, doubts monetary policy would be able to offset the macroeconomic impact of the increased capital requirements totally. He still believes the next move in OCR will be a hike – eventually – as any move put in place purely to counter capital changes would only be a temporary stopgap.

The key risk of banks reducing their lending is specifically that they lower the intensity of their exposure to higher-risk assets that contribute more to economic growth, such as SMEs, Lubberink argues. He says the context of recent economic data pointing to either stabilising or negative economic growth means this type of credit withdrawal would present a significant risk to the broader economy.

When the European Banking Authority (EBA) began implementing new bank capital requirements, it also issued two warnings – in 2012 and 2013 – instructing banks not to meet the requirements through de-risking.

The EBA asked national supervisory authorities to ensure banks maintained a nominal amount of capital corresponding to their capital requirements. This was designed to preserve the flow

“If the proposals are brought in, there will likely be a race to the top and the banks that can will begin raising the capital immediately. Some of the smaller banks, which will have fewer options to meet the requirements, may struggle to keep up.”

MARTIEN LUBBERINK VICTORIA UNIVERSITY OF WELLINGTON



## THEORY ISSUES

The Reserve Bank of New Zealand (RBNZ) used several parameters to establish its proposals for new bank-capital requirements. Market participants have expressed particular concern over the applicability of the Modigliani-Miller (MM) theory.

Proponents of heightened capital requirements place heavy reliance on the MM theory, which posits that a firm's capital structure is irrelevant to its value. Instead, value is discerned completely from earnings potential and underlying asset risk.

This is important in assessing the cost of increased capital requirements because, if it is true, there should be no funding-cost increase passed through to borrowers in the real economy. Even though equity capital is more expensive than debt, a bank's overall cost of capital will be equalised through the reduction in its risk.

The extent of any MM offset is therefore critical in assessing the likely cost of an increase in the required level of common equity.

The theory, though, is dependent on assumptions such as there being no taxes, no transaction costs and the existence of perfect market efficiency.

The RBNZ's consultation paper states that "on average, we found that around half a bank's average funding costs that would be implied by a change to a higher share of capital funding would be offset by a lower return on a bank's capital and noncapital funding".

A 50 per cent offset is in line with similar studies in

other jurisdictions. However, Ross Pennington, partner at Chapman Tripp, says the theory's assumptions limit its real-world value. He cites theoretical and empirical literature assessing the extent of a MM offset.

Pennington says: "The fact that banks provide liquidity services as a central part of their operations alters the application of MM theory. What this means for an optimal level of capital is a matter for debate."

There are also questions about the degree to which an MM offset is influenced by the size and depth of the relevant country's capital markets or by situations in which the capital impost takes place at a subsidiary level, creating an agency link in the capital chain, according to Pennington.

He points to several studies which have concluded that the theory may not make the same sense for banks as it does for industrial companies. Banks' capital-structure decisions are linked to liquidity production and therefore high leverage tends to be optimal.

A UBS research note suggests that, rather than using academic theory to estimate the impact on banks, it is best to look at how banks have reacted to increased capital requirements in the past. This, the note says, has typically been to materially increase the interest rates on mortgages.

"As a result, we believe the major banks would need to reprice their New Zealand mortgage books by 86-122 basis points. This is materially higher than the 35 basis points implied by the RBNZ's analysis," the UBS note states.

### Premises questioned

The RBNZ consultation paper also draws on international research from which it arrives at 16 per cent as the appropriate capital ratio to mitigate against a crisis in the financial system.

The problem with this research, says Pennington, is that it brings in jurisdictions with fundamentally different financial systems and risk profiles. It also derives data disproportionately from the financial crisis, which occurred primarily as a result of the subprime mortgage lending market in the US. New Zealand, he says, does not and has never had such a market.

Pennington also questions the focus on capital in isolation from other prudential responses – including greater stable funding from deposits and new bank-resolution regimes. He says studies have shown factors other than capital to have a stronger correlation to the probability of crisis and the speed of resolution, and to have less cost-of-capital risk.

The contribution made by these new tools was one of the factors leading

the Bank of England to settle on a considerably lower common-equity requirement for UK banks.

The RBNZ acknowledges that the absence of banking crises in New Zealand, and the small and concentrated nature of the country's banking system compared with jurisdictions where there have been crises, places limits on the analytical tools available.

The RBNZ therefore undertook a modelling exercise "which included New Zealand-specific issues, such as the tax-revenue impacts of different capital settings given the high proportion of the banking system that is foreign-owned".

The reserve bank says due to uncertainty around the "optimal capital ratio" it does not use its own modelling to recommend such a ratio unilaterally. Rather, it says a combination of its own modelling work and the international literature was used to arrive at the 16 per cent figure that it believes meets its objective of protecting sector soundness.

The RBNZ adds: "It is important to note here that, had our analysis indicated that we needed more tier-one capital than 16 per cent to meet our soundness objective, that objective implies we would, within reason, propose the higher level regardless of the level of expected output associated with it."

of lending into the real economy and thus maintain credit and economic growth.

Lubberink believes a similar message from the RBNZ could be warranted to ensure credit supply in New Zealand is maintained. This is not something the RBNZ is currently

consulting on, according to its Wellington-based deputy governor and general manager, financial stability, Geoff Bascand. He adds, though, that the reserve bank may look at how the new capital is raised if capital availability did become a concern or if the consultation suggests it is likely to do so.

“Interest rates on New Zealand bank paper reflect the fact that they are subsidiaries of the Australian major banks, with only a small premium paid. If the New Zealand subsidiary becomes safer that premium may fall, but it will likely be very marginal.”

DOMINICK STEPHENS WESTPAC BANKING CORPORATION NEW ZEALAND BRANCH



But he does not expect this to be necessary given the competitive nature of the banking sector. “The banks are very profitable, with rates of return on equity of 13-14 per cent. It would take a lot to drive this down to levels where they would rather pull out or shrink their business.”

Market participants admit that it is too early to attempt to make final-position predictions about credit supply and cost in a new capital environment. Toplis insists there is little doubt that banks will supply less credit than they otherwise would, but the magnitude is difficult to predict.

“When a vacuum is created in financial markets, typically other actors will come in and fill it. While supply of credit from banks will likely be slower, the negative implications of this for the wider economy aren’t necessarily a given as it is likely other players – such as international banks or nonbanks – will play a larger role in the lending market,” Toplis tells *KangaNews*.

Pennington is sure the new regime will give wholesale-funded nonbank lenders a competitive boost – unless the equivalent impact on banks’ provision of credit to this sector is even greater. While there are plans to bring nonbank lenders into the capital-adequacy framework, Pennington has doubts this can be achieved.

Tripe is more circumspect on the likelihood of nonbank lenders having sufficient capacity to make up a potential credit shortfall. Given New Zealand’s largest nonbank lender, UDC Finance, is owned by ANZ and the second-largest, Latitude Financial Services, currently has less than 1 per cent lending market share, he says it is difficult to envision these institutions making a meaningful difference across the credit landscape.

## CERTAIN UNCERTAINTY

**M**ore fundamentally, there are also questions about whether the 16 per cent capital figure the RBNZ has landed on is really necessary for the “soundness and efficiency” of the New Zealand financial system.

“Stability and efficiency are companion pieces and the way the RBNZ has dealt with them is artificial,” says Pennington. “It has sought an amount of ‘soundness’ required to survive a one-in-200-year banking crisis, and only then does it look at how much more equity can be brought into the system without affecting efficiency. The efficiency element is completely ignored in the first part of the equation.”

Tripe says while the increased capital ratio has a good chance of making the financial system somewhat safer, one

of the consequences of a decrease in lending – particularly to businesses – could be economic distress which could then lead to problem loans.

The bulk of New Zealand bank books comprises residential mortgages. The major risk factor in this context is that a policy aimed at bolstering financial-market stability could end up doing the opposite by creating a credit squeeze and thus property-market weakness.

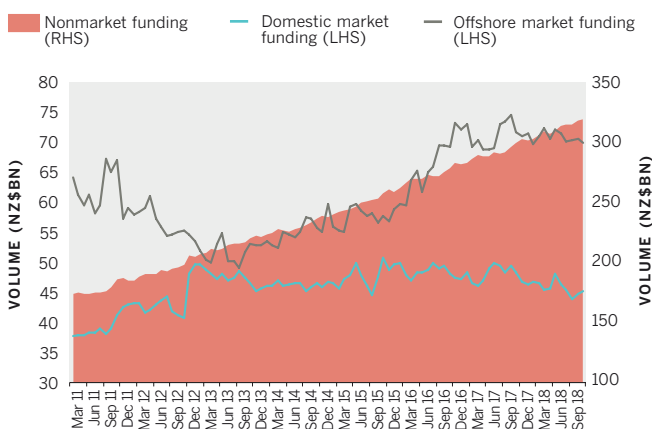
A UBS research note argues that the RBNZ is underestimating the potential mortgage repricing that could result from the new requirements, which would come at a “significant cost to the New Zealand economy”.

The RBNZ’s own calculations suggest a 3 basis point decline in the steady-state level of GDP for every 1 percentage point increase in banks’ required tier-one capital ratio. But the central bank says this should be balanced by the benefits of the additional safety this capital would provide.

Observers are not convinced by the theory or parameters used by the RBNZ in its consultation paper (see box on facing page). The reference to a one-in-200-year crisis in particular has caused consternation.

Pennington points out that in the last 40 years – which he says constitutes the time in which the banking system has been comparable to what exists now – New Zealand is one of only three countries that has not had a bank crisis, along with Australia and Canada.

CHART 2. NEW ZEALAND BANK FUNDING



SOURCE: RESERVE BANK OF NEW ZEALAND 25 JANUARY 2019

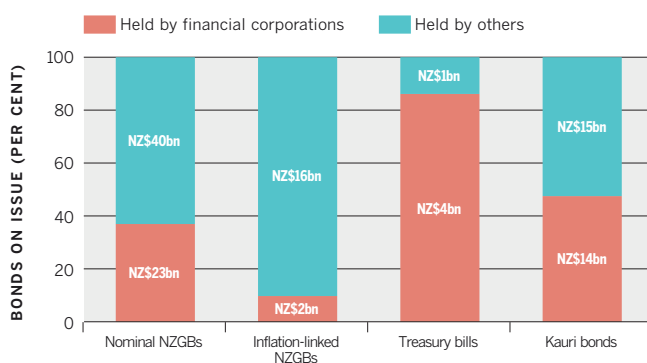




“Stability and efficiency are companion pieces and the way the RBNZ has dealt with them is artificial. It has sought an amount of ‘soundness’ required to survive a one-in-200-year banking crisis, and only then does it look at how much more equity can be brought into the system without affecting efficiency.”

ROSS PENNINGTON CHAPMAN TRIPP

**CHART 3. BANK HOLDINGS OF NEW ZEALAND DOLLAR HIGH-GRADE BONDS**



SOURCE: RESERVE BANK OF NEW ZEALAND 26 JANUARY 2019

Another senior bank funder tells *KangaNews* that the level of incremental capital the RBNZ is requiring to safeguard against such a crisis is perhaps past the point of diminishing marginal returns. In other words, the amount of safety the incremental capital brings is not worth the cost – to the banks or the broader economy.

Furthermore, Tripe says: “No-one can know what the impact of such an event would be because there is no data available. Even if there was, what happens at one point in a probability distribution does not give any basis for knowing what happens at another point in the probability distribution.”

### DEBT MARKET IN FLUX

For debt-market participants, the consequences of the RBNZ’s capital proposal could run much deeper even than a reshaped and repriced lending market. The additional equity funds the banks need can be expected to result in an equivalent reduction in wholesale debt issuance. The major banks are significant sources of issuance in an already undersupplied domestic bond market.

However, Nick Smyth, Wellington-based interest rate strategist at BNZ, says this outcome is not certain. In fact, it depends on how the relationship between credit and deposit growth plays out. Smyth adds that any slowdown in wholesale debt issuance by the banks is most likely to come in offshore funding given this is where funding growth has been focused in recent years and is also where funding is most expensive (see chart 2).

One bank funder *KangaNews* spoke to is explicit on the assumption that the proposed changes would result in a decreased appetite for offshore funding.

The domestic capital market would not be immune to such a shift, though. Less offshore funding could result in a less liquid and repriced New Zealand dollar basis swap, which could in turn put a drag on Kauri-market economics.

Demand for Kauri and other high-grade product would already be under question. With more CET1 capital, less wholesale funding and – perhaps – less lending, banks’ high-quality liquid asset needs might be expected to fall. RBNZ data confirm that financial corporations are substantial holders of New Zealand government bonds (NZGBs) and Kauris (see chart 3).

BNZ research states: “In time, this might be expected to put some marginal upward pressure on NZGB yields relative to swaps, although we expect this should be second order compared to the NZGB supply outlook and broader trends in investor demand.”

Less frequent senior wholesale bank funding might be expected to benefit spreads – and this is a key plank of the RBNZ’s thinking on the overall cost impact of its proposed capital changes.

But Stephens says: “The benefit for bank senior bondholders might be positive but it is likely to be vanishingly small. Interest rates on New Zealand bank paper reflect the fact that they are subsidiaries of the Australian major banks, with only a small premium paid. If the New Zealand subsidiary becomes safer this premium may fall, but it will likely be very marginal.”

There is a potential positive consequence for the New Zealand domestic credit market. If higher capital requirements force up the cost of corporate lending, as many in the market believe they will, Stephens says it is possible that some additional corporate borrowers may look to finance through direct debt issuance.

Smyth agrees that there is some potential for capital-market growth from increased bank regulation. He cites the disintermediation that has occurred in Europe over the last 10 years in which he says bank regulation has played a part.

“It would likely take some time to play out, but if the cost of accessing credit becomes higher one implication could be that some larger names, which would typically borrow from banks, may look to borrow in their own name if the cost is advantageous,” Smyth tells *KangaNews*. •



# RBNZ ADDS COLOUR TO A DEVELOPING PICTURE

Local market participants are thinking through the likely consequences of increased capital ratios for banks proposed by the **Reserve Bank of New Zealand** (RBNZ) at the end of 2018. In an exclusive interview with *KangaNews*, **Geoff Bascand**, the RBNZ's Wellington-based deputy governor and general manager, financial stability, says any wider market consequences are a necessary step in ensuring the long-term stability of New Zealand's financial system.

**T**here was a sense that most of the post-financial-crisis capital regulation had been completed. What makes it necessary to increase bank capital requirements now and how long has this been in process?

It is important to review capital ratios from time to time and to consider whether they are where they should be in the scheme of our regulatory settings. Levels of capital need to be consistent with the risks as we understand them.

We started this process in 2016. It has been released in parts with various stages of consultation. The paper released at the end of 2018 was the culmination of that process.

Capital is a crucial part of the regulatory approach. We want to ensure it is there on a long-term basis, through the various economic and financial cycles. We didn't set the review because we were worried about any particular current risk, but because we want to adjust the long-term setting and have it at a level where we are comfortable.

We can then use other instruments to adjust for short-term risks, such as macroprudential or loan-to-value-ratio policies. We haven't been in a desperate rush to do it. We want to get it right.

**You mention the "various stages of consultation" undergone in reaching this point. Can you give some more detail about this?**

Each piece in this process has been open for consultation and we are open to consultation now on the proposed ratios and the package as a whole. This consultation process is open until the beginning of May.

We had substantial discussions on the principles of the review, the capital instruments and the risk-weighting modelling before we arrived at this point. It has been a process of discussions and dialogue.

**The deadline for consultation was extended from March to May. Why was this decision made?**

We had requests from some of the participants to have more time to consider their input and provide quality submissions. We are not in a rush and we want well-considered submissions, so we are providing more background information and extending the deadline to allow for this.

**One of the main points of consternation around the proposals is that the level of capital required would be higher than most other jurisdictions in the world. What is the benefit for New Zealand in going further than many peers with these requirements?**

Capital requirements need to be set to suit the jurisdiction where they are applied. The international standards are a minimum and the idea is that

countries can set levels above these that are appropriate for them. We are trying to find the right risk tolerance for New Zealand and what level of bank-failure risk society is prepared to accept.

We do think the proposed level is at the high end – particularly for tier-one capital – but it is not too extraordinary. We wouldn't be far out on our own and the proposal is also not that extraordinary if you look at total capital. Looking at composition, there are other jurisdictions – including Australia – that have, or are proposing to move to, very high total-capital ratios.

We acknowledge what we are proposing would represent a significant lift and is high by international standards. But ratios are going higher around the world. As you look at global benchmarks over time, New Zealand used to be at the conservative end. But we have slipped.

For example, the relative standing of the large New Zealand banks has declined over time within S&P Global Ratings' risk-adjusted capital ratios. We think New Zealand is a risk-exposed, small economy that is vulnerable to shocks. The welfare costs of such a shock would be high, so we have put out for consultation that we think we should be towards the conservative end.

**The consultation paper says banks should be able to raise the capital through retained earnings over five**

**years, but we have heard doubts expressed about how plausible this really is. Is the RBNZ prepared to offer any flexibility around the implementation timeframe?**

This is something we are specifically consulting on. We are asking what stakeholders think of the proposals and the implementation. None of these are set in stone.

We are mindful that it is possibly going to be tougher for some of the smaller banks than it will be for the major banks in that timeframe. The sums are obviously bigger for the larger banks, but so are their profits and dividends.

We have looked at how feasible it is to meet the requirement either through earnings or funding markets and we appreciate feedback as to what the market considers is possible.

We don't think this will be the prime mechanism. The banks are very profitable, with rates of return on equity of 13-14 per cent. It would take a lot to drive this down to levels where the banks would prefer to pull out or shrink their businesses.

Of course we are interested in credit growth. And we agree there is the possibility that some banks will say the margin on some of their products or services is no longer what they would like and thus cut back. We look to the effects of competition.

As much as one bank might want to cut back in one segment, another might say it is worth growing into that market. Our proposal delivers a more level playing field and banks can be expected to re-examine opportunities.

If banks make the call that they can't profitably lend quite as much as

There will still be good business in lending in New Zealand.

Banks will need to put more equity in, but the counter to this is that they become safer. The reality is that if capital ratios are high on a world scale the banks are also safer on a world scale. Some of the credit rating agencies have acknowledged this. At this point, a bank's target rate of return is arguably lower.

**Most market participants are anticipating a more substantial increase in funding costs for the banks than the RBNZ estimates. If this is right, presumably banks will pass higher margins on to consumers. How well do you think the New Zealand economy can absorb a higher cost of credit?**

We are clear in the paper that we think the increased cost of credit will be

"We think New Zealand is a risk-exposed, small economy that is vulnerable to shocks. The welfare costs of a shock would be high, so we have put out for consultation that we think we should be towards the conservative end."

**Why is it necessary for the increment to be core, rather than additional, capital?**

It has been a core principle from the very early consultations that the quality of the capital is important. We have a view that common equity has a lot more advantages for the resilience of the banking system.

Additional capital and tier-two instruments are only useful at the time of a bank being in severe distress. They mean some debt or equity holders would lose money rather than others, but they don't make the bank safer.

**There is some conjecture, among analysts and others, that banks may opt to meet the higher requirement by de-risking – in other words by tightening the supply of credit. Do you see this as a possibility?**

they were before, or sustain the rate of growth they had before, this is ultimately a reaction to the price of risk. The reality is that we are trying to manage risks, which sometimes means curbing rapid and excessive credit growth.

**When increased capital requirements were introduced in Europe the European Banking Authority stipulated that regulators should introduce measures to ensure the supply of credit would remain. Would the RBNZ consider implementing anything similar?**

It isn't in the proposals. If it did become a real concern, or the consultation suggests this is very likely, we could think about how the capital is raised. It's not something we think we'll have to face – we're looking to the competitive landscape to ensure this won't happen.

relatively small. The working estimate I have is around 40 basis points and some parts of the [RBNZ] building would have it a bit less, heading towards 25 basis points. There are a number of moving parts here – including how banks will respond and competitive effects. One commercial bank has come out with a similar estimate.

The impact we're expecting is nowhere near some of the higher estimates. We did some work on this, but if we get more information we will update our estimate.

It does hinge a lot on how we assume banks will respond. The high estimates assume that all of this goes on mortgages even though banking mortgages are somewhere shy of 60 per cent of banks' balance sheets.

They also assume no substitution of equity for debt funding, let alone a



potential reduction in the cost of debt if investors are happier with the safety of the institutions.

We accept that there is uncertainty about the numbers, but we think the impact is far more likely to be at the low end of the estimates. We also accept that this will have some impact on the cost of lending. But the cost to borrowers will come at a gain to society of the reduced risk of the bad outcomes that can come from a banking crisis.

**The main parameters framing these proposals are the maintenance of stability and efficiency in the banking system. Was any consideration given to competition?**

Our primary objective is financial stability. We are mindful of the efficiency objective, in the sense of minimising the cost of regulation and

There is a bit of concern with mutual banks' ability to raise capital. We are committed to looking at their available capital instruments because we don't want them to be disadvantaged by our proposals.

**There was some optimism around the potential for the New Zealand securitisation market towards the end of last year, but it has been suggested that a revised capital regime could reduce major banks' need or desire to issue securitisation. Can you give an update on the RBNZ's securitisation plans and whether you think the asset class's value will be affected by the capital proposals?**

We are keen to proceed with the objectives and intent of those proposals. We are consulting on a revised set of proposals for the instrument – the

**oversight of the nonbank sector. Do you have any thoughts on how the lending landscape in New Zealand might change?**

Having a vibrant, competitive financial system is a good thing. It is part of the competitive dynamic that some institutions can try to grow relative to others. What we want to ensure is that risks are appropriately managed when this growth happens.

There is a continuous watch over the nonbank sector and whether it is growing in any unexplained or extraordinary way. But we would also monitor and ensure risks are managed appropriately if it was a credit union or a small deposit-taking institution.

The environment is continuously changing and evolving with technology, so it is being closely monitored. But it isn't of particular concern.

“We think the increased cost of credit will be relatively small...The impact we're expecting is nowhere near some of the higher estimates. We did some work on this, but if we get more information we will update our estimate.”

also in wanting to have a competitive and dynamic market. We want it to continue to supply good services to borrowers and savers.

We think the proposal includes factors that are supportive of competition. We proposed dual reporting of internal-ratings based (IRB) models and standardised reporting to establish a more level playing field in setting capital requirements. We have proposed flooring for IRB models so they don't have such an advantage over the standardised-model banks, which gives competitive support to the sector.

We accept there is merit in IRB models and the sophistication of risk modelling that comes with it, but it is a question of how much that should reduce risk weights. We think it is currently excessive. These changes should aid competition in that regard.

residential-mortgage obligation – and the rules around it. We hope to make the final policy decisions on this before the middle of the year.

The implementation schedule is still under consideration. We are consulting with the banks on what they think they can cope with. We want confidence in the quality of the collateral we hold and to get the markets operating, but it is not imperative on time.

We are being flexible as to what investors and issuers could cope with and we are also talking to them about these capital instruments.

**In Australia, increasing capital requirements on banks have seen market share of lending taken by nonbank financial institutions start to rise – to the extent that the local regulator has now taken on some**

**The proposed capital measures could have wider consequences for the New Zealand debt capital market including banks potentially having less need for wholesale debt funding and for regulatory liquid assets. To what extent are secondary or unintended consequences of the capital requirements a consideration for the RBNZ?**

The primary focus is the resilience of the banks and having the quality capital we think facilitates that resilience. If this means they have less need for debt instruments, from our point of view, so be it.

We want healthy capital markets with a variety of instruments available. It should be said that nothing stops banks having additional funding if they want to grow – as long as they have the capital to meet requirements. •



# THE REFERENCE-RATE CONUNDRUM

**T**he impending likely demise of global interbank offered rates (IBORs) has sparked many questions for the Australian market. Its local credit reference rate appears to be relatively robust – though its status is not unimpeachable – while the importance of cross-border issuance to Australian borrowers requires engagement with international IBOR developments. *KangaNews* and **Commonwealth Bank of Australia** (CommBank) brought together key market participants in late January to discuss the way forward.

## PARTICIPANTS

- **Ben Alexander** Principal ARDEA INVESTMENT MANAGEMENT ■ **Pieter Bierkens** Executive Director, Regulatory Strategy COMMONWEALTH BANK OF AUSTRALIA ■ **Fergus Blackstock** Head of Term Funding COMMONWEALTH BANK OF AUSTRALIA
- **Adam Donaldson** Head of Macro Sales COMMONWEALTH BANK OF AUSTRALIA ■ **Linda Hutchison** Executive Director, Fixed Income Sales COMMONWEALTH BANK OF AUSTRALIA ■ **Andrew Kennedy** Director, Treasury Services SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY
- **Ray Lee** Portfolio Manager KAPSTREAM CAPITAL ■ **Peter Psihoyos** Head of Pricing Capital and Valuation Adjustments COMMONWEALTH BANK OF AUSTRALIA ■ **Tony Togher** Head of Short-Term Investments COLONIAL FIRST STATE GLOBAL ASSET MANAGEMENT
- **Fiona Trigona** Head of Funding and Balance Sheet NEW SOUTH WALES TREASURY CORPORATION
- **Martin Whetton** Head of Bond and Interest-Rate Strategy COMMONWEALTH BANK OF AUSTRALIA

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- **Laurence Davison** Head of Content and Editor KANGANEWS

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**Commonwealth**Bank  
of Australia





“We will issue the most liquid instrument. If BBSW is the basis on which we achieve the most liquidity, we will continue to issue to BBSW. If AONIA becomes the most liquid we will issue to this reference rate.”

**FIONA TRIGONA** NEW SOUTH WALES TREASURY CORPORATION

## THE AUSTRALIAN EQUATION

**Davison** Unlike global jurisdictions, Australia is not forecasting the demise of its domestic IBOR – the bank bill swap rate (BBSW). How closely do local market participants need to watch global developments?

■ **BIERKENS** Australia has to be conscious of the consequences of all these developments for BBSW. Australia is settling for a two-rate solution: an IBOR that the Reserve Bank of Australia (RBA) believes is still viable alongside a risk-free rate. The question is what happens if the whole world moves away from IBORs.

The RBA has said we may see some change in BBSW usage in contracts if and when that happens – specifically, but not exclusively, in cross-currency swaps. That’s a logical observation, but we don’t yet know how big the impact will be.

**Davison** I have heard RBA deputy governor, Guy Debelle, warning Australian market participants that they cannot assume either that the issue of IBOR change is going to go away or that it will be resolved without their active engagement. The cynical question has to be whether this is true or whether Australians can wait for all the issues to be resolved externally?

■ **BIERKENS** I don’t think that’s possible. Markets underlying IBORs globally are just too thin, and even if you were trying to ‘redefine’ LIBOR – which might not even be possible – there would likely be legal challenges around using a different rate from what has been written into contracts.

The fact is that these rates, globally, are based on a type of activity that is drying up and I don’t see any obvious way to get

around this without fundamentally re-examining the nature of the the use of rates markets.

**Davison** Would a long-term equilibrium position be possible that sees Australia – and possibly some other jurisdictions – continuing to use IBORs while most others only use risk-free benchmarks? Or is it inevitable that the world will have to transition to a single approach?

■ **BIERKENS** I think a two-track approach is possible. If it wasn’t, we should be looking much more closely at the viability of BBSW. Even if it’s a relatively small proportion of the market still using it, it would be possible to argue that there is demand for what is a well-used and robust IBOR.

**Davison** How high on the agenda is this issue for Australian market participants and which of the specific issues involved are of most concern?

■ **ALEXANDER** Ardea Investment Management uses derivatives markets that are based on IBORs very actively. Our primary focus is Australian dollars so our primary interest is BBSW, but we also use IBORs relating to sterling, Canadian dollars, euros, yen and others. The changes are potentially very significant for us.

Ultimately, what we are trying to do is add alpha from relative-value positions. We need an interest-rate derivative to do this and the reality is that LIBOR-based contracts are the benchmark for this type of transaction.

We use things like swaptions, and the last time we asked if it was possible to do a swaption based on OIS in the US market the answer was: “forget about it”. We had to go back to a LIBOR-based contract. What I’m saying is that there is no



“We are not seeing any change in the way funds benchmark. I have to say, from experience, that trying to persuade trustees to explore benchmark change is not something anyone in the funds industry wants to take on unless it’s absolutely required.”

**TONY TOGHER** COLONIAL FIRST STATE GLOBAL ASSET MANAGEMENT



## REFERENCE-RATE ACRONYM GUIDE

ACRONYM	IN FULL	TYPE OF RATE	JURISDICTION	DESCRIPTION
IBOR	Interbank offered rate	Unsecured, term, credit	Global	Generic term for existing credit reference rate. Includes specific rates in Australia (BBSW), UK (LIBOR), US (US LIBOR) and Europe (EURIBOR)
SOFR	Secured overnight funding rate	Secured, overnight, risk-free	US	Repo-based overnight alternative risk-free rate.
OIS	Overnight indexed swap	Unsecured, overnight, risk-free	Global	Generic term for overnight unsecured lending between banks. Basis of most jurisdiction-specific alternative risk-free rates.
SONIA	Sterling overnight indexed average	Unsecured, overnight, risk-free	UK	Alternative risk-free rate based on unsecured overnight transactions brokered in London by Wholesale Markets Brokers' Association members.
€ONIA	Euro overnight index average	Unsecured, overnight, credit	Eurozone	Overnight interbank lending rate; in effect, one-day EURIBOR.
ESTER	Euro short-term rate	Unsecured, overnight, risk-free	Eurozone	Alternative risk-free rate based on individual euro transactions reported by banks in accordance with the ECB's money-market statistical reporting.
AONIA	Australian overnight indexed average	Unsecured, overnight, risk-free	Australia	Potential Australian alternative risk-free rate similar to SONIA.

SOURCE: KANGANEWS 2 FEBRUARY 2019

progress being made – or at least none that we can benefit from or encourage by adopting it ourselves.

Our attitude is that if IBORs are going to end we would expect to close out legacy positions and start replacing them with the replacements. But it doesn't seem that this is going to happen any time soon.

■ **LEE** We haven't spoken about IBOR transition too much at Kapstream Capital (Kapstream) – which I think is based on a view that BBSW isn't going anywhere. The new BBSW methodology has increased the rate-set window and brought in more participants, with the effect that there is a decent amount of trading activity – certainly compared with the US.

The concern we have is that pricing credit instruments off a cash rate with no credit premium opens up basis risk. If I buy a credit instrument and there is a funding crisis tomorrow there is a decent chance that the risk-free rate won't move – so what happens to that instrument?

We're also not sure what happens in the event that an Australian issuer prints in Australia with BBSW as reference and also prints the same note offshore with a risk-free benchmark. Does the offshore bond trade at an initial premium to compensate for the lack of credit premium in the base rate?

To be honest, we quite like the status quo in which three-month BBSW is a standard and robust benchmark.

**Donaldson** In the same example, if an issuer printed against both BBSW and OIS would it provide a de facto spread to the benchmark?

■ **LEE** I think OIS would have to capture optionality of LIBOR widening, and capturing and pricing that optionality would be very difficult. I also suspect the liquidity and other technicals on the BBSW bond would be much better. The US is predominantly a fixed-rate bond market even for banks, whereas most of the bank issuance in Australia is in floating-rate format. This makes me think investors will naturally migrate to the BBSW issuance if they have the option.

■ **TOGHER** We have been discussing the go-forward proposition for BBSW for years and in many different forums. The resolution of the process we have gone through with Australian Financial Markets Association committees and other groups, including the appointment of a segregated administrator, has shored up the stability of BBSW at least for the medium term.

The reality is that you can base a transaction on whatever rate you want – I've never had any problem on that side. The difficulty is getting out of it or hedging away from it.

Markets tend to gravitate towards the frameworks with the greatest liquidity, and the longstanding liquidity of the BBSW environment is what makes it hard for me to see it disappearing with any great speed.

"There needs to be a good reason to make the change. The ultimate question is whether such a reason exists. The only one I could see is if there are grounds to believe that BBSW can't exist forever."

**BEN ALEXANDER** ARDEA INVESTMENT MANAGEMENT



## IBOR TRANSITION: A GLOBAL PRIMER

There is a multiplicity of moving parts in global IBOR transition. Keeping abreast of developments and the consequences for Australia has become a full-time job for one top Commonwealth Bank of Australia (CommBank) executive – Pieter Bierkens.

■ **DAVISON** You are working full-time on the issue of IBOR transition at CommBank nowadays. What is the global state of play and what should Australian market participants be thinking about?

**BIERKENS** As we all know, LIBOR could disappear any day after 1 January 2022 – or at least from that day onwards LIBOR rates will no longer be required to be submitted. The challenges are that we don't know how we're going to get there, when the date will be or exactly what the end state is going to look like. It's possible that LIBOR will continue to be published in some form, perhaps in some markets but not in others.

It's interesting to note that – although it may not

be receiving appropriate attention from everyone as yet – the International Swaps and Derivatives Association (ISDA) expects huge changes in the market as a result of this development. More than US\$300 trillion of contracts reference LIBOR and EURIBOR, most of them derivatives.

One of the things I emphasise to clients is that we would still be talking about SOFR and SONIA even if the market underlying LIBOR was more liquid and robust.

A key takeout from the regulatory discussion around benchmark reform – as articulated in the Financial Stability Board's market participants report in 2014 – is that there was a clear need for an alternative reference rate that doesn't

include a credit component and doesn't fluctuate in line with the market's view of bank creditworthiness.

The market as a whole is increasingly 'riskless'. In fact, well over 70 per cent of the derivatives which make up the bulk of LIBOR referencing contracts are now cleared or margined. To have them referencing LIBOR even though they are mostly discounted with another rate was never optimal. A risk-free rate was going to be adopted, regardless of what happened to LIBOR.

Another important point – and one that was emphasised by [Reserve Bank of Australia (RBA) deputy governor] Guy Debelle at the ISDA conference in Sydney in 2018 – is that this transition is not being driven by regulators. Although

the regulatory framework around LIBOR submission is of course very relevant, it's more a matter of the underlying market no longer being viable.

To demonstrate this you only have to look at how much actual trading goes on in the rate used by US\$200 trillion of LIBOR-based contracts. Even though a lot of transactions would qualify, not many take place. The median number of daily transactions in three-month US dollar LIBOR – which is the most quoted – in Q2 2018 was seven. It was two in one-month LIBOR, and zero in one-year LIBOR.

We need to be ready to move to alternative rates – which, as I said, are needed anyway – if and when LIBOR dries up for good. Ideally we would have two rates, so the question becomes whether we can find something to replace LIBOR.

Andrew Bailey [chief executive of the UK Financial Conduct Authority (FCA)] gave a very informative speech on the future of LIBOR in July last year. He talked about the creation of a "synthetic LIBOR", but said there is no compelling answer as to how we can create one.



**"THERE IS CURRENTLY NO ALTERNATIVE FOR LIBOR, IN THE SENSE OF BEING A LIKE-FOR-LIKE REPLACEMENT. IN THIS CONTEXT, WE HAVE TO START MOVING TOWARDS THE ADOPTION OF RISK-FREE RATES."**

**PIETER BIERKENS** COMMONWEALTH BANK OF AUSTRALIA

Pieter Bierkens has mentioned the challenge of different types of bases for cross-currency or other swap activity, for instance SOFR on one leg and an IBOR in Australia. I also think this is possible – it would just have to factor in basis risk.

History tells us that if a fundamental type of basis risk emerges it is likely that a new market will spring up to trade it. If a market provides sufficient liquidity to operate an IBOR in a fluid environment I don't see any reason why it shouldn't flourish. This is why I think BBSW, as currently constructed, has a sound future.

I'm not saying other benchmarks can't eventuate – they clearly can. Indeed, there may be times when it is appropriate for securities – such as those that don't carry any element of bank-credit risk – to price off them. But we know that markets

gravitate towards liquidity and BBSW is the most liquid option we have.

■ **DONALDSON** We are hearing a variety of questions about IBOR evolution from investor clients. The most engaged are from the hedge-fund community – they tend to be interested in how they might be able to exploit movements in the basis.

Real-money investors are typically coming at it from the perspective of understanding the risks involved in buying a bond marked against a specific benchmark and how they will be able to exit positions. I think they tend to be reasonably relaxed about BBSW and believe it will be sustained.

It's the issuers that are most engaged, in our market at least. This is especially notable for any issuers using US markets, where they can see regime change is clearly happening.



three- and six- or 12-month bank credit spreads that can be reliably measured on a dynamic and daily basis. If we could do it we would have done so already.

What this means is that there is currently no alternative for LIBOR, in the sense of being a like-for-like replacement. In this context, we have to start moving towards the adoption of risk-free rates.

#### ■ **DAVISON** Why would a move of this type be problematic?

**BIERKENS** There are several risks. One is how quickly the market is able to adopt risk-free rates. SOFR is a new risk-free rate as designated by the New York Federal Reserve. Its futures trading activity and open interest doubled between October and December last year – but from a very low base. A more sobering statistic is that in Q3 last year there were 15 trades in SOFR swaps of which 13 were basis swaps.

SONIA is a little different because it is a pre-existing rate. But in general there is an open question about how the market creates sufficient liquidity to transition to a new rate.

Another issue is that LIBOR may disappear in some currencies but not in others. Intercontinental Exchange (ICE)'s LIBOR submission policy states that the rate will

be published unless it receives submissions from fewer than five banks, for instance. If LIBOR exists in some currencies but not others it will create issues for cross-currency basis swaps.

For cross-currency swaps, if one leg has its fallback reference rate triggered, swap counterparties will probably want the other leg to be on its fallback rate too. It is my understanding that ISDA anticipates putting a protocol in place to facilitate this.

There are a number of risks specifically related to fallback rates, too. Much as we may try to get a net-present-value neutral fallback rate, anything that is effectively a risk-free rate with something added to make it look and feel like LIBOR is never going to be exactly the same. There's an inherent risk to this.

Also, while ISDA's fallback rates are only triggered if LIBOR actually ceases to exist, proposed fallbacks in other markets have what are called "pre-cessation triggers". This means fallbacks may activate at different times and they can also trigger into a different rate – or to a differently calibrated rate.

One of the specific issues here is that the derivatives market will most likely be falling back to a backward-looking-coupon rate that

compounds in arrears based on overnight risk-free rates, while the cash markets may use a forward-looking rate. Again, this immediately introduces basis risk into hedging.

The other major risk is that, even if we go to risk-free rates, globally these rates are not the same. Some are secured and some are unsecured. Even though they are all labelled overnight and risk-free they are not all going to behave the same way in times of financial dislocation, for example. This also raises risk in cross-currency swaps using risk-free rates, among others.

The market is increasingly looking at how it gets to the transition or phasing out of LIBOR. ISDA has said LIBOR will disappear when the regulators or ICE say it has – but it may be very illiquid even prior to this.

In this case, it is quite possible that supervised firms in the EU could only use LIBOR for legacy contracts but not for new business. This is because the EU benchmarks regulation (BMR) stipulates that a benchmark that is not reflective of an underlying market cannot be used in new contracts.

What could happen in this scenario is that effectively half of the market will not be able to hedge existing trades using new contracts. It brings in a lot of additional illiquidity risk.

The BMR itself states that from 1 January 2020, EONIA – which is not overseen by the FCA and is therefore technically different from LIBOR though it has the same problems of a thin underlying market – can no longer be used for new contracts. This means the market will have to switch to ESTER – but this rate will not be published until the second half of 2019.

The market has, in effect, three months to switch all its systems to adopt ESTER in all new contracts. The European Central Bank published a transition paper at the end of last year but it remains a big risk and a very, very short timeframe. There have been discussions about postponement and while I don't have any inside knowledge this does at least seem to be possible.

The approaches being taken across jurisdictions are not all the same, either. While the US seems pretty adamant about adopting a risk-free rate, EU regulators are trying to salvage EURIBOR with something called "EURIBOR plus" that is BMR compliant.

This is partly because EURIBOR is used so much in retail exposures, particularly for mortgages. It's doubtful that this will be successful, but it is still something that is being attempted.

## BORROWER CONSIDERATIONS

**Davison** How are issuers thinking about IBOR evolution?

■ **KENNEDY** I first raised it as an issue within South Australian Government Financing Authority (SAFA) in 2011, in the sense that investigations into credit benchmark market practices made me question the appropriateness of credit benchmarks as part of SAFA's suite of risk-management tools. My view was that we should be ensuring we have a level of risk in our portfolios that reflects government risk and not the credit-curve risk of the banks.

As a first step, we realigned our client borrowings. For the past four years we have referenced a borrowing rate as a margin

over the RBA cash rate for any of our clients that borrow on a floating-rate or short-term basis.

The second step is to align our floating-rate issuance to reference the RBA cash rate, in order to remove the credit-risk element from both sides of the balance sheet.

This work has been ongoing for SAFA and it included keeping a close eye on regulatory developments. As momentum has built over the last 18 months, the evolution of benchmark reform in global markets has picked up pace in expectation of the imminent removal of IBORs.

In Australia we have a credit-based benchmark that is judged as suitable at this point in time. But our goal is to seek opportunities for an alternative benchmark that is appropriate for SAFA's business.

■ **BLACKSTOCK** There are issues across the bank but from a treasury perspective the questions are how we issue going forward and what we do with legacy transactions that were issued before anyone envisaged LIBOR no longer being published.

From there, we break it down into the domestic and global markets. Locally, we also feel much more comfortable with BBSW under its new methodology. For instance, we issued a five-year floating-rate note (FRN) with BBSW pricing domestically in January 2019 and we had no qualms about doing so.

Globally, it's worth noting that the majority of our issuance is in fixed-rate format. This means our legacy-issuance challenge is relatively small, although even though the volume is not material we will have to deal with it at some point in time.

Our approach has been to get ourselves ready to issue come what may. This means having fallback language in our programmes such that we have a mechanism for deals we have issued to move to a new risk-free rate subsequent to the demise of LIBOR.

We have issued two sterling transactions linked to SONIA in the past three months. These were relatively short in maturity but were intended to test mechanics such as back-office systems. Tenor and volume were less important than testing the processes we have in place.

We elected to issue first off the SONIA risk-free rate because the UK market is most developed in this regard and, at the time we issued, pricing was flat to where we could have issued in other markets. Not paying a premium to issue is clearly an important additional consideration.

**Davison** How far progressed is the sterling market in transitioning FRN issuance to a SONIA basis?

■ **BLACKSTOCK** I believe the first couple of SONIA deals issued by the UK banks were driven in part by the market wanting to demonstrate progress to regulators. However, to the best of my knowledge all UK primary-market FRNs are now SONIA-linked so what perhaps started as a regulatory-inspired move is now supported by robust take-up and solid support. For example, ANZ Banking Group issued £750 million (US\$980.6 million) in a SONIA covered bond in January 2019.

The SONIA market is by now well established to the extent that I don't envisage issuing linked to LIBOR again. As far as

I understand, it may not be 100 per cent of sterling investors that are able and willing to buy SONIA-based paper but the majority certainly are.

**Davison** New South Wales Treasury Corporation (TCorp) is predominantly a fixed-rate, domestic-currency borrower – so why is IBOR transition relevant?

■ **TRIGONA** We have carried out considerable work on the cessation of IBORs, for several reasons. The primary reason is that a small percentage of our client loans are linked to BBSW and we have A\$2.4 billion (US\$1.7 billion) of FRNs on issue to fund these.

TCorp has explored the impact on bondholders if BBSW ceased to be the benchmark market rate. TCorp's documentation relating to existing FRNs does not include a fallback clause that allows an automatic amendment to the reference rate. To get bondholders to agree to a change would require 75 per cent engagement, which would be challenging.

TCorp has revised its documentation to include relevant fallback clauses which allow for flexibility of other indices. Clearly it gives us confidence that the RBA has indicated BBSW will remain as a benchmark alongside a risk-free rate.

The other reason we have worked on the impact of the cessation of IBORs is that we provide interest-rate and FX hedges for our clients. Most of the work we've carried out has been focused predominantly on this area. We have also sent a submission to the International Swaps and Derivatives Association (ISDA) with our preferred fallback clause.

## BBSW'S FUTURE

**Davison** Tony Togher seems confident that BBSW, under its new calculation methodology, has been reinforced and that as the centre of market liquidity we should expect it to continue to exist in the medium-to-long term. Is this a generally held view?

■ **WHETTON** I think BBSW is secure in the context of the cross-currency basis and company loans. But it may become more difficult when it comes to mortgage pricing.

■ **BLACKSTOCK** There is a big distinction between three-month and one-month BBSW, as Guy Debelle has called out. This is visible in the volume of bank-bill issuance. For



"We are hearing a variety of questions about IBOR evolution from investor clients. The most engaged, I'd say, are from the hedge-fund community – they tend to be interested in how they might be able to exploit movements in the basis."

**ADAM DONALDSON** COMMONWEALTH BANK OF AUSTRALIA



net stable-funding ratio (NSFR) and liquidity-coverage ratio (LCR) reasons, the major banks no longer issue at one-month duration. I can therefore understand the issue with the one-month rate going forward.

We are very much in favour of the development of an AONIA product in Australia and there would be advantages to issuing in AONIA-linked format. This is notwithstanding the fact that the majority of the bank's assets are residential mortgages that are paid on a monthly basis, and at times volatility in the bills-OIS spread has resulted in a change in pricing for customers.

I am not looking to challenge the robustness of three-month BBSW. But if there was an alternative – like the ability to issue linked to the cash rate, particularly for one month – and if the benchmarks could exist side by side, this would suit CommBank as an issuer and an institution.

■ **PSIHOYOS** Going back six months or so we priced an instrument off converting a one-month BBSW to an OIS-plus basis, but there seemed to be a lot of reluctance on the investor side to branch out and buy something off a different benchmark. This was during a period of major volatility on the issuer side, to be fair.

**Davison** There is always reluctance to confront the cost and resources involved in transition unless there is actual or expected compulsion. Are investors sufficiently comfortable with BBSW that they don't feel they need to move to a new benchmark?

■ **TOGHER** I know from experience that there has been a reasonable proportional allocation to securities with cash-type benchmarks and we are not reluctant to participate in this type of transaction. The decision will come down to price.

Most asset managers, superannuation funds, pension funds and insurers benchmark their cash cohort against the 90-day average, so there is a tendency to gravitate towards this to reduce the basis risk of the construct.

However, we are in an environment of no change in monetary policy for a considerable period of time and, as a result, many investors would be happy to take on some exposures – subject to the attractiveness of the specific offering – with an underlying cash benchmark instead of 90-day BBSW.

■ **LEE** We have spent time looking at the new BBSW methodology. Our concern is that one-month will die out over



time because of LCR requirements. Regulatory requirements negate the value of issuing 30-day tenor or shorter to banks.

If one-month BBSW is phased out it will, as others have mentioned, have considerable impact on mortgages. As a mortgage investor, I'd prefer to get amortising payments every month rather than every three.

Mortgages are less liquid compared with corporate or bank bonds, so the fact that they amortise monthly is helpful from a liquidity perspective. The cash rate is an overnight rate so there's a term mismatch as well.

■ **TOGHER** I'm not as concerned as others even that one-month BBSW will fall away. It's true that, for regulatory reasons, banks are not going to be issuing 30-day paper. But every security on issue is at some stage going to have 30 days of residual maturity. There will be a ready pool of available assets that asset managers and investors will use for liquidity when the curve is steep.

■ **PSIHOYOS** On BBSW's robustness in general, it's fair to say there are some periods in which lack of trading is apparent. Looking at volume-weighted average price (VWAP) statistics, there is clearly underlying activity in six months and not much around the one-month point – though, as Tony Togher says, there is stock on issue as three- and six-month notes roll down.

My feeling is that BBSW is still quite viable based on underlying trading activity. The problem with IBORs globally is that they are still survey-driven, which is likely to be discontinued. BBSW is still traded and the VWAP system is a good method of converting the activity to a price. It would be great if volume was higher but what we have is still a better option than what they are dealing with offshore.

"The US is predominantly a fixed-rate bond market even for banks, whereas most of the bank issuance in Australia is in floating-rate format. This makes me think investors will naturally migrate to the BBSW issuance if they have the option."

**RAY LEE** KAPSTREAM CAPITAL







“The entire Australian financial system – including mortgages, credit cards, and personal, business and commercial loans – is set off a one-month rate. Yet we have a one-month credit rate with serious questions about its robustness.”

**ANDREW KENNEDY** SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY

If I’m right and BBSW continues, the next question is what happens to the basis swap when there is BBSW on one side and a risk-free rate on the other. I suspect the market will be able to develop to manage this, though.

**Davison** Can one-month price discovery remain robust?

■ **TOGHER** Provided it’s transaction-based, absolutely. I can’t imagine a period when no transactions are undertaken in the one-month for an extended period. That would require no investor redemption for a period of more than a day, which I just can’t envisage happening.

It would be better if the banks were issuing. But banks are also interested in buying back one-month paper, which prints a rate in itself.

The construct of the time period around the mid-point will continue to be a work in progress to get a less volatile rate construct. But the rate itself – I don’t see it going anywhere.

**Davison** One-month BBSW is most closely associated with securitisation – virtually all of which uses the shorter-term benchmark as its reference rate. CommBank looked at a three-month based residential mortgage-backed securities (RMBS) deal a few years ago but the concept never developed wider momentum. In an environment in which regulators are hinting, if not outright demanding, that the securitisation market re-examine the robustness of one-month BBSW as a benchmark, how straightforward or otherwise would transition be?

■ **BLACKSTOCK** It’s true that CommBank offered a three-month BBSW tranche of RMBS and I think it’s fair to say we

weren’t overwhelmed by the response from the market. Part of the reason for this certainly related to what Ray Lee has mentioned about how useful it is to investors to have liquidity coming back via monthly amortisation. One-month-based issuance is more common and was probably seen as more liquid in general, too.

We would be happy to issue RMBS off a three-month benchmark – it’s not impossible from an issuer perspective. But we want to issue what investors want to buy. If it’s clear that investors don’t want to buy a product, it’s not in anyone’s interest to offer it.

What I’d say is that there is definitely appetite on our side and encouragement from regulators to look at something different. If there was demand from the market we would certainly be happy to issue into that demand.

It’s really a question of whether the wider market considers something to be price-appropriate and sufficiently liquid. This is why I welcome SAFA’s step of saying it is going to issue an AONIA-linked deal – because any transition has to start somewhere. There are lots of good arguments as to why we should be issuing one-month-based securities linked to the cash rate. But we want to be confident that investors will buy it.

■ **KENNEDY** The concept I’ve been working hard to get across is that the entire Australian financial system – including mortgages, credit cards, and personal, business and commercial loans – is set off a one-month rate. Yet we have a one-month credit rate with serious questions about its robustness.

One associated change to mention is the introduction of regulatory standard APS 221. This requires banks to implement measures and set limits to monitor and control their large exposures and risk concentrations. The implication is that banks may hold less of each other’s assets and potentially further reduce liquidity in negotiable certificates of deposit (NCDs).



“I think BBSW is secure in the context of the cross-currency basis and company loans. But it may become more difficult when it comes to mortgage pricing.”

**MARTIN WHETTON** COMMONWEALTH BANK OF AUSTRALIA



This may have an additional negative impact on the ability to set a rate for BBSW across the curve, especially in light of the impact that the NSFR has had on the one-month rate set.

## CONNECTING THE MARKET

**Davison** SAFA has been talking to Australian dollar investors about appetite for an FRN that isn't priced off BBSW. How willing is the buy side to engage with the transition?

■ **KENNEDY** Australian real-money investors are very heavily focused on benchmark performance. Money-market funds are benchmarked to returns over BBSW. This means there are issues around where the product we are offering would sit within portfolios. In turn, this means that, for now, there is no economic advantage for investors to modify their systems to engage in this transaction.

I'm not overly concerned about this because the reality is that change is happening, globally and in Australia. We are already seeing dislocation in short-term markets based around regulatory changes such as the NSFR and APS 221, and these changes may further alter the shape of the NCD market.

We know the new product is unlikely to appeal to everyone. However, for a certain sector of the investment community it makes perfect sense. For instance, if you are an authorised deposit-taking institution with holdings including semi-government floating-rate commercial paper (CP), an AONIA FRN makes complete sense.

Instead of buying three-month SAFA CP you can buy a one-year SAFA AONIA FRN with monthly resets and a yield-equivalent pickup which, at the same time, decreases duration risk – because the product uses a daily compounded look-back rate – and extends the maturity profile.

There is no urgency to transition in Australia because BBSW will continue to exist for the time being. In the mindset of the investor community, until there is a desire to start changing the matrix for how the benchmarking for money-market funds is managed there will be no urgency for change in systems or technology.

■ **TOGHER** We are not seeing any change in the way funds benchmark. I have to say, from experience, that trying to persuade trustees to explore benchmark change is not something anyone in the funds industry wants to take on unless it's absolutely required. Most trustees – and indeed most

investors – don't see anything wrong with BBSW now or in the foreseeable future. I haven't been involved in any discussions about changing benchmark standards for broader-based money-market or cash funds.

Having said this, products have been developed that reference the cash rate – particularly deposit arrangements with extendable or callable features. But most superannuation funds, and therefore fund managers, continue to use the 90-day bank-bill rate as the primary benchmark.

■ **LEE** We have heard some discussions about changing from US LIBOR as an international benchmark. Our business is more focused on absolute return and we benchmark fund performance in Australia off the cash rate. But it's not difficult to work out the cash rate to BBSW spread.

**Davison** On the basis of comments we've heard, we seem to be at a challenging juncture in any transition. Issuers are happy to offer product with alternative benchmarks if investors will buy it. Investors are happy to buy if they feel this is the direction in which liquidity is moving. But there is no catalyst to make the move happen – especially in light of the relatively robust state of BBSW. Can anything break the circuit?

■ **ALEXANDER** When we're looking at a transition of this scope – abandoning LIBOR, which would be a wholesale change for the market – we have a decision to make. We have to identify and analyse the cost and the benefit.

The benefit from abandoning something that works is arguably zero. The cost is quite substantial. We have established that FRNs based on BBSW are the most well recognised, so when an issuer – taking SAFA as an example – says it wants to issue against AONIA it will be creating an instrument that is less liquid and less well recognised.

The bottom line is that an investor in an instrument like this will require an illiquidity premium for it – and the good people of South Australia will have to pay this premium for the benefit of the market.

There needs to be a good reason to make the change. The ultimate question – in Australia, putting international developments aside – is whether such a reason exists. The only one I could see is if there are grounds to believe that BBSW can't exist forever.

“To the best of my knowledge all UK primary-market FRNs are now SONIA-linked so what perhaps started as a regulatory-inspired move is now supported by robust take-up and solid support.”

FERGUS BLACKSTOCK COMMONWEALTH BANK OF AUSTRALIA



# AUSTRALIAN *ALTERNATIVES*

Australia has not officially settled on a local alternative risk-free rate. But the smart money is on AONIA – the basis of South Australian Government Financing Authority (SAFA)'s water-testing deal – getting the nod.

■ **DONALDSON** Is it universally accepted that AONIA is the likely future risk-free rate in Australia? Australian T-notes are trading around 1.85-1.95 per cent, which is very elevated relative to an unchanging cash rate of 1.5 per cent, while repo rates are even higher and are pretty volatile at the moment. Neither are particularly suggestive of a risk-free rate, so there seems to be a serious issue about adopting either as a benchmark.

**KENNEDY** The calculation rate for AONIA is almost identical to the one that is being used and widely accepted for SONIA. It is not clear yet whether this will prove to be the 'right'

risk-free rate in the long term, but AONIA is simply the daily compounded Reserve Bank of Australia (RBA) overnight cash rate. The question is whether the reserve bank believes the RBA-30 accurately reflects the official market rate.

I can't speak for the central bank of course, but developments point to the likelihood that this is how the RBA is thinking. For example, in 2016 the reserve bank started publishing on its website the daily compounded rate of index data back to 2011.

This provides some comfort that we are using the most appropriate risk-free rate at this point in time. If markets determine there is a better

methodology and move accordingly, we are not wedded to using the AONIA risk-free rate and can also evolve.

It has taken us considerable time to reach the position we have around the appropriate risk-free rate. We worked with a number of different stakeholders outside SAFA along the way, and this has been where we have landed. If the market moves, we will move with it, clearly.

■ **DAVISON** Do these stakeholders include the RBA itself?

**KENNEDY** It's hard to comment on this beyond saying that we have engaged with a number of

significant stakeholders throughout this process.

**BLACKSTOCK** There are benefits to AONIA and there is a reason it has been identified as an alternative rate. I am not looking to debate the rights and wrongs of each option, and ultimately as a borrower we want to issue where there is demand. If the market moves to a point where it thinks the repo rate, for instance, is the right way to go, this is something we could issue.

**HUTCHISON** The issue seems to be that the market is looking for liquidity to land on one option but until certain thresholds are reached we can't know where that will be. The question is whether external forces can be brought to bear, for instance by regulators, to generate initial liquidity.

■ **BLACKSTOCK** My understanding is that other jurisdictions have made their



"THE MARKET IS LOOKING FOR LIQUIDITY TO LAND ON ONE OPTION BUT UNTIL CERTAIN THRESHOLDS ARE REACHED WE CAN'T KNOW WHERE THAT WILL BE. THE QUESTION IS WHETHER EXTERNAL FORCES CAN BE BROUGHT TO BEAR, FOR INSTANCE BY REGULATORS, TO GENERATE INITIAL LIQUIDITY."

LINDA HUTCHISON COMMONWEALTH BANK OF AUSTRALIA

From my perspective, as long as the four major banks are issuing bills every day – which they obviously are, at least in three- and six-month tenor – I personally don't see why there should be an issue with BBSW.

I look at the situation in Australia somewhat differently. The move to a new calculation methodology is effectively a transition to a new index – so we have already taken the step that's being discussed globally. I think this has been a great initiative.

The hangover we are dealing with is around the manipulation of rates. The banks are justifiably nervous about being accused of rate manipulation, with the consequence that nobody seems to know whether it is ok to transact in the market. The rules of conduct for what is and is not a legitimate transaction are still not clear. No-one wants to end up in court defending the legitimacy of a transaction.

■ **KENNEDY** We have a slightly different perspective, of course – it has been a different journey with a different motivation for

SAFA. We have around A\$2 billion outstanding in CP and euro CP programmes at any point in time. One risk in managing liquidity is in the cash-flow profile, particularly when CP is maturing at various times in differing volumes. It allows us less control than if we were to have a regular maturity and roll.

Our goal is to use the AONIA-linked FRN to replace our CP programmes. We want to issue A\$500 million in each quarter for a year – to have A\$2 billion outstanding – and we hope to roll A\$500 million every subsequent quarter. This will improve our control around liquidity management and profiling.

We have clients that take monthly-reset floating or overnight-rolling loans. A quarterly FRN benchmarked off BBSW re-embeds credit risk and basis risk into our book.

■ **BIERKENS** In an environment in which BBSW is working well, at least in three- and six-month tenor, one may ask whether we need an additional rate alongside it. The point is that in a market that is increasingly moving towards 'riskless'





**decisions on alternative rates based on where the greatest transactional activity is taking place. This is why the US identified SOFR and the UK SONIA even though the two rates have fundamentally different characteristics. Is the transactional issue the case for AONIA versus other options in Australia?**

**ALEXANDER** I think it's pretty clearly not – that's the fundamental issue. The RBA has decided to let the repo rate find its own level independent of where the cash rate is. The result is that the number of transactions taking place at the official cash rate is extremely limited.

This is another challenge with transitioning to alternative rates. Once upon a time, the AONIA rate and indeed the BBSW rate used to be very stable – as did repo. This is no longer the case, and indeed we now have three indices all moving independently.

**TRIGONA** This certainly creates a lot more volatility in funding costs.

**ALEXANDER** That's right. It's not a problem in and of itself. But when we're talking

about making a transition to different indices it's much harder to make the right decision when they are all moving independently.

**WHETTON** This goes back to the people of South Australia paying more for state debt. Well, the whole population of Australia is currently paying more for sovereign T-notes – by 45-50 basis points – because of the free-floating repo rate.

It would be worth considering the value of something that was managed a bit more by the reserve bank – where it had more balance sheet and took on more volume and encouraged the market by presenting a term curve.

A decade or so ago it would have been a sin for central banks to be involved in the market in this manner. But it's now understood across major markets that this type of involvement is needed to 'grease the wheels'. It's odd, I think, that the RBA is happy to endorse BBSW but to let the market sort out repo.

**ALEXANDER** I find the RBA's position on repo very surprising. I must admit. Other central banks have acted to keep the rate closer to the cash rate.

**■ DAVISON What sort of dialogue should the Australian market be having about these issues, including what the alternative risk-free rate should be?**

**WHETTON** We need to establish whether this market is big enough to support repo, AONIA, BBSW and OIS with various instruments priced off all of them. If so, we need to be fully supported by all the arms of regulation as well as borrowers and investors.

**DONALDSON** It's definitely true that when we're looking at an issue where liquidity is key it is very hard to know which way to head. This also applies to issuers – you wouldn't want to issue against a benchmark that isn't being used as a reference rate in two years' time.

**TRIGONA** That's right – and it's also important that investors can be confident that what they are buying is going to be relevant on an ongoing basis. We don't want to transition from one reference rate to another while investors are holding affected bonds.

**■ DAVISON What are the challenges around issuing long-duration instruments in this uncertain environment?**

**Obviously no issuer wants to have an orphaned security on issue, but equally no-one wants to stop issuing long-term debt.**

**BLACKSTOCK** There are two parts to this. One is having fallback provisions in documentation, which should ideally future-proof an issuer and provide clear direction to investors on what would happen in any scenario. Within this, we want to stay in line with industry precedent and market developments rather than independently declaring a preference.

If we were to issue a five-year note linked to EURIBOR, for instance, we would include fallback language stating that the note will move to the alternative rate on the cessation of EURIBOR – without specifying what that is. This is in line with regulatory guidance.

The second issue is whether we would issue a five-year euro floating-rate note at all at the moment. We should be comfortable with our fallback language in place, but the transition is still something we know we will have to deal with in future. It probably reduces the marginal willingness to do that trade in the first place.

transactions – by which I mean things like centrally cleared and margined derivatives – it makes sense for these riskless transactions to reference a riskless rate as they will increasingly do elsewhere.

This doesn't mean BBSW will disappear. It just means there is a clear economic rationale to have a risk-free rate that is more actively traded and broadly adopted in the market. It is not optimal for a riskless transaction, like a cleared derivative, to have its net-present value be dependent on the funding cost of an individual bank. The two-rate solution makes a lot of sense for Australia.

**■ TRIGONA** This point is the source of some forced action, in the sense that issuers and investors are now being forced to look at their own systems in order to accommodate new types of deals internationally. This might be the trigger point that persuades investors that it's worth investing the time and money to be able to handle this type of deal in the future.

**Davison** My understanding is that SAFA's initial decision to explore OIS-based pricing was not related to views on IBOR transition but more to do with what Pieter Bierkens mentioned about the appropriateness of a credit benchmark as the basis for semi-government pricing.

**■ KENNEDY** Absolutely. The opening sentence of SAFA's risk-appetite statement reads: "SAFA has a low appetite for risk." It has never been our goal to replace BBSW. Our goal is best and most appropriately to manage risk for the state.

**■ ALEXANDER** We certainly don't have any problem with an issuer like SAFA pricing the type of bond it is looking at. As it happens, we don't buy floating-rate semi-government paper for our funds – because these bonds are already less liquid even though they price at around the same level as fixed-rate bonds. My only point is that the transition to OIS from BBSW will

**KANGANEWS ASKED ROUNDTABLE PARTICIPANTS: “AT THE POINT WHERE GLOBAL IBORs BECOME DEFUNCT, HOW CONFIDENT ARE YOU – ON A SCALE OF ZERO TO 10 – IN THE FOLLOWING OUTCOMES?”**

OUTCOME	LOWEST PROBABILITY (0-10)	HIGHEST PROBABILITY (0-10)	AVERAGE OF ALL RESPONSES (0-10)
The mechanics of cross-currency issuance and investment have not been significantly negatively affected.	5	10	7.2
Australia is still predominantly a BBSW-based market.	1	10	7
The fate of instruments with transition issues has been successfully managed.	3	9	6.7
Transition has been managed without causing a major liquidity or volatility event.	5	8	6.1

SOURCE: KANGANEWS 2 FEBRUARY 2019

inevitably come with costs and complexity. It's not a judgement call on whether an issuer like SAFA should or should not do something.

■ **TRIGONA** We will issue the most liquid instrument. If BBSW is the basis on which we achieve the most liquidity, we will continue to issue to BBSW. If AONIA becomes the most liquid we will issue to this reference rate. However, TCorp is predominantly a fixed-rate borrower – our floating-rate requirements are limited.

**Davison** It seems pretty clear that transition comes with cost, and in this case there will be ongoing resistance to it in the absence of compulsion. Could this compulsion happen organically – for instance global transition starting to make it impossible for investors to access the exposures they want?

■ **ALEXANDER** It's not something we have any control over, and we recognise this. We're just looking to trade instruments that have liquidity. If this happens to shift to a different benchmark, that's what we'll trade. We'll also make the effort if we believe it's for the best of everyone in the market – or of course if we're told we have to.

It has to be in conjunction with everyone else, though. We can only trade what counterparties will make markets in.

■ **PSIHOYOS** I think having the potential for a two-rate system in Australia makes us quite lucky, because of the way this issue of compulsion is playing out internationally. It's pretty hard,

perhaps impossible, to legislate for nonbank market participants in a way that compels them to adopt fallback protocols.

Given asymmetry in derivatives exposures, the impact of benchmark transition on contracts and markets more generally may be substantial. But the consequences will be commensurately less in Australia.

**CROSS-BORDER  
HARMONISATION**

**Davison** What was liquidity like in the basis-swap market when CommBank came to swap back SONIA-linked sterling funds to their ultimate landing place of BBSW-based Australian dollars?

■ **BLACKSTOCK** We have been very encouraged by the pace of development of liquidity in the offshore basis market. Bid-offer spreads have shrunk considerably from when we first started looking at it and pricing was extremely competitive when we looked to swap from SONIA into LIBOR and from there to BBSW.

It is very positive to think we could establish a basis-swap market between an offshore risk-free rate and BBSW domestically. Everything we've seen so far suggests this could develop without too much trouble.

**Davison** If we ended up in a situation where the US and UK abandoned LIBOR completely but the EU retained some form of credit-based rate, would this have any impact on the marginal propensity of Australian issuers to print in euros versus other currencies?

■ **WHETTON** The fact that US cash and derivatives markets are deeper – and that they tend to evolve more quickly, especially on the derivatives side – would if anything make the US more appealing in this scenario. Any marginal benefit of a shared credit rate would likely not be sufficient to change the fundamental issuance equation. •



“The problem with IBORs globally is that they are still survey-driven, which is likely to be discontinued. BBSW is still traded and the VWAP system is a good method of converting the activity to a price.”

**PETER PSIHOYOS** COMMONWEALTH BANK OF AUSTRALIA

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