

SECURITISATION:
NEW LANDSCAPE FOR
LENDING MARKET

COAL: INVESTORS ON
SECTOR PROXIMITY AND
WILLINGNESS TO BUY

SUSTAINABLE FINANCE:
AUSTRALASIAN MARKET
INITIATIVES LAUNCHED

KangaNews

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AUSTRALASIAN FIXED INCOME: GLOBAL REACH, LOCAL EXPERTISE

BOUNCING BACK

AFTER A TUMULTUOUS YEAR, THE AUSTRALIAN DEBT
MARKET IS LOOKING FORWARD TO 2021 WITH A
MORE POSITIVE OUTLOOK THAN IT MIGHT HAVE
EXPECTED JUST A FEW MONTHS EARLIER



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Head of content and editor

LAURENCE DAVISON
ldavison@kanganews.com

Deputy editor

MATT ZAUNMAYR
mzaunmayr@kanganews.com

Staff writer

CHRIS RICH
crich@kanganews.com

Editorial consultant

NICK HOWELL
nhowell@kanganews.com

Head of commercial

Jeremy Masters
jmasters@kanganews.com

Head of operations

HELEN CRAIG
hcraig@kanganews.com

Chief executive

SAMANTHA SWISS
sswiss@kanganews.com

Design consultants

HOBRA (www.hobradesign.com)

Photography

DAVID SMYTH PHOTOGRAPHY, JULIAN WATT PHOTOGRAPHY, BEDFORD PHOTOGRAPHY (SYDNEY), TIM TURNER (MELBOURNE), THE PHOTO (WELLINGTON), GALEXIA STUDIOS (MIAMI), GEORGE ARCHER (LONDON), TIGER TIGER (AUCKLAND), IRWIN WONG PHOTOGRAPHY (TOKYO)

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Means of support

There can be no doubt that swift and decisive policymaker action saved markets and economies a lot of pain in 2020. Moving into a new and hopefully less dispiriting year, a big question is whether the best means of cultivating a fragile recovery is really to continue trying to force credit indiscriminately down the throats of business and household sectors that are certainly not crying out for it.

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Issuer-level strategy the focus for climate transition

The Green Bond Principles and Social Bond Principles, administered by the International Capital Market Association, launched the *Climate Transition Finance Handbook* on 9 December. The handbook marks a new phase in the evolution of the sustainable-finance market, according to market participants involved in its development.

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NEWS FEATURE

ASFI plots Australia's path to zero emissions

The Australian Sustainable Finance Initiative roadmap, published on 24 November, puts forward a plan to align the Australian economy and financial system with outcomes that encourage sustainability, resilience and future prosperity. It sets ambitious targets, including some that stretch beyond federal government goals, and lays out a timeline for achieving them.

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COPUBLISHED ROUNDTABLE

As safe as bricks and mortar

In the second of two roundtables exploring corporate sectors on the front line of the COVID-19 crisis, in November 2020 *KangaNews* and **Westpac Institutional Bank** hosted issuers and analysts from the Australian REIT sector to talk about pandemic fallout.



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NEWS FEATURE

NZSFF targets transformation, simplicity and urgency

The New Zealand Sustainable Finance Forum's final roadmap plots a route for reform that its authors say is necessary for the financial system to be fit for purpose in a sustainable future. The roadmap's focus is long-term and transformative in nature, but it proffers immediate, actionable measures appropriate for the urgency of the task.

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More support in reserve

The Reserve Bank of Australia and Reserve Bank of New Zealand used their respective November monetary-policy decisions to roll out a raft of additional support measures for economies in the earliest stages of recovery. There are reasons for optimism – including a receding prospect of negative rates in New Zealand.

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COPUBLISHED COLUMN

Australasian retail REITs: pandemic leaves lasting pain

The fallout from COVID-19 will linger beyond lockdowns for rated retail REITs, according to **S&P Global Ratings** senior director, corporate ratings, **Craig Parker**, and associate, corporate ratings, **Rhys Corry**. In Australasia, COVID-19 containment measures are eroding retail REIT earnings and reducing asset value amid unprecedented structural disruption.

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COPUBLISHED ROUNDTABLE

2020 challenges returned with interest

Toward the end of a tumultuous year, leaders of **ANZ's** institutional business across a raft of sectors gathered at a *KangaNews* roundtable to discuss the impact of COVID-19, how they supported customers during this unprecedented period, how business has changed and the bank's role in resetting investment and growth on a more positive trajectory.

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COPUBLISHED FEATURE

LEADING FROM THE FRONT

European Investment Bank is one of the EU's primary vehicles for achieving its sustainability goals and is therefore at the vanguard of European and global sustainable debt markets. The supranational tells *KangaNews* it aims to use this position to provide a blueprint for itself and others to implement ambitious sustainable-finance strategies.



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EVENT REPORT

KangaNews DCM Summit US election webinar

On 12 November, just a week after the most contentious and controversial election in US history, a panel of US-based market participants convened to discuss the fallout as part of the **KangaNews Debt Capital Markets Summit 2020** webinar series. The conversation covered the impact of a divided government, monetary and fiscal policy, and the US's place on the world stage.

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COPUBLISHED ROUNDTABLE AUSTRALIAN CORPORATE CREDIT ON THE REBOUND

Investment-grade corporate Australia has weathered the COVID-19 crisis better than could have been expected as the pandemic accelerated in March and April 2020, according to participants at a **Fitch Ratings-KangaNews** roundtable at the end of the year.



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FEATURE

Exposure cost

As environmental, social and governance issues become ever-more integrated with the credit investment process in Australia, the issue of pricing consequences for strong and weak performers is more relevant than ever. This is no longer just a question for direct emitters but also for companies with business models adjacent to emissions-intensive industries.

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SURVEY

WHAT THE BUY SIDE WANTS IN ESG

As the sustainable debt market evolves at a quickening pace, the most important factor for issuers to keep abreast of is what investors want from them. In December, *KangaNews* polled Australasian investors to ascertain their up-to-the-minute thinking.

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FEATURE

Reflect and reposition

The Australian securitisation industry is taking stock of a period of resilience and

a reshaped competitive landscape. Top of mind for market participants are the way crisis response has changed the cost of funding unevenly for different issuer types and mooted changes to responsible-lending rules.

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EVENT REPORT

KangaNews DCM Summit capital issuance webinar

The **KangaNews Debt Capital Markets Summit 2020** webinar series included a session on additional capital, which focused on supply dynamics, demand drivers and the ever-present tension between retail, wholesale and true institutional participation.

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EVENT REPORT

KangaNews DCM Summit duration webinar

Local and global market participants shared views on how duration has evolved internationally and what might be in store for Australia, at a November

KangaNews Debt Capital Markets Summit 2020 webinar.

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

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

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To subscribe or request a free trial please contact
Jeremy Masters
jmasters@kanganews.com
+61 2 8256 5577

TRANSACTION ANALYSIS

Demand conditions put QTC's green programme back on track

Queensland Treasury Corporation (QTC) says a disrupted market earlier in 2020 delayed its return to the green-bond market. Its latest transaction was greeted with a significant oversubscription and greater participation from offshore.



Issuer: **Queensland Treasury Corporation**

Issuer rating: **(AA+/Aa1/AA)**

Pricing date: **10 November 2020**

Maturity date: **10 March 2031**

Format: **green bond**

Volume: **A\$1.5 billion (US\$1.1 billion)**

Book volume at pricing: **A\$2.8 billion**

Margin: **21.2bp/ACGB**

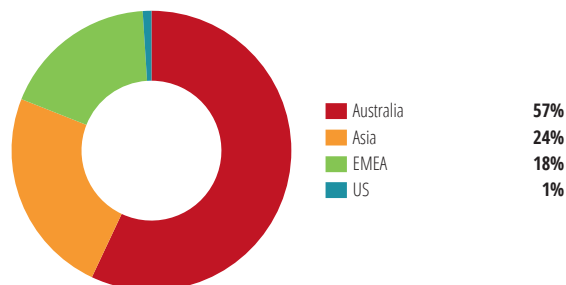
Indicative margin: **21.3-24.3bp/ACGB**

Geographic distribution: **see chart 1**

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

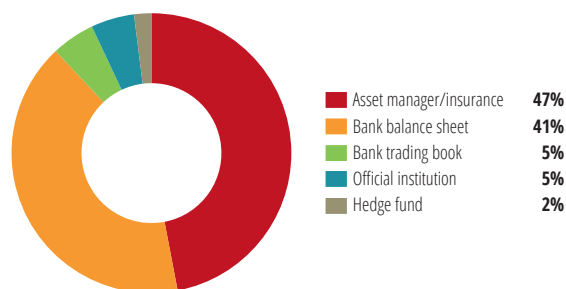
Lead managers: **Deutsche Bank,
National Australia Bank,
Westpac Institutional Bank**

CHART 1. QTC GREEN BOND GEOGRAPHIC DISTRIBUTION



SOURCE: QUEENSLAND TREASURY CORPORATION 10 NOVEMBER 2020

CHART 2. QTC GREEN BOND DISTRIBUTION BY INVESTOR TYPE



SOURCE: QUEENSLAND TREASURY CORPORATION 10 NOVEMBER 2020

ISSUER INSIGHTS



JOSE FAJARDO
EXECUTIVE DIRECTOR, FUNDING
AND LIQUIDITY
QUEENSLAND TREASURY CORPORATION

"While the number of participating accounts was similar to our 2029 deal, we saw an increase in ticket size. This demonstrates the growing demand for certified green product."

"While issuance could have been successfully completed across the curve, enhancing liquidity for QTC's investors was an important factor in deciding the tenor – along with balancing client needs."

"With around A\$2.3 billion remaining in the green-bond pool, we have eligible assets to support future issuance. We continue to look for opportunities to expand and diversify the pool in response to investor demand."

"This has been a good opportunity to discuss the government's commitments, which include achieving 50 per cent renewable energy by 2030 and net-zero emissions by 2050."

Behind the downgrades: S&P discusses NSW, Victoria and state outlook

The challenging path back to budget balance rather than the first-order impact of the second lockdown was behind S&P Global Ratings' two-notch downgrade of the state of Victoria. The rating agency emphasised the long term in a 9 December webinar on its 7 December downgrades of Victoria and New South Wales.

S&P downgraded New South Wales (NSW) to AA+ from AAA and hit Victoria with a two-notch downgrade, to AA from AAA. S&P justified downgrading both states on the basis of material increases in gross debt, significant write downs in revenue and grants as well as forceful fiscal responses.

While Victoria's second lockdown was of course a key driver of the different severity of the actions on the two states, Martin Foo, associate director, sovereign and international public finance at S&P in Melbourne, explained that the primary consideration is that Victoria's path of fiscal repair will be a lot longer than it is for NSW.

S&P expects NSW to return to an operating surplus in the 2021/22 financial year but does not anticipate Victoria to do so in its three-year forecast horizon. "NSW has the added benefit of asset sales or divestments, which could lead to a faster recovery in its numbers," Foo added.

He also identified operating-expense control between the states as a point of difference, and in particular that the public sector wage bill has grown "at a rapid pace in Victoria for several years".

In other words, the downgrades are not a hair-trigger response to a short-term shock. Anthony Walker, director, sovereign and international public finance at S&P in Melbourne, pointed out that the rating agency has some capacity to look through exceptional economic shocks if there are not significant underlying structural problems.

For instance, while Australia's deficit of 14 per cent of GDP is not consistent with a typical triple-A rating, S&P expects it will narrow over the coming years – something that cannot be said for Victoria, according to Walker. "Going forward, we are seeing after-capital-account deficits in Victoria being two-to-three times higher than historical numbers."

He added: "We look to see what the rating is going to be in 2-3 years' time. We are confident that, in two years' time, NSW's rating will be AA+ and that Victoria's rating will be AA – otherwise we would not have done the rating actions."

Nor are the Australian states being singled out on a global basis. While acknowledging that Australia has performed better at controlling the pandemic than many countries, Foo maintained the budgetary performance of Victoria and, to a lesser extent, NSW will be weaker than that of most highly rated international peers.

He pointed to the performance of a clutch of German states, including Baden-Württemberg, Bavaria and Saxony, and Canada's Province of British Columbia – noting that these subsovereigns have better outlooks on their operating balances and after-capital-account deficits.

Future rating actions

S&P placed the Australian sovereign on negative outlook from stable in April this year and has kept it there since the budget was announced in October. The rating downgrades on NSW and Victoria do not affect how S&P views the sovereign's rating, Walker said.

However, there is some expectation in the bank analyst community that Australian federal and state ratings may be living on borrowed time more generally. A Commonwealth Bank of Australia research note published just after the NSW and Victoria downgrades said: "If S&P's patience is running out and [it is] more assertively following [its] methodology, we may see further movements in other ratings. The sovereign rating and the Queensland rating would seem the most likely to be next."

Walker pointed out, however, that the sovereign rating is measured against GDP and not, as is the case with the states, revenue. The sovereign can tax the wealth of the nation, whereas the wealth of a state does not materially affect its ability to generate revenue, he said.

The negative outlook, rather than a downgrade, for the Australian sovereign is in place because S&P expects the budget deficit to narrow over the forecast period – to the extent that Australia may not use all the headroom in its rating band. Its debt-to-GDP ratio would have to rise to 60 per cent, from 40 per cent currently, possibly to trigger a rating downgrade, Walker added.

Like other states, Queensland – which released its budget in October following a state election – has seen revenue fall and expenditure rise. However, there is a good chance of this being absorbed at its current AA+ rating level, according to Rebecca Hrvatin, associate, sovereign and international public finance at S&P in Melbourne.

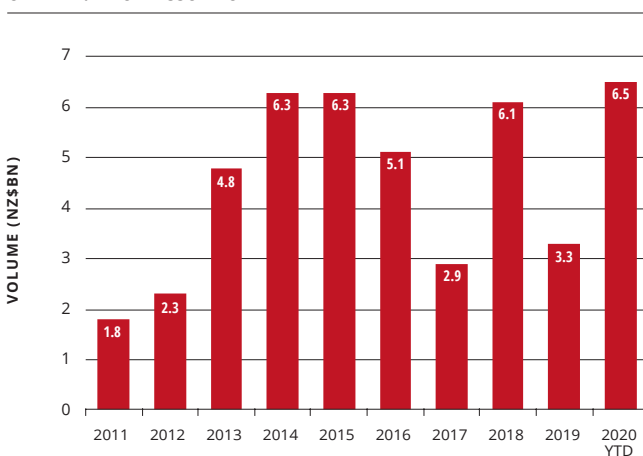
Walker said the rating agency will consider taking further rating actions upon the release of budget information but also warned a trigger for a rating downgrade would be if S&P was not confident about recovery profiles. •

TRANSACTION ANALYSIS

World Bank breaks records in Kangaroo and Kauri format

World Bank's Q4 2020 Kangaroo and Kauri deals made up for the borrower's long absence from the Australian dollar market and took annual Kauri issuance to an all-time record (see chart 1). The deals were the largest in Australian dollars by a global supranational, sovereign and agency borrower and New Zealand's largest-ever nonsovereign transaction (see tables 1 and 2).

CHART 1. KAURI ISSUANCE BY YEAR



SOURCE: KANGANEWS 9 DECEMBER 2020

TABLE 1. LARGEST-EVER SSA KANGAROO DEALS

PRICING DATE	ISSUER	TENOR AT ISSUE (YEARS)	TOTAL VOLUME (A\$M)
10 Nov 20	World Bank	5.5 & 10	1,650
11 Nov 09	European Investment Bank	5.5	1,500
4 Feb 10	World Bank	5	1,500
27 Jul 11	International Finance Corporation	5	1,500
7 Oct 09	World Bank	5 & 10	1,400

SOURCE: KANGANEWS 9 DECEMBER 2020

TABLE 2. LARGEST-EVER NONSOVEREIGN NEW ZEALAND DOLLAR DEALS

PRICING DATE	ISSUER	TENOR AT ISSUE (YEARS)	TOTAL VOLUME (NZ\$M)
26 Nov 20	World Bank	5.5 & 10	1,300
9 Apr 20	New Zealand Local Government Funding Agency	6	1,100
21 Oct 05	Vector	10, 12 & 15	1,000
12 Mar 19	New Zealand Local Government Funding Agency	5	1,000
17 Apr 20	Kāinga Ora – Homes and Communities	5 & 10	1,000

SOURCE: KANGANEWS 9 DECEMBER 2020

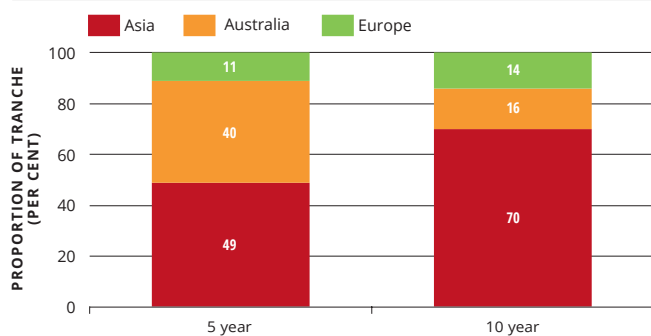


Issuer: **World Bank**
 Issuer rating: **AAA/Aaa**
 Pricing date: **10 November 2020**
 Maturity date: **18 May 2026 & 18 November 2030**
 Volume: **A\$1.1 billion (US\$811.3 million) & A\$550 million**
 Volume at launch: **A\$500 million & A\$200 million**
 Margin: **20bp/s-q swap & 34bp/s-q swap**
 Indicative margin: **20bp/s-q swap & 34bp/s-q swap**
 Geographic distribution: **see chart 2**
 Distribution by investor type: **see chart 3**
 Number of investors in book: **"around 60"**
 Lead managers: **ANZ, Nomura, RBC Capital Markets, TD Securities**



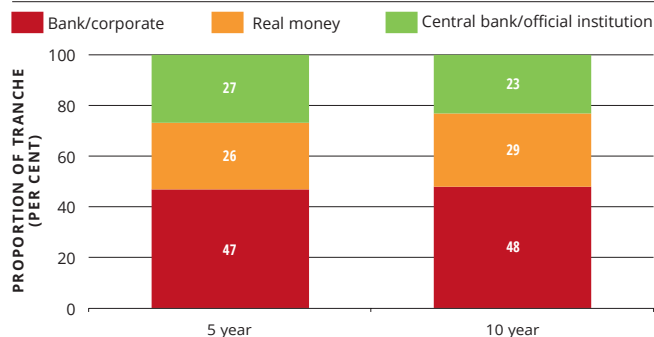
Issuer: **World Bank**
 Issuer rating: **AAA/Aaa**
 Pricing date: **26 November 2020**
 Maturity date: **10 June 2026 & 10 December 2030**
 Volume: **NZ\$1 billion (US\$707.2 million) & NZ\$300 million**
 Volume at launch: **NZ\$200 million & NZ\$100 million**
 Margin: **23bp/mid-swap & 39bp/mid-swap**
 Indicative margin: **23bp/mid-swap & 39bp/mid-swap**
 Geographic distribution: **see chart 4**
 Distribution by investor type: **see chart 5**
 Lead managers: **ANZ, BNZ, Commonwealth Bank**

CHART 2. WORLD BANK KANGAROO DEAL GEOGRAPHIC DISTRIBUTION



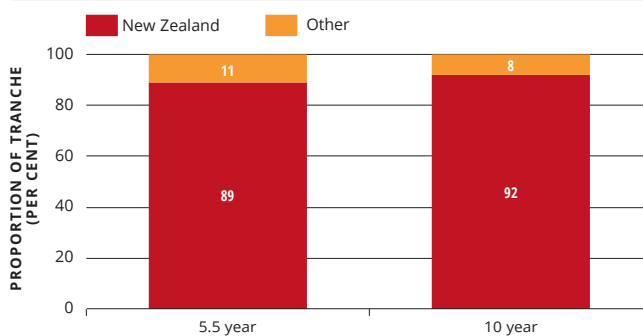
SOURCE: WORLD BANK 13 NOVEMBER 2020

CHART 3. WORLD BANK KANGAROO DEAL DISTRIBUTION BY INVESTOR TYPE



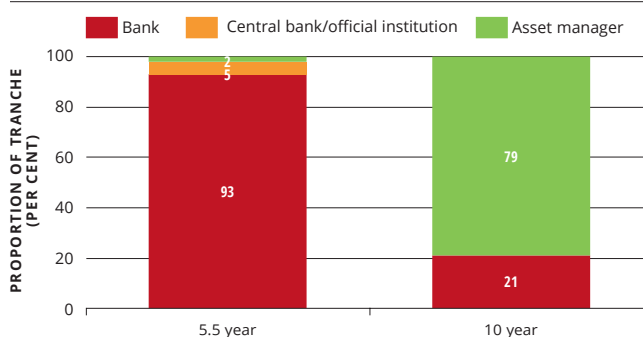
SOURCE: WORLD BANK 13 NOVEMBER 2020

CHART 4. WORLD BANK KAURI DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: WORLD BANK 30 NOVEMBER 2020

CHART 5. WORLD BANK KAURI DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: WORLD BANK 30 NOVEMBER 2020

ISSUER INSIGHTS



ANDREA DORE
HEAD OF FUNDING
WORLD BANK

"The Australia-US cross-currency basis became more favourable in the week prior to the Kangaroo return. Furthermore, spreads rallied significantly on the back

of the 3 November Reserve Bank of Australia board meeting."

"The Australian dollar market remains an important diversifier for World Bank. Many of the domestic accounts we can access in Australian dollars are not participants in World Bank's benchmark US dollar deals. Meanwhile, Australian dollars can also prove attractive for many of World Bank's international investors."

"World Bank runs to an end-June financial year, and with deal economics aligning we were keen to return to the [Kangaroo] market and take advantage of pent-up demand."

"World Bank's goal has been to establish liquid lines across the curve since we began issuing in the New Zealand dollar market in 2007. Achieving a deal of NZ\$1 billion volume and extending the New Zealand dollar curve to 10 years were among the longer-term targets."

"The [Kauri] volume achieved exceeded expectations. However, the strategy we took to market – of targeting different investor bases with a dual-tranche deal – is proving effective for garnering volume in various jurisdictions."

TRANSACTION ANALYSIS

Ampol fills up capital position with new hybrid

Ampol became the latest Australian borrower to tap the hybrid debt market, on 30 November. The issuer says its transaction had been on the cards since late 2019 and that it drew strong support from an investor base that was largely familiar with issuance under its previous guise of Caltex Australia.

Issuer: **Ampol**

Issuer rating: **Baa1**

Issue rating: **Baa3**

Pricing date: **30 November 2020**

Call date: **9 March 2026**

Maturity date: **9 December 2080**

Format: **50% equity credit hybrid**

Volume: **A\$500 million (US\$368.8 million)**

Book volume at pricing: **"approximately two times oversubscribed"**

Margin: **360bp/3m BBSW**

Indicative margin: **380bp/3m BBSW**

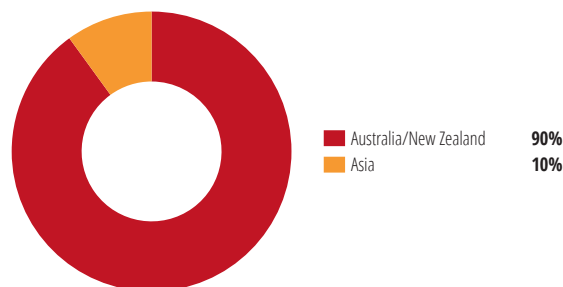
Geographic distribution: **see chart 1**

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

Structuring adviser: **UBS**

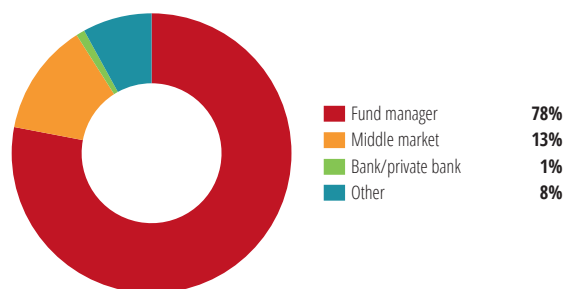
Lead managers: **Citi, Commonwealth Bank of Australia, National Australia Bank, UBS**

CHART 1. AMPOL HYBRID GEOGRAPHIC DISTRIBUTION



SOURCE: UBS 3 DECEMBER 2020

CHART 2. AMPOL HYBRID DISTRIBUTION BY INVESTOR TYPE



SOURCE: UBS 3 DECEMBER 2020

TRANSACTION INSIGHTS

JEFF ETHERINGTON
INTERIM CHIEF FINANCIAL OFFICER
AMPOL

"The structure is vanilla for a hybrid instrument, although it was relatively unique as one of the few hybrids globally to be solely rated by Moody's Investors Service. There were questions around the purpose and rationale for the transaction but no concerns on this from investors."

"The investor base was largely familiar to us from the 2018 senior-unsecured [Caltex] transaction but there were also some new investors in the book with specific demand for hybrid capital."



TIM GALT
EXECUTIVE DIRECTOR AND HEAD OF
DEBT CAPITAL MARKETS
UBS

"Investor demand has been supported by the completion of the US election and positive news flow on COVID-19 vaccine development. This backdrop, combined with very low rates and supportive policies from governments and central banks, has created strong demand conditions for hybrids and other higher-yielding instruments."

NBN Co finds ample domestic bandwidth for bond debut

NBN Co says the two domestic benchmark deals it issued in November and December provide good foundations for an expected increased call on public capital markets. The government-owned corporation says it will be an active issuer, with offshore markets also on the cards.

Issuer: **NBN Co**

Issuer rating: **A1/AA**

Pricing date: **26 November 2020**

Maturity date: **3 December 2025**

Volume: **A\$1.2 billion (US\$885 million)**

Margin: **70bp/s-q swap**

Indicative margin: **80-85bp/s-q swap**

Geographic distribution: **see chart 1**

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

Lead managers: **ANZ, Commonwealth Bank of Australia (CBA), National Australia Bank, Westpac Institutional Bank**



Issuer: **NBN Co**

Issuer rating: **A1/AA**

Pricing date: **8 December 2020**

Maturity date: **16 December 2030**

Volume: **A\$400 million**

Margin: **125bp/s-q swap**

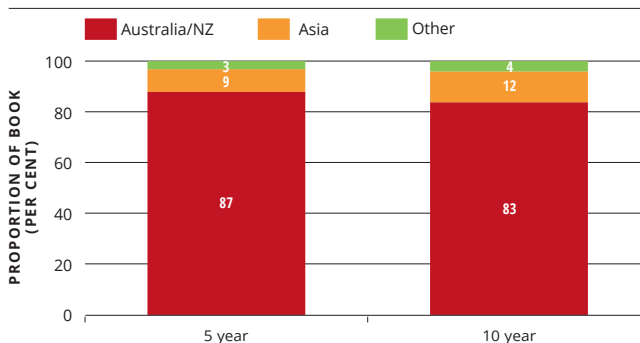
Indicative margin: **125-130bp/s-q swap**

Geographic distribution: **see chart 1**

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

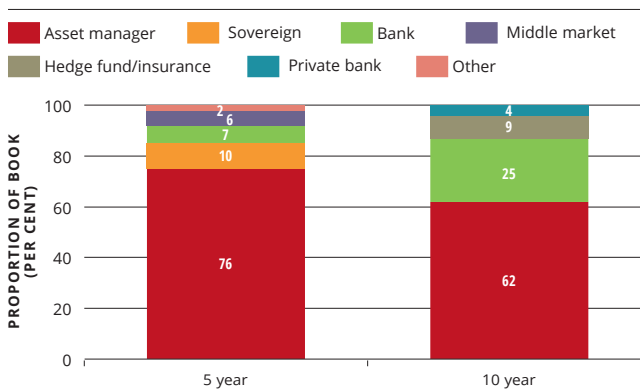
Lead managers: **CBA, Deutsche Bank**

CHART 1. NBN CO DEALS GEOGRAPHIC DISTRIBUTION



SOURCE: NBN CO 14 DECEMBER 2020

CHART 2. NBN CO DEALS DISTRIBUTION BY INVESTOR TYPE



SOURCE: NBN CO 14 DECEMBER 2020

ISSUER INSIGHTS

MARTIN GRAVARE
TREASURER
NBN CO

"We hoped to raise A\$1 billion and were aiming for at least A\$500 million. Demand surprised to the upside and, with rates as low as they are, we were able to upsize to A\$1.2 billion."

"We have been working on public issuance since March and we came to the market as soon as

everything was lined up. We judged the market to be very conducive at the moment, with low credit margins and interest rates. We are a fixed-rate borrower with an outright interest in the rates environment, so this was a large incentive for us."

"The intention is to remain present with Australian dollar benchmarks but we have a global focus and want to be set up so we can go to all markets and meet investor interest at short notice."

TRANSACTION ANALYSIS

Asset growth spurs Kiwibank tier-two return

Kiwibank has become the first New Zealand bank to test the waters for subordinated debt issuance since the Reserve Bank of New Zealand revealed its new bank-capital requirements a year earlier. The borrower says the impact of COVID-19 on its capital position and strong asset growth in 2020 propelled it to consider the new issue.

The transaction is the first New Zealand dollar bank-capital deal since the Reserve Bank of New Zealand (RBNZ) finalised its capital requirements in December 2019. This raised the total capital requirement on the big-four banks to 18 per cent of risk-weighted assets – from 10.5 per cent – and for all other banks to 16 per cent. Only 2 per cent

of the total capital ratio can be in tier-two format. RBNZ data show Kiwibank has had positive asset growth in each quarter of 2020 so far, the only one of the six largest New Zealand banks to achieve this (see chart). It was also the only one of the six to have a larger volume of total assets at the end of September 2020 than it did six months previously.

Issuer: **Kiwibank**

Issuer rating: **A1**

Issue rating: **Baa3**

Pricing date: 4 December 2020

Interest-rate reset date: **11 December 2025**

Maturity date: **11 December 2030**

Format: **tier-two**

Volume: **NZ\$275 million (US\$194.5 million)**

Volume at launch: **NZ\$275 million**

Margin: **190bp/mid-swap**

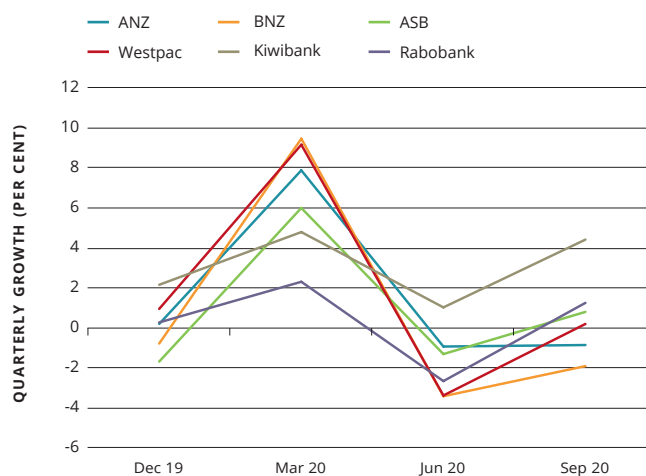
Indicative margin: **190-205bp/mid-swap**

Distribution by investor type: **54% retail, 46% wholesale/institutional**

Arranger: **Craigs Investment Partners**

Lead managers: **Craigs, Forsyth Barr, Jarden Securities**

NEW ZEALAND BANKS TOTAL ASSET GROWTH



SOURCE: RESERVE BANK OF NEW ZEALAND 7 DECEMBER 2020

ISSUER INSIGHTS



TIM MAIN
TREASURER
KIWIBANK

"We called an outstanding tier-two deal in July 2019 and the intention was always to replace it at some stage. Plans crystallised based on the impact of COVID-19

and related provisioning on Kiwibank's capital position, and by the strong asset growth the bank has experienced in 2020."

"Kiwibank's risk-weighted asset growth throughout 2020 meant it was a good time to

top up the capital ratio [and we] revised our tier-two documentation to ensure we would comply with the RBNZ's pre- and post-transition requirements. The new issuance takes Kiwibank to near its maximum tier-two ratio."

"We prefer to keep growing and lending. This means we need to increase our capital level and funding over time to accommodate."

"There was a good spread of investor names – including some that were new to this form of debt and did their due diligence to participate in the transaction. Investors are going along the credit spectrum in search of yield."

New Zealand institutional bid firms for 10-year duration

Chorus took advantage of supportive conditions to print the year's largest New Zealand dollar corporate deal ahead of a May 2021 maturity. The issuer says it was very confident it would be supported by retail and institutional investors, including at 10-year tenor.



Issuer: **Chorus**

Issuer rating: **BBB/Baa2**

Pricing date: **20 November 2020**

Maturity date: **2 December 2027
& 2 December 2030**

Volume: **NZ\$200 million (US\$141.4 million)
& NZ\$200 million**

Volume at launch: **NZ\$200 million total**

Margin: **140bp/mid-swap
& 170bp/mid-swap**

Indicative margin: **140-150bp/mid-swap
& 170-180bp/mid-swap**

Arranger: ANZ

Lead managers: **ANZ, Craigs Investment
Partners, Forsyth Barr, Westpac**

The transaction is the largest New Zealand dollar corporate deal since the same issuer executed a NZ\$500 million 10-year with a five-year interest-rate reset in November 2018. At NZ\$200 million, the new 10-year tranche also represents the largest senior vanilla 10-year deal from a New Zealand corporate in the domestic market since the 2008 financial crisis.

Tenor extension has been a talking point in the local rates market in 2020 as the Reserve Bank of New Zealand's policy response has driven bond interest rates to an all-time low. Long-tenor corporate issuance has been solid compared with recent years but has not yet displayed as much of a trend towards long duration, with most transactions still coming at 5-7 year tenor.

However, Chorus's deal provides some evidence of a developing 10-year institutional bid for corporates. In previous years, a significant portion of 10-year-plus corporate volume has been through deals with interest-rate resets, or in subordinated or hybrid format. In 2020, all long-tenor New Zealand corporate deals were vanilla senior transactions.

Andrew Hopkinson, Wellington-based treasurer at Chorus, tells *KangaNews* its resetting 10-year deal in 2018 was designed to target retail investors. This time around, a vanilla 10-year deal was suitable for institutional investors and minimised risk to demand from a non-vanilla structure issued in an uncertain market environment.

Chorus was keen to access a supportive market ahead of its NZ\$400 million May 2021 maturity. The issuer also has two euro EMTNs on issue but only considered the domestic market for the latest deal, according to Hopkinson.

"We had a high degree of confidence that we could access strong retail demand at seven years and also tap into the growing appetite of institutional investors for longer-dated debt with a 10-year tranche. Demand for the deal reflected this expectation, though with some crossover of institutional support in the seven-year and retail support in the 10-year tranche," Hopkinson explains.

Jason Green, director, DCM at ANZ in Wellington, says longer-dated institutional demand was evident in a number of wholesale New Zealand dollar deals in 2020. He adds that the transaction was an opportunity to bring together complementary institutional and retail investor pools.

According to ANZ data, Chorus's 10-year tranche is the first bullet deal at the tenor to be offered to New Zealand retail investors since 2016. Green confirms the New Zealand dollar corporate market has displayed versatility since it reopened in July 2020, supporting the full spectrum of rated and unrated borrowers from various sectors and in different tenors. Momentum is gaining to the degree that Green says domestic banks are now contemplating additional-capital deals. •

"We had a high degree of confidence that we could access strong retail demand at seven years and also tap into the growing appetite of institutional investors for longer-dated debt with a 10-year tranche. Demand for the deal reflected this expectation, though with some crossover of institutional support in the seven-year and retail support in the 10-year tranche."

ANDREW HOPKINSON CHORUS



LAURENCE DAVISON
LDAVISON@KANGANEWS.COM

Means of support

There can be no doubt that swift and decisive policymaker action saved markets and economies a lot of pain in 2020. Moving into a new and hopefully less dispiriting year, a big question is whether the best means of cultivating a fragile recovery is really to continue trying to force credit more or less indiscriminately down the throats of business and household sectors that are certainly not crying out for it. Instead of pulling out the stops to reboot the housing market, perhaps stimulus would be better directed toward an area that will deliver genuine growth and productivity gains.

Before going any further, I want to make it clear that I hope what follows does not come across as being wise after the event. We have all read acres of commentary about how the financial-crisis bailouts and other support mechanisms could have been done differently – meaning ‘better’ – and in almost all cases these neglect to consider the fact that policymakers were responding to a rapidly unfolding crisis that posed a proximate threat to the financial system and, at the risk of resorting to hyperbole, our way of life.

I have written quite a lot in the years since 2008-9 about how we may have missed a golden opportunity to have a public debate about some pretty critical issues in our societies, such as how and by whom credit is provided. But I find it hard to criticise the immediate response of governments and central banks as the financial crisis spiralled, leading up to and immediately after the collapse of Lehman Brothers. Sometimes you just need to keep shooting and worry about ammunition later.

The response to the escalating pandemic in March 2020 showed that policymakers have learned from the last major crisis and refined their tactics in the past decade. A key lesson from the financial crisis – and the Eurozone sovereign-debt crisis that followed a few years later – was that half measures are effectively no measures at all, so when governments and central banks decided to pull the trigger on fiscal support they went hard from the word go.

This is not to say that support packages entered the market in their final form, because of course we have seen plenty of expanded and additional measures over the course of 2020.

But let’s remember the counterfactual: it took nearly three years for the Eurozone to get from the first signs of significant default risk in Greece to Mario Draghi’s legendary “whatever it takes” speech. The Reserve Bank of Australia (RBA) announced an unlimited volume of sovereign-bond buying for yield-curve control on 19 March 2020, just seven days after the World Health Organisation officially declared COVID-19 a pandemic.

It was abundantly clear even by this early stage that markets were going into a potentially catastrophic tailspin. Looking back at that frightening period, Australian market participants universally agree about three points in particular: that liquidity vanished for a period of a few weeks – in a manner akin to the financial crisis – that this period was relatively brief and market functionality rebounded quickly, and that the decisive actions of central banks were the main reason why confidence returned.

SEISMIC SHIFT

The impact of this support on the Australian economy – and the more direct fiscal intervention of federal government – has been tremendous. It enabled households to avoid penury even as unemployment spiked during the national and subsequent Victorian lockdown. Many people kept their jobs because of wage subsidies, and many that didn’t

were able to keep their homes because of enhanced unemployment payments and forbearance arrangements.

Household spending did not collapse, though the extent to which it moved online poses questions for the Australian retail sector. Moving into the latter part of the year, the economic recovery is surprising to the upside as people gradually return to something like normality – though a COVID-19 outbreak in New South Wales (NSW) in mid-December reminded that the crisis is far from over.

Australia is reasonably placed for recovery, it seems. But there is nothing to suggest the systemic challenges that existed before the pandemic will not still be there on the other side. In particular, while the Australian housing market seems as primed as ever to keep roaring ahead after the briefest of pauses in 2020, wage growth and business investment have been sluggish for years and COVID-19 does not seem likely to promote the type of confidence that would provide momentum.

Meanwhile, Australia’s capital market has been reshaped by fiscal policy. The new landscape provides further clues as to what the country can expect from its economy in the next phase. In particular, a banking complex that was until recently a massive net importer of capital is now flush with cash.

Some of this has arrived directly from the RBA, via the term-funding facility. But bank treasurers are quick to point out that the tsunami of deposits flooding into the system has been just as great a cause of the banks’ sudden lack of call on wholesale funding markets (see

p72). Australia is awash with liquidity: from government borrowing and the RBA, from corporates that cashed up in preparation for challenging times ahead, and from households that drew down on superannuation or took advantage of the constraints of 2020 to consolidate their own balance sheets.

The banking sector is the nexus for this unprecedented ocean of liquidity, and all the signs are that banks are keen to lend. Funding risk – including cost of funds – has been all but eliminated by the RBA and the pandemic had a smaller-than-anticipated impact on capital ratios. Profitability depends on the banks finding a home for their money.

CREDIT SUPPLY

The problem is locating someone to take it. Animal spirits are hard to find in the corporate sector, where many borrowers say they are still leaning more toward preserving cash in expectation of challenges when government support for households runs out in the first half of 2021 than to taking advantage of cheap liquidity to invest for growth.

Business confidence is picking up at the back end of 2020, though from an incredibly low base. And while the COVID-19 outbreak in South Australia turned out to be something of a false alarm, it is harder to be optimistic about the situation emerging in NSW just before Christmas.

This desire to invest – which is felt just as keenly by Australian fund managers, especially given the supply gap left by the absence of major-bank issuance – could be the catalyst for a quantum leap in sustainable finance.

It has been on my mind for some time that a key selling point of green and sustainable debt – access to a new pool of investor funds – was not really that compelling in a world of abundant liquidity. The liquidity position has only

grown, but the need to access funds may be changing. When borrowers had little to do but refinancing, the impetus to access new investors was limited. On the other hand, genuine commitments to environmental transition are likely to be accompanied with significant capex requirements.

Aligning those needs with a ready-made sustainable-debt market – that now offers a wider range of product and programme options than ever before – seems like a much more natural fit than trying to persuade a corporate treasurer to find a set of assets to do a vanilla refinancing in green-bond format.

In effect, this would represent a version of the much-maligned “green new deal” conducted entirely through the private sector and capital markets. Issuers and investors are getting to grips with the real and pressing nature of environmental risk,

“WHILE THE AUSTRALIAN HOUSING MARKET SEEMS AS PRIMED AS EVER TO KEEP ROARING AHEAD AFTER THE BRIEFEST OF PAUSES IN 2020, WAGE GROWTH AND BUSINESS INVESTMENT HAVE BEEN SLUGGISH FOR YEARS AND COVID-19 DOES NOT SEEM LIKELY TO PROMOTE THE TYPE OF CONFIDENCE THAT WOULD PROVIDE MOMENTUM.”

and the next step should be borrowers in particular making plans – that include new investment – for transition. If investors demand a premium for poor performers in the environmental, social and governance space (see p50 and p54) it can surely only provide another spur to action.

Guidance from the federal government would help, of course. If, for instance, corporate and subsovereign borrowers could peg their own plans to a credible policy trajectory toward net-zero emissions it could only assist with visibility and measurability. Such leadership is not going to be forthcoming in Australia,

however – at least not in the timeframe needed for action. So we will have to hope for critical mass of borrower commitments based purely on good faith and good analysis of future risk.

One area where Australia's federal government is more than happy to promote flow of capital is of course the housing market. Here, the desire to force credit into the already highly leveraged hands of households has reached a state that could under other circumstances be regarded as close to parody. Barely a decade after irresponsible lending caused the near-collapse of the world financial system, the Australian government considers house prices to be so critical to economic growth that it wants to dial back or remove responsible-lending obligations.

I am not suggesting that Australian banks will use any change in requirements immediately to start pumping out liar loans. On the other hand, there does not seem to have been any suggestion from the banking sector that its hands were tied when it came to provision of housing credit.

Even if they were, the robust nonbank lender sector seemed to be doing a more than adequate job of providing credit in the areas outside the banks' comfort zone – with the added bonus of not creating any

risk to deposit holders.

I tend to suspect the responsible-lending changes may turn out to be something of a fizzer. Certainly, nonbanks are more worried about the banks' cost-of-funds advantage than they are of an unchained stampede of new credit pouring into the nonconforming space. But it still seems a curious selection of priorities for government to be further opening the credit taps in a sector that has never struggled to rebound – housing – while doing next to nothing to promote the absolutely critical sustainable transition in the wider economy. •

Issuer-level strategy the focus for climate transition

The Green Bond Principles and Social Bond Principles, administered by the International Capital Market Association, launched the *Climate Transition Finance Handbook* on 9 December. The handbook marks a new phase in the evolution of the sustainable-finance market, according to market participants involved in its development.

BY SAMANTHA SWISS

The voluntary guidelines in the handbook are the result of a year's work of industry-wide and global collaboration managed by the Green Bond Principles and Social Bond Principles (GBP SBP) Climate Transition Finance Working Group.

The handbook's focus on issuer-level guidance rather than instrument-based principles is a clear difference from the GBPs, SBPs, sustainability bond guidelines (SBGs) and sustainability-linked bond principles (SLBPs).

The GBPs, SBPs and SBGs provide principles and guidelines for use-of-proceeds (UOP) bond instruments. The SLBPs, introduced in June 2020, cover bonds issued for general corporate purposes but which have their coupons linked to the issuer's overall sustainability performance. This marked an awareness by the GBP SBP that issuer-level strategy is becoming the most important factor for investors.

The SLBPs also introduced the concept that targets need to be core and material to a company's operations. The *Climate Transition Finance Handbook* takes this to another level via a thematic overlay focusing on climate-transition strategies to complement the issuance of any instrument, whether UOP-based or for general corporate purposes, to fund climate transition.

Adam Matthews, London-based director, investment team – ethics and engagement at the Church of England Pensions Board and co-chair of the Transition Pathway Initiative, said at a handbook launch event that it represents the GBP SBP building the architecture for the capital markets to play their role in supporting transitions.

“Companies are starting to detail how they can get from where they are today to alignment with the goals of the Paris Agreement. One of the keys to achieving this will be the ability to access finance that can enable transition to happen at pace in a credible, transparent way that is consistent with those goals,” Matthews commented.

EYES ON PARIS

While the guidelines can be used by any issuer, the focus is on hard-to-abate sectors. Denise Odaro, head of investor relations at International Finance Corporation in Washington and chair of the GBP SBP executive committee, explains: “To achieve the global goal of net zero by 2050 we need to beckon to the high-emitting sectors to partake in transition. This handbook offers the bridge for these hard-to-abate sectors to credibly access green, social and sustainability [GSS] bond financing, to enable them to take the steps needed to arrive at our overall objective.”

Paris goals are the ultimate aim and thus were also the starting point for the Climate Transition Finance Working Group. Yo Takatsuki, head of ESG research and active ownership at AXA Investment Managers in London and working-group co-chair, said at the pre-launch press conference: “There was a very strong feeling within the working-group members that achieving the Paris Agreement is the most important goal of all. We are not talking about business-as-usual decarbonisation.”

Using the handbook's guidelines to frame bond issuance implies a more strategic direction for issuers. As such, compliance may prove to be more onerous even than issuing a use-of-proceeds



“To achieve the global goal of net zero by 2050 we need to beckon to the high-emitting sectors to partake in transition. This handbook offers the bridge for these hard-to-abate sectors to credibly access GSS bond financing.”

DENISE ODARO INTERNATIONAL FINANCE CORPORATION

product like a GSS bond if an issuer does not already have a transition strategy in place.

The handbook recognises that issuers may be starting from scratch, either due to constraints within their industry or because they are making a new commitment to transition.

Robert White, executive director and head of green and sustainable hub – Americas at Natixis in New York, said at the pre-launch press conference: “The guidelines have been written to support issuers at various points in their transition journey, but it is on a best efforts basis. At the very least, issuers need to be able to articulate to the market how they are progressing against each of the recommended elements. This is a way for issuers to signpost how they are developing plans to expand or enhance their transition strategies.”

The handbook also aims to ensure that issuers can make use of existing frameworks, methodologies and reporting documents. Farnam Bidgoli, head of sustainable bonds, EMEA at HSBC in London, explained at the launch event: “The handbook is meant to incorporate a view on what is happening globally and ensure that we are aligned with other recommendations. It is not to duplicate work or add to reporting requirements but rather to clarify and highlight what is critical for debt issuance when it comes to climate-transition finance.”

Paris Agreement goals cannot be achieved without high-emitting sectors joining the climate-transition journey. But not all companies in these sectors have green or social assets to fund with UOP bonds. Even if they do – or if they consider SLBs – there are reputational risks to consider given the heightened public scrutiny such issuers face.

These are the companies and sectors that most need access to sustainable funding if they commit to climate transition, though – because adapting entire business models typically requires substantial capex and possibly opex commitments.

The Climate Transition Finance Working Group recognised this barrier to entry. The handbook’s four elements (see box on p16) show issuers how they can position their debt issuance within a transparent and science-based climate-transition strategy.

Using the tools in the handbook, which emphasise engagement, transparency and disclosure, issuers should be able to develop confidence to access sustainable financing credibly and without fear of reputational risk or accusations of greenwashing.

The handbook also acknowledges other challenges for companies in hard-to-abate sectors. In particular, these include variation between companies within a sector and the limits on

individual entities’ ability to move the dial. Constraints can be imposed by external factors such as regulation and policy.

Dialogue and transparency are key in helping investors understand what a company is doing and the limitations it is operating under. The handbook aims to provide a common language for issuers in high-emitting sectors to articulate transition strategy to investors.

Johannes Böhm, ESG analyst at Union Investment in Frankfurt, added: “Determining the shade of green of a particular transaction comes down to taking a deep dive together with the issuer. Dialogue gets to the point where one has an honest sense of how ambitious and credible an issuer is in tackling its own transformation toward a more sustainable business model.”

NOT ABOUT THE LABEL

By focusing on communicating issuer-level strategy to investors, the handbook recognises that sophisticated investors are looking beyond labels. As Matthews said: “If you are in a hard-to-abate sector, whatever label of bond you issue you need to demonstrate this kind of information.”

As such, the handbook focuses on the outcome of achieving the Paris Agreement goals and credibility by aligning with climate science. Takatsuki explained: “Labelling is how you signal, to the market and wider stakeholders, alignment with end outcomes and credibility around this strategy.”

The working group was therefore happy to leave the choice of debt instrument to issuers and investors. As Paul O’Connor, executive director and head of EMEA ESG debt capital markets at J.P. Morgan in London, said at the launch event: “It is up to the issuer to build a rationale and construct a case to use a label, and up to the investor to accept it. The handbook is all about the music being played, not about the instrument or the orchestra. If the music is right, we will make progress.”

The focus on the overarching theme of climate transition also enables issuers to incorporate broader concepts into their transition strategies and debt issuance. The handbook’s third element introduces the concept of “just transition”, for example.

As White said: “This is issuer-level guidance so the issuer may not just be issuing a green bond or an SLB. It could be doing a sustainability bond that also incorporates social-bond elements.”

He explained that an issuer can deploy various levers to achieve its climate-transition strategy. For issuers in certain sectors – especially greenhouse-gas-intensive ones – rapid decarbonisation can have material social impact, including on employees.

“There was a very strong feeling within the working-group members that achieving the Paris Agreement is the most important goal of all. We are not talking about business-as-usual decarbonisation.”

YO TAKATSUKI AXA INVESTMENT MANAGERS



Four elements of the handbook

The *Climate Transition Finance Handbook* comprises four pillars that aim to give issuers the building blocks credibly to communicate their alignment with global climate goals when raising funds in debt markets for climate-transition-related purposes.

The pillars require a climate transition strategy to be strategic, material, science-based and transparent. Means of disclosure are addressed within each element, and verification is also recommended for the first three.

The first element is an issuer's climate-transition strategy and governance, which encompasses strategic, issuer-level intentionality. The strategy should clearly communicate how the issuer intends to adapt its business model to make a positive contribution to transition to a low-carbon economy.

Farnam Bidgoli, head of sustainable bonds EMEA at HSBC, said at the handbook launch event: "There was clear consensus within the working group that climate-transition finance should not be marginal to what the issuer is doing but rather should be part of a holistic strategy to adapt the business model to make a positive contribution to the transition to a low-carbon economy."

According to Bidgoli, the governance aspect of this pillar aims to ensure that, in addition to senior-level oversight of the climate-transition strategy, the strategy sits within a broader sustainability approach that mitigates other environmental and social externalities and contributes to sustainable development more broadly.

When it comes to disclosures to investors seeking to assess the credibility of a strategy, the working group points to existing guidance such as the Task Force for Climate-related Financial Disclosures and other frameworks. The handbook also recommends a technical review of a strategy including alignment of long- and short-term targets with the overall scenario and the credibility of the issuer's plan to reach the targets.

The second element is business-model environmental materiality. Paul O'Connor, executive director and head of EMEA ESG debt capital markets at J.P. Morgan, said at the launch event: "The idea here is to ensure that, if

a transition-finance market emerges, it is focused on issuers and industries that could make best use of it. It's an effort to make sure we don't have ideas in play that won't move the needle very far."

O'Connor said there are a number of ways to think about materiality – including whether a business's prospects will be impaired by government intervention to limit carbon emissions, or whether a business is exposed to technology change that would result in demand for a product dropping off as a result of low- or zero-carbon alternatives becoming available.

Also important, he added, is the extent to which the level of emissions and a company's overall contribution is significant in the broader context.

"There is a lot of flexibility here," O'Connor said. "The sectors in play are very different from each other, and the companies within those sectors have different operating contexts. We need maximum flexibility to allow potential issuers of

transition-finance instruments to talk about materiality in a way that makes sense for them."

Ultimately, he added, this is all about disclosure, transparency and building dialogue with investors.

The third element is that a climate-transition strategy should reference science-based targets and transition pathways. Bidgoli explained: "The key takeaway here is that investors expect transition trajectories should be quantifiably measurable and benchmarked against science-based trajectories where they exist, and that this should be publicly disclosed and independently verified."

The fourth handbook element is implementation transparency. The idea is for issuers to provide transparency over the expenditures that will help them achieve their climate-transition strategy. These could be R&D-related, relevant operating expenditures, or any costs outside business as usual that are incurred to deliver the strategy.

"Providing guidance on any investment or expenditures related to just transition is very helpful in this context, and it is also tied into a number of the [UN] Sustainable Development Goals," said White.

Deploying the concept of a just transition enables issuers to make transition as painless as possible, or even a wider positive.

O'Connor explained: "In the oil and gas sector, for example, companies can look at skills transferability into the hydrogen economy. It's not just a question of shutting down stranded assets and walking away – this is the worst outcome for everyone. It's about retraining and support. These transitions are not without opportunities if approached in a thoughtful way." •



"The handbook is meant to incorporate a view on what is happening globally and ensure that we are aligned with other recommendations. It is not to duplicate work or add to reporting requirements."

FARNAM BIDGOLI HSBC

ASFI plots Australia's path to zero emissions

The Australian Sustainable Finance Initiative roadmap, published on 24 November, puts forward a plan to align the Australian economy and financial system with outcomes that encourage sustainability, resilience and future prosperity. It sets ambitious targets, including some that stretch beyond federal government goals, and lays out a timeline for achieving them.

BY MATT ZAUNMAYR

The roadmap is the culmination of around two years of collaboration between 140 finance-industry, government, regulatory and academic representatives, from 80 institutions. It seeks to provide guidance for the financial system to address the challenges presented by climate change, worsening biodiversity, and inequality of income, health and education.

It joins an increasing array of roadmaps rolled out by industry bodies and governments in jurisdictions around the world. The New Zealand Sustainable Finance Forum released its roadmap just a few weeks before the Australian publication (see p20).

Among the goals and outcomes of the Australian Sustainable Finance Initiative (ASFI)'s roadmap are a net-zero carbon-emissions target by 2050, the implementation of mandatory reporting against the Taskforce for Climate-related Financial Disclosures (TCFD), the facilitation of capital to support delivery of the UN Sustainable Development Goals (SDGs) and to establish Australia as a hub for sustainable finance.

The roadmap offers 37 recommendations categorised under four key themes: embedding sustainability into leadership, integrating sustainability into practice, enabling resilience for all Australians and building sustainable-finance markets. Each recommendation has implementation targets in each of 2022, 2025 and 2030.

The roadmap also sets out an action plan to identify the financial-system participants that should be responsible for the implementation of recommendations.

In a briefing to launch the roadmap, Melbourne-based ASFI co-chair and chief executive at Responsible Investment Association Australasia, Simon O'Connor, said that to achieve the vision of the roadmap "we need whole-of-system change... We need to effect change at the multiple levels of the financial system, but also to collaborate efforts across industry, regulatory and government levels".

ESTABLISHING ACCOUNTABILITY

The roadmap identifies leadership across all parts of the financial system as crucial for the achievement of its vision.

At the KangaNews Sustainable Debt Summit (SDS) on 25 November, Jacki Johnson, co-chair of ASFI in Sydney, said: "It is very important to consider the current conditions we operate in while being mindful of the long-term shift needed. Decision-making needs to happen in this continuum, which is why we think it needs to be embraced at board and executive level as well as in the purpose of corporations."

The roadmap process was industry-led, with government and regulatory bodies participating as observers, and the accountability for outcomes will be the same. The first recommendation of the roadmap is for accountability to be led from the top of financial institutions (FIs). This refers to the integration of sustainability in FIs' purpose, corporate strategy, risk-management frameworks, remuneration structures and organisational culture.

On the same panel at SDS, David Atkin, former chief executive at Cbus Super in Melbourne and ASFI steering

"It is very important to consider the current conditions we operate in while being mindful of the long-term shift needed. Decision-making needs to happen in this continuum, which is why we think it needs to be embraced at board and executive level and in the purpose of corporations."

JACKI JOHNSON AUSTRALIAN SUSTAINABLE FINANCE INITIATIVE



committee member, said: “We are saying to the finance sector that regulation and policy is important, but actually our own agency as organisations in addressing sustainability is also fundamental. We do not need to wait for policy to drive outcomes.”

This is different from the approach taken in many other jurisdictions, including the EU, UK and New Zealand, where embedded policy and regulatory recommendations have been key. But the context in which ASFI has created its roadmap is one of much less domestic political leadership.

Australia was already a laggard in tackling climate change when ASFI began its work in 2018. By 2020, with the roadmap finished, Australia’s federal government is becoming increasingly isolated on the global stage in not committing to net-zero carbon emissions by 2050.

The roadmap’s authors are confident, though, that Australia’s response can be robust even in the absence of strong government policy signals. O’Connor says embedding sustainability into the culture and targets of individual organisations starts with the leadership of boards and executives. This will be critical in setting the tone for implementation of the roadmap.

Many FIs are already some way down the road to hitting this target by implementing sustainability strategies and targets. In fact, O’Connor stresses that a key point of the roadmap is to join the dots of the vast amount of activity to meet sustainability objectives that is already underway, and to harmonise this with global developments.

However, the roadmap pushes individual entities within the financial system to go further, for example by building partnerships that capitalise on the expertise of institutions outside the financial sector to build mutual understanding and improve activities’ impact.

Accountability is not intended to sit only with individual institutions, either. Roadmap recommendation five is to establish a permanent ASFI to deliver and monitor progress toward the stated objectives. This would be governed by a board of representatives from FIs and have an advisory council comprising government, regulators, industry bodies and civil society representatives.

The body would also establish and run forums for financial risk and sustainable practices, sustainable-finance markets, leadership, and the Australian sustainable-finance system. The permanent body is expected to be in place by July 2021.

Such an entity is not intended to replace existing organisations, though. At SDS, Johnson told the virtual audience that many of the roadmap recommendations touch on commitments made by organisations to global bodies such as the Principles of Responsible Banking and Principles of Responsible Insurance. Nothing in the report is at odds with these existing commitments, she adds.

Instead, the ASFI permanent body will oversee cross-sector implementation of the roadmap’s recommendations and facilitate the development of measures requiring ongoing industry collaboration, for instance an Australian market taxonomy for sustainable finance.

The roadmap suggests further measures designed to increase Australian accountability within the global system, such as joining the International Platform on Sustainable Finance, and within Australia itself through measures such as the establishment of a First Peoples Financial Service Office. This would be headed by an indigenous person and is intended to build partnerships with Aboriginal and Torres Strait Islander groups, thereby establishing better access to suitable financial services.

“No-one in ASFI views Aboriginal and Torres Strait Islander people as vulnerable, but it is true that the financial sector has been poor in seeing the needs for banking, insurance and investment in these communities,” said Johnson at the roadmap launch. She added that the body would be as much about the financial sector learning from First Nations people as it is about providing better services.

SUSTAINABILITY IN PRACTICE

By setting out the various channels of leadership and accountability required to implement the roadmap, ASFI is hoping sustainability targets and measurements can be brought into mainstream practice across the financial system.

ASFI hopes some approaches that are mandatory in other jurisdictions, such as TCFD reporting, can be installed in the Australian economy voluntarily. ASFI recommends that all ASX300 companies should report according to the TCFD by 2023 on an ‘if not, why not’ basis.

It also recommends the development of several other avenues for guidance, including the establishment by ASFI of a taxonomy, akin to what has come into force in the EU, which by 2025 would provide common language and measurements for engaging with sustainable finance.

Furthermore, it urges the creation and development of stress-test and scenario-analysis frameworks so the financial system can be better prepared for future crises, the development of a taskforce for nature-related financial disclosures and the development of stewardship codes.

All of these are expected to contain science-based targets and measurements, O’Connor explains, so capital can be aligned with the outcomes outlined by the roadmap.

Through these recommendations, the idea is that the market and wider economy will naturally develop a carrot-and-stick approach to companies and their sustainability strategies. To an extent this has already developed but the ASFI vision is for it to be accelerated and become far wider reaching.

“Those that are genuine in their commitments will be rewarded by the marketplace, whereas those that are laggards will be caught out by customers and investors,” said Atkin at the SDS virtual event. He added that while the regulatory impetus in Australia has been slower than he would like, the global regulatory trend is only going in one direction.

Atkin also said that, if implemented, the roadmap recommendations will help facilitate mobilisation of capital for long-term value creation that sets up the Australian economy

to deal with negative externalities that are only increasing in materiality.

Johnson added that the increasing robustness of corporate sustainability reporting is already yielding benefits for companies that are genuine, and pitfalls for those that are not, through staff retention.

Michael Chen, head of sustainable finance at Westpac Institutional Bank in Sydney, said at SDS that this mobilisation of capital was likely to be the component of the roadmap that gathers most investor and issuer attention. “An overarching strategy needs to be in place for this to be done successfully,” he suggested.

ASFI would also like to see an increase in the granularity and availability of data to assess progress at national level. “Disclosure and reporting are not the end goal. They are critical enablers to get where we need to go, but they only work when complemented by goals and measures at entity and national level,” O’Connor explains.

ASFI’s permanent body will be crucial in enabling this, Johnson explained at SDS, by allowing various sectors where rich data already exists to share expertise.

market that efficiently directs capital to sustainable outcomes, according to O’Connor.

The overarching goal of Australia’s sustainable-finance market, per the roadmap, should be to set science-based targets and trajectories that facilitate the Australian economy’s transition to net-zero emissions by 2050. This would apply even if a commitment never comes from the federal government.

“The eight recommendations within the ‘building sustainable capital markets’ theme are very important. There is a lot of fragmented data in the marketplace and the transparency and labelling of products is part of this,” said Johnson at SDS.

By sharing data and collaborating across industries, Johnson believes better outcomes can be achieved from debt instruments. Objectives and achievements for labelled and unlabelled bonds could be made much more transparent, for instance.

Atkin added that investors are already positioning their strategies for a future defined by sustainability and climate change, and that the recommendations of the roadmap will help them and issuers better to define and meet these requirements. “Investors are identifying this as a present, macro-strategic challenge that they must incorporate into their strategies.

“Disclosure and reporting are not the end goal. They are critical enablers to get where we need to go but they only work when complemented by goals and measures at entity and national level.”

SIMON O’CONNOR AUSTRALIAN SUSTAINABLE FINANCE INITIATIVE



ASFI envisions the expansion of reporting and data provision will support the resilience of individuals and the wider financial system by allowing institutions to craft targeted and robust financial products with better labelling standards, as well as in reporting on measures such as financial distress and outcomes for Aboriginal and Torres Strait Islander people.

Chen said while some boards and executives may balk at the prospect of increased reporting, many are now viewing the challenge of sustainability and climate change as one where they may gain competitive advantage. Increased reporting and disclosure is important in unlocking this.

ASFI also intends increased data to assist with the development of an Australian wellbeing framework similar to what the New Zealand government has put in place, to measure and target social and economic wellbeing alongside economic growth.

MARKET ENABLERS

The first three recommendation categories in the ASFI roadmap – embedding sustainability in leadership, integrating it into practice and enabling resilience – should enable the development of a robust sustainable-finance

They are looking to do analysis on their portfolios to mitigate the risks of climate change, but also to identify and take up opportunities,” he explained.

While many of the roadmap’s suggestions to beef up sustainable-finance markets will be participant driven, ASFI also suggests some can be achieved, or at least supported, by regulatory intervention.

For example, the roadmap says market development should involve the provision of regulatory incentives to FIs to direct capital toward sustainability-linked assets. It proposes this could be achieved by tinkering with Australian Prudential Regulation Authority’s Pillar 2 supervisory review process, or by the Reserve Bank of Australia applying a reduced haircut to suitable high-quality liquid assets and securities eligible for the committed liquidity facility.

By promoting the development of a larger and more robust market, ASFI believes Australia can become a regional sustainable-finance hub and also build out the market to support measures for large-scale deployment and development of innovative technologies, climate-change risk mitigation and the regeneration of real assets such as infrastructure and property so they are fit for a low-emissions future. •

NZSFF targets transformation, simplicity and urgency

The New Zealand Sustainable Finance Forum's final roadmap plots a route for reform that its authors say is necessary for the financial system to be fit for purpose in a sustainable future. The roadmap's focus is long-term and transformative in nature but it proffers immediate, actionable measures appropriate for the urgency of the task.

BY MATT ZAUNMAYR

The roadmap's overarching purpose is to detail the necessary steps required to transform New Zealand's financial system into one that supports long-term environmental, social and economic prosperity instead of focusing purely on short-term goals at the expense of natural and social capital. The results are designed to align with Paris Agreement outcomes and the UN Sustainable Development Goals.

The roadmap is the result of nearly two years' work, since the New Zealand Sustainable Finance Forum (NZSFF) was established by the Aotearoa Circle in January 2019. It was initially due for release in July 2020, following the publication of the NZSFF's interim report in October 2019. However, the unique circumstances of 2020 pushed the launch to November, as financial market participants dealt first with the immediate threat of COVID-19 and related economic turmoil.

Karen Silk, Auckland-based outgoing co-chair of the NZSFF and general manager, experience hub at Westpac, says the delay affected neither the outcome nor priorities. She adds, though, that it did allow for extra stakeholder engagement, particularly with the government and Māori and iwi groups.

The report outlines three key themes that between them incorporate 11 priority areas with recommendations for implementation and accountability for leadership. The "changing mindsets" theme comprises the responsibility, capability and governance priorities. "Transforming the financial system" incorporates data, disclosure, coordination, value, inclusiveness and government leadership. Finally, "financing the transformation" incorporates resiliency, and standards and pathways as its priorities.

The roadmap also sets out five implementation principles designed to remind market participants of the NZSFF's overarching vision for roadmap implementation.

First is leadership, which is required across all financial-system actors to address the challenge with urgency. Second is system change, which emphasises the need to start from first principles and reconsider the status quo rather than simply add to existing legislation, norms and frameworks. The third principle stresses

the need to shift markets to consider all stakeholders rather than just shareholders. The fourth recognises that all the roadmap's priority areas are interconnected. Finally, the fifth implementation principle places NZSFF's proposals in the international context, where much sustainable finance policy has already been set.

REVOLUTION NOT EVOLUTION

The NZSFF's emphasis is on system-level change. While it is imperative for individual actors to transition to sustainable means of doing business, ad-hoc individual implementation will not be sufficient to meet the challenge of moving a whole economy and financial system to a sustainable base level of operation.

As Silk says: "Unless the whole system changes, we could end up with something that sits on the side and won't achieve the transformation we are aiming for. To transform an economy, you need to transform everything that goes with it."

System-level change will require coordination, and for this the NZSFF recommends the establishment of an independent Centre for Sustainable Finance (CSF), which would be funded and designed to manage the implementation of the roadmap through partnership between public, private, iwi and Māori, and philanthropic entities. The roadmap states that a similar approach has already been taken in the UK, Canada and Australia.

The NZSFF roadmap leverages the insights and expertise of New Zealand's finance industry to identify what needs to be done but acknowledges that it is beyond the scope of the voluntary initiative to "delve into how this will be achieved".

"Governance is important to set the tone from the top. We do not want this to become a compliance outcome, rather we want to capture innovation outcomes which will be crucial for transformation," Silk explains.

Bringing the government into the equation is also essential to round out the circle of accountability between public and private institutions as well as other stakeholders, she adds.

The New Zealand government has been making moves to encourage a more sustainable economy, such as implementing mandatory reporting against the Task Force on Climate-Related

Financial Disclosures (TCFD) for some institutions. However, in New Zealand as in most countries, the government is the largest player in the game. It can be a leader down to simple facets of agencies' operations, such as embedding sustainability in their procurement processes or mandating the use of electric vehicles in their fleets.

The CSF will ideally provide a significant impetus for ministers and agencies to engage with the necessary reforms and create capacity for their achievement. It also would ensure that no sector is left behind, says Silk, adding that all the recommendations in the roadmap are critical and their outcomes are interdependent.

SIMPLICITY IN REFORM

The advances made so far by financial markets to embed sustainability in processes have been mostly through addition to existing structures rather than a rethink of the entire system as the NZSFF proposes is necessary.

The ad-hoc approach potentially discourages some market participants due, for example, to the added burden of reporting on sustainability compliance outcomes, on top of the regular

LONG-TERM URGENCY

The roadmap's main goal is to develop a sustainable financial system by 2030 that is also resilient, inclusive, robust and agile. For this to happen, the NZSFF says its recommendations must be implemented within the next five years. The recommendations are presented in three waves of priority order.

Wave one includes goals that can be implemented immediately and are expected to be so within 1-2 years, even if they require legislation. Wave two includes actions that may require additional research or consultation and is expected to be implemented within 2-3 years. Wave three encompasses those actions that are expected to require extensive development, consultation and potentially legislative change, and are expected within five years.

The roadmap does not discuss any activities to be pursued only over the long term, the purpose being to reflect the urgency of required action. "We do not have the luxury of waiting until 2030 to meet these challenges. Some things need to be developed but many others are critical and can be implemented now," Silk tells *KangaNews*.

"Unless the whole system changes, we could end up with something that sits on the side and won't achieve the transformation we are aiming for. To transform an economy, you need to transform everything that goes with it."

KAREN SILK NEW ZEALAND SUSTAINABLE FINANCE FORUM



reporting they need to do. Silk comments that this method, where criteria are always being added to existing requirements, will result in institutions only dabbling in various and disparate parts of sustainable finance.

She says: "We do not want to make things more complex. Simplification is difficult to achieve but if you do not try to make it simple you risk either creating loopholes or discouraging engagement."

In the roadmap's detailed recommendations for disclosure, a key desired outcome is to improve and extend reporting of environmental and social performance. Crucially, however, a key part of this is ensuring that all stakeholders and participants in the finance industry are reporting according to the same suite of credible and comparable metrics.

This is similar to aspirations of the EU's taxonomy for sustainable activities, which provides a framework for all market participants to assess the impact of their investments via credible and comparable metrics.

Heralding system-level change is not simple, but the NZSFF believes it is important in resetting the playing field so that all actors are guided by a coherent set of outcomes and can more easily assess their progress and achievement.

Some of the 11 priority areas can be achieved within wave one or two, such as establishing the CSF and developing a whole-of-government sustainable-finance strategy. However, most require steps to be taken and achieved in all three waves.

For example, under the standards and pathways priority area, wave one involves developing standards for sustainable finance and investment. Wave two is to consider same-class exemption rules for labelled bonds, improve regulatory oversight and review liquidity requirements for KiwiSaver. Finally, wave three is to transform public-sector investment to deliver on sustainable outcomes.

The ideal end-state of this process is one where sustainability is considered in all activities and by all players in the finance industry, and to ensure the future use and value of commodities and resources is incorporated in the present assessment of their worth. This is intended to enshrine the importance of sustainability and resource regeneration in shareholder value.

Silk says this reflects a shift in conversation evident in the last five years, under which sustainable finance has become increasingly mainstream including a greater focus on ensuring investments are not compromising the ability of future generations to meet their needs. •

More support in reserve

The Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ) used their respective November monetary-policy decisions to roll out a raft of additional support measures for economies in the earliest stages of recovery.

There are reasons for optimism – including a receding prospect of negative rates in New Zealand.

BY LAURENCE DAVISON AND CHRIS RICH

As widely expected, the RBA used its 3 November statement on monetary policy to unveil new measures designed to support Australia's economic recovery, including a cash-rate 'micro cut' and A\$100 billion (US\$73.8 billion) of additional government-sector bond purchases. At the same time, the statement delivered a relatively positive view on the economic trajectory.

Noting that recovery is "expected to be bumpy and drawn out", the RBA cut the cash rate to 0.1 per cent from 0.25 per cent and reduced to the same level the target rate for the three-year Australian Commonwealth government bond (ACGB) and the bank term-funding facility (TFF). It also cut the interest rate on exchange-settlement (ES) balances to zero.

There is also an expansion of direct support for sovereign-sector borrowers. The RBA will purchase A\$100 billion combined of ACGBs and semi-government securities with tenor of "around" 5-10 years over six months, all in the secondary market. The reserve bank has an "expected 80-20 split" between sovereign- and state-government debt for these purchases.

This marks a change in approach from the RBA's yield-curve targeting at three-year tenor. Here, there is no limit to the volume of bonds the reserve bank is prepared to buy to keep ACGB yield at or close to its target.

The longer-dated buying is the first market intervention the RBA would itself categorise as QE. In a 16 November speech, RBA governor, Philip Lowe, noted that the new bond-purchasing scheme represents an additional focus on the quantity of money instead of just its price – which was the only goal when reserve-bank activities were purely targeted at the short-term interest rate.

The announcement of the new buying programme was followed almost immediately by a significant increase in RBA purchasing activities. Having not acquired any longer-dated ACGBs since May, the RBA bought A\$16 billion of maturities

from November 2024 to May 2032 in November as well as A\$5 billion of shorter-dated bonds (see chart).

The scale of the new programme came as no surprise to the analyst community – in fact, the figure of A\$100 billion had been widely mentioned as the most likely scale of asset purchases, should one be announced, in analyst commentary immediately preceding the November RBA rate decision.

Overall, however, most observers believe QE of this scale leaves the RBA with room to do more both in absolute terms and relative to its global peers. For instance, speakers at a KangaNews Debt Capital Markets Summit webinar in October noted that the RBA's assets on balance sheet are still significantly less, as a share of GDP, than most central banks'.

"We are trying to figure out how big the RBA's programme could be under QE. As a back-of-the-envelope calculation, by June 2021 after all the TFF drawdowns have taken place the RBA will have a balance sheet of around A\$420-450 billion. To get anywhere near the Fed [US Federal Reserve] or BoE [Bank of England], at 35 per cent of GDP, it suggests a QE programme of A\$250-300 billion," Prashant Newnaha, senior Asia-Pacific rates strategist at TD Securities in Singapore, said at a KangaNews webinar in mid-November.

The additional A\$100 billion does not include purchases made in the ongoing yield-curve targeting programme – which amounted to more than A\$31 billion since introduction in March, including nearly A\$17 billion in the August-November period – or TFF lending to banks.

Even so, by late in the year many analysts expected an extension of the RBA's QE programme in 2021. An ANZ research note published on 19 November says: "While the economy is performing better than expected, it still faces considerable challenges. And if the RBA does nothing, monetary policy will be tightening in mid-2021 as the TFF and QE programmes expire."

The note argues that an extension of QE and the TFF beyond their current end dates is “inevitable” though some degree of tapering is possible. On the other hand, it adds: “Only extreme circumstances, such as a failed recovery and dysfunctional markets, would cause the RBA to broaden its QE programme by purchasing private-sector securities.”

TECHNICAL NEGATIVE

The RBA’s decision to cut the ES rate to zero also attracted some attention, as most analysts had expected a residual positive interest rate, albeit one as low as 1-5 basis points, would be retained. Analyst interest focused on the increased likelihood of a negative front-end rate following the cut.

For instance, a Commonwealth Bank of Australia research note published on 3 November said a negative bank-bill swap rate (BBSW) would be possible as early as the following day and that “as the RBA buys over the next six months ES balances will rise and the BBSW will come under further downward pressure”.

While negative BBSW did not emerge immediately, the same note points out that the March 2021 bank-bill futures contract did trade at 100.01 per cent – technically a negative rate.

The RBA appears to be less concerned about the impact of a technically negative rate in capital markets relative to its oft-repeated resistance to a negative headline cash rate. *KangaNews* understands the rationale for dropping the ES rate to zero was the RBA’s belief that there would be little or no material difference between this and a rate of a nominal handful of basis points, and no additional value in further ‘micro cuts’ like that applied to the cash rate in November.

Meanwhile, the money market is already familiar with ultra-low front-end rates. But, by contrast, there is little evidence of negative rates applied in offshore jurisdictions being passed on to retail borrowers.

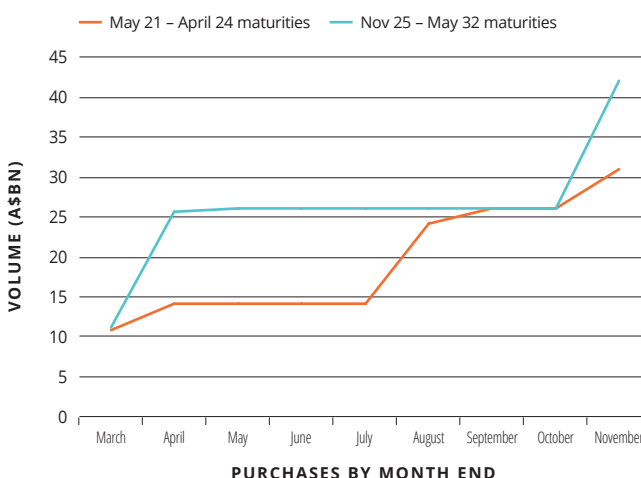
POSITIVE OUTLOOK

Despite the package of new measures – which in the main had been widely anticipated by the market and analysts – the RBA struck a relatively upbeat tone in its November statement. It noted that recovery is underway globally, led by China, and it expects positive GDP growth in Australia in Q3. The Q3 GDP number, published on 2 December, came in at 3.3 per cent.

Also in its November statement, the RBA revised its peak unemployment forecast to “a little below 8 per cent” from 10 per cent, and says it also expects the rate to drop to 6 per cent by the end of 2022.

Even so, the RBA expects inflation to remain low for some time – at 1 per cent in 2021 and 1.5 per cent in 2022. It said: “The board views addressing the high rate of unemployment as an important national priority. Today’s policy package, together with the earlier measures by the RBA, will help in this effort. The RBA’s response is complementary to the significant steps taken by the Australian government, including in the recent budget, to support jobs and economic growth.”

CUMULATIVE RBA PURCHASES OF ACGBs



SOURCE: KANGANEWS, RESERVE BANK OF AUSTRALIA 7 DECEMBER 2020

The RBA maintains its expectation that it will not increase the cash rate for “at least three years”, adding that it is “prepared to do more if necessary” with its bond-purchase programme.

NZ GETS FLP

A week after the RBA’s November statement, the RBNZ followed with its own package of additional support measures. Notably, the November monetary policy statement (MPS) included the introduction of a funding-for-lending programme (FLP) that could total NZ\$28 billion (US\$19.8 billion). At the same time, the RBNZ noted that an improved economic outlook also makes a negative cash rate less likely in 2021.

In accordance with guidance issued in March, the RBNZ held the official cash rate (OCR) at 0.25 per cent. It also maintained its existing large-scale asset purchase (LSAP) programme of NZ\$100 billion.

As flagged at its August MPS, the RBNZ released details of the FLP including confirming its launch in early December. The goal is to provide additional monetary stimulus to the economy by lowering the cost of borrowing for businesses and households.

This will be achieved through three main channels: directly through cheaper FLP funding to finance lending by eligible participants, indirectly through a reduction in interest rates on other forms of funding and by supporting the supply of credit to the economy.

Banks will be eligible for funding of up to 4 per cent of their outstanding loans and advances at a cost of the prevailing OCR, with an additional 2 per cent also be available under certain conditions.

RBNZ assistant governor, Christian Hawkesby, estimates the programme will, if fully drawn, total NZ\$28 billion. He says, though, the RBNZ is focused less on the size of the programme and more on its impact on assisting banks to lower lending rates across their books.

HIGH LVR RESTRICTIONS BACK ON THE TABLE IN NEW ZEALAND

Loan-to-value (LVR) restrictions on high-risk lending is back on the table in New Zealand from March 2021, having been removed in May 2020 to enable freer credit flow.

The Reserve Bank of New Zealand (RBNZ) revealed on 11 November that it is taking action based on improved lending market conditions and its observation of “rapid growth in higher-risk lending”.

Adrian Orr, the RBNZ's governor, said although it was a hard decision to renege on a commitment to keep the LVR restriction lifted for 12 months, ultimately the RBNZ's financial-stability mandate demanded it be reinstated. March is the earliest possible date given the need for consultation with lenders.

Orr added that multiple stakeholders, including

banks, have explicitly asked the RBNZ to reintroduce the LVR restriction. To support financial stability, the central bank also announced a further delay in the implementation of increased capital requirements for banks, to July 2022 from July 2021, to continue allowing headroom for banks to respond to COVID-19. The implementation was first delayed in March.

There seems little prospect of the Reserve Bank of Australia (RBA) following suit with its own measures to restrict housing-market lending. A source familiar with RBA thinking tells *KangaNews* it is comfortable that the housing market is part

of, rather than a distortion to, the overall economic recovery.

In fact, the RBA appears to believe higher house prices could actually improve financial-system stability. This relies on higher house prices increasing the likelihood of home owners retaining some capital should they be forced to sell – a potential consequence of higher unemployment.

There is a notable divergence in thinking on house prices between Australia and New Zealand – but at government level. The Australian federal government clearly believes higher house prices are positive in an economic

recovery, and has even moved to ease responsible lending rules further to boost housing finance (see p69).

By contrast, New Zealand's minister of finance has requested the RBNZ to “work together to address the issue of rising house prices”, including a suggestion that “avoiding unnecessary instability in house prices” could be added to the monetary-policy remit.

The LVR move would not be a long-term answer, in the RBNZ's view. Its response to the minister argues that a supply-side focus has a more significant impact on prices.

Hawkesby explained that the RBNZ decided against limiting banks' lending through the programme to favour businesses in its initial or additional allocations. This is because the reserve bank does not believe the current reduced level of lending to businesses is a product of cost but rather subdued confidence in the market. After studying targeted constraints implemented overseas, Hawkesby said the RBNZ concluded they are not effective.

In a further effort to facilitate credit supply, the RBNZ also announced in November that it will further delay the implementation of increased capital requirements for banks, to July 2022 from July 2021, to continue allowing headroom for lenders to respond to COVID-19. The implementation was first delayed in March.

RBNZ deputy governor, Geoff Bascand, said the reserve bank “remains committed to increasing capital requirements in the medium term”. He also reiterated the importance of buffers like enhanced capital requirements even during the COVID-19 crisis.

But he added: “Delaying the implementation of parts of the capital-review decisions by a further 12 months strikes the right balance between providing more headroom for banks to support lending now by drawing on their capital buffers, while also ensuring that capital levels lift in the longer term to support financial stability.”

Even the revised implementation timeline is uncertain, as the RBNZ said it will “consider making further amendments to the timing if the conditions warrant it”.

The regulatory environment is not quite full-steam-ahead for the New Zealand banking sector, however, as the RBNZ is also exploring the possibility of reintroducing restrictions on higher-risk mortgage lending (see box on this page).

IMPROVING OUTLOOK

Overall, the RBNZ cast a relatively upbeat tone in its November MPS as several leading indicators have surprised to the upside. “Economic activity since the August MPS, both international and domestic, has proved more resilient than earlier assumed. In New Zealand this trend was evident across a range of indicators, including employment, household spending, GDP, and asset prices,” the RBNZ said.

The November MPS forecast unemployment to peak at 6.4 per cent in the middle of next year, a stark contrast to the 8.1 per cent forecast for Q4 2020 in the August statement. The RBNZ acknowledged the COVID-19 shock to the economy will persist for a prolonged period, nonetheless.

The RBNZ's rosier outlook and reserved language around the prospect of a negative OCR led many analysts to revise their OCR calls.

BNZ and ASB Bank both now expect the RBNZ to hold off the dive into negative territory in 2021. ANZ believes a negative OCR is more likely than not but admits the urgency for a negative OCR has reduced. It anticipates the OCR to be cut to 0.1 per cent at the May MPS with a further cut to minus -0.25 per cent in August. •

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AS SAFE AS BRICKS AND MORTAR

In the second of two roundtables exploring corporate sectors on the front line of the COVID-19 crisis, in November 2020 *KangaNews* and **Westpac Institutional Bank** hosted issuers and analysts from the Australian REIT sector to talk about pandemic fallout. The conversation covered crisis response and the new shape of the sector in future, including the likely impact on individual property categories.

PARTICIPANTS

■ **Lilly Cheung** Group Treasurer GPT GROUP ■ **Pauline Chrystal** Portfolio Manager KAPSTREAM CAPITAL ■ **Matt Kennedy** Head of Investment Origination, Asia Pacific ROTHESAY LIFE ■ **Helen Mason** Credit Analyst SCHRODER INVESTMENT MANAGEMENT ■ **Craig Parker** Senior Director, Corporate Ratings S&P GLOBAL RATINGS ■ **David Rowe** Group Treasurer STOCKLAND ■ **Phil Schretzmeyer** Head of Treasury and Group Planning CHARTER HALL ■ **David White** Head of Treasury DEXUS

WESTPAC INSTITUTIONAL BANK PARTICIPANTS

■ **Gary Blix** Head of Corporate Origination ■ **Peter Block** Head of DCM, Australia ■ **Michael Chen** Head of Sustainable Finance ■ **Tim Keating** Executive Director, Head of Real Estate ■ **Michael Lucas** Head of Institutional Credit Sales

MODERATOR

■ **Matt Zaunmayr** Deputy Editor KANGANEWS

BUSINESS IMPACT

Block Can the borrowers give an overview of how business performance has been affected by the events of 2020? The composition of REIT portfolios is obviously very different, so it would also be interesting to hear some thoughts about the relative performance of the sectors

in which issuers operate – where performance has been challenged and what has held up relatively well.

■ **SCHRETZMEYER** A global pandemic and everything that has come from it has made for a year that has not been a pleasant experience for anyone.

Charter Hall now has A\$43 billion (US\$32.7 billion) of assets under management across office, industrial, retail and

social-infrastructure sectors. Charter Hall is a fund manager so does not hold direct property on balance sheet but manages capital on behalf of third-party investors in listed and unlisted funds. Going into March, we did a stocktake of our business. We looked through our list of tenants and assets, and generally made sure the business was as resilient as it could be.

We have always had a long WALE [weighted-average lease expiry] theme across the business. This means we do not have a large number of imminent lease maturities in any given year. This placed us in a good position to manage through the market disruption.

We do have retail shopping centres in our portfolio, accounting for around 10 per cent of funds under management, and this was the first area we focused on. Our shopping centres are anchored by tenancies with Coles, Woolworths or Aldi, which make up a large proportion of the GLA [gross lettable area] and rents.

Pleasingly, as essential services, all our grocery tenants continued to trade through the pandemic so these centres kept generating income for our funds. Everyone saw the empty aisles in shopping centres when the pandemic first hit. Supermarkets were struggling to keep up with demand in the early part of the pandemic rather than having any significant revenue issues.

Even so, we stepped in quickly to work with our non-grocery tenants. Alongside the supermarkets we worked with our speciality shops – including chains and small businesses.

In the office space, once we got through the initial couple of months of the pandemic, we wanted to make people comfortable with coming back to the office again. Offices should be a safe space and a good place to work, where employees get efficiency from being close to their co-workers.

Meanwhile, industrial has been the darling of the property sector. Investors have been very comfortable with industrial exposure as they see the growth in e-commerce – a trend coming into the pandemic that has been accelerated. We have seen strong capital flows in this sector and recently completed a A\$2.6 billion equity raise for our prime industrial fund. We have also raised 10-year money in the debt capital markets for this fund.

■ **ROWE** COVID-19 had an impact in the second quarter of the calendar year, particularly across our retail portfolio, despite the portfolio being about 70 per cent discretionary

spending. In our 30 June results, the bulk of the debt we had coming through the portfolio from not receiving rent was largely from our retail book.

This amounted to about A\$100 million where it is typically around A\$10 million on an end-of-month basis, and the expected credit loss on this portfolio was also much higher than we normally expect. But we have seen our rental collections improve as stores have opened up. Our shopping centres are now operating at around 96 per cent foot traffic.

The national code of conduct set out a format for negotiations over the March-June period, and we are now in a level of abatement and deferrals that is lower than prior periods. Rent collections are increasing as lockdowns ease and economies open.

The other interesting part of the portfolio is the residential space. We slowed down our development expenditure over the six-week period in April and May but it has returned to long-run average. Our June results show very strong flows coming out of the residential part of the business and operating cash flow is very strong.

Enquiry into the residential market is at a two-year high and this has clearly been helped by the stimulus going through the economy. We have seen all residential property markets perform well and various state-based measures are continuing, which we expect will continue to provide a tailwind for the business.

All things being equal, the business has performed quite well despite the pandemic. The advantage of having a diversified business is that cyclicalities in some parts of the business can offset downturns in other parts of the portfolio.

Block Stockland has a number of land banks. Will these continue to underwrite the business for the foreseeable future?

■ **ROWE** I think so. We have also been able to restock this part of the portfolio. We did a very large transaction in New South Wales just prior to the pandemic and we recently restocked in Victoria, too. We have seen a number of opportunities to restock the land bank come across the desk and I think this will continue to facilitate cash flows going forward.

Block What has been GPT's experience of the crisis, across business areas?

"Industrial has been the darling of the property sector. Investors have been very comfortable with industrial exposure as they see the growth in e-commerce – a trend coming into the pandemic that has been accelerated."

PHIL SCHRETZMEYER CHARTER HALL



THE FUTURE OF **OFFICE WORKING**

Empty CBDs were perhaps the most visible sign of COVID-19 in Australia, as many thousands switched to home working during lockdown. Most office workers are yet to return even as infection rates have cratered, and the future of the office sector itself is under discussion.

ZAUNMAYR Has the way people work during the pandemic changed the long-term outlook for the office sector in particular?

■ **CHEUNG** I think there will be ongoing discussion around flexible working and the future of the office. The key for tenants is to work out what their staff want and what their future office looks like.

There are mixed messages, but most employers are trying to strike a balance between workplace flexibility and recognising that the role of the office is still important in relation to the mental health of their staff and making sure people remain connected. There are further business benefits of having a central workplace, such as driving company culture, collaboration and innovation.

■ **WHITE** We think demand for office space will grow in line with employment growth over

the long term. In the post-COVID-19 environment, most of the impact on demand for office space will be a result of the economic slowdown rather than changes in work practices.

We have seen examples of major global firms that currently have their staff working remotely taking up leases on large office spaces in the major cities of the world. They clearly have a long-term view that they will be back in the office at some point.

A lot of discussion around the future of the office has been at one end of the spectrum or the other – either we will not be in the office at all or we will be in the office 100 per cent. The focus right now is on flexibility, but we do not see this going to an all-or-nothing situation.

Offices have a core role to play in developing culture and fostering collaboration and innovation. Many of our customers are working hard

to understand how they can make a hybrid model work and we expect some businesses to continue to experiment with providing more flexible working arrangements in the short term. They will need to understand the real productivity impact of alternate models before attempting to strike the balance that best suits their circumstances.

■ **MASON** Office was a booming market prior to the pandemic, with exceptionally positive leasing spreads. With developments in 2020, there are questions around whether things like hot-desking will remain viable – even with a vaccine.

The health and wellbeing of staff has become paramount and we know packing everyone into an office is not going to be popular going forward. However, absorption in the office space has been quite high so we are not overly concerned about the outlook.

There are also questions now around hub-and-spoke offices. Our view is that this seems unnecessary when people can work comfortably from home.

BLOCK What proportion of staff at REITs themselves are now coming into the office to work?

■ **SCHRETZMEYER** We can have 80 per cent of our people in the office at any time. I have been coming to the office full time since June, which has been fantastic. This is the state of play for senior management in the business and the others are on a rotation.

■ **WHITE** We are also back at 80 per cent of staff in the office across the country, except for Melbourne. Where we could get people back, we have done so. We are pleased with the New South Wales government's announcement to remove the public health order requiring employees to work from home if they can and expect numbers to grow in Melbourne as its restrictions are further eased.

Flexible working was a part of our culture before the pandemic, and will continue to be so, but we recognise our best performance as a team



"THE CFOS WE HAVE SPOKEN TO BELIEVE ENFORCED SOCIAL DISTANCING AND WORKING FROM HOME HAS PROVEN SUCCESSFUL. THEY HAVE BEEN ABLE TO CONTINUE OPERATING AND, IN THE LONGER TERM, SEE THIS AS AN OPPORTUNITY TO REVISIT THEIR TENANCY REQUIREMENTS AND POTENTIALLY REDUCE COSTS."

CRAIG PARKER S&P GLOBAL RATINGS

■ **CHEUNG** We are exposed across the office, retail and logistics sectors but retail has been the most affected by the government shutdowns. At one stage in the peak of the lockdown we were down to only essential retail being open, which was 30-40 per cent of retailers in our centres.

The situation has improved as restrictions have lifted. Outside Victoria, around 95 per cent of our retailers are now open, and our foot traffic and sales are only down by around 5 per cent from the same time last year. As lockdowns have eased

in Victoria, we have seen regional centres trading at similar statistics.

Our Melbourne Central shopping-centre asset in the Melbourne CBD is an exception. It has been affected by the tourism and education sectors' challenges and low physical office occupancy. Even then, foot traffic is down by around 50 per cent and we have around 80 per cent of our retailers back open. These trends are improving week-by-week and we will hopefully see a better 2021.

happens when people are collaborating in the office.

It is great being in the office. Conversations are much more effective when you can do them in person and coming across people in the corridors is a great way of quickly resolving an issue or strengthening relationships. From my own team's perspective, we get more out of having five minutes face-to-face than we do in half an hour across multiple phone or Zoom calls.

It is also very difficult to build team culture at the end of a video line. A lot of what younger people in organisations learn comes from being in an office environment.

■ **ROWE** As an organisation, we are implementing a hybrid model where the treasury team has a few days in the office and one day optional. We will identify two or three days within this where we synchronise having everyone from the team in the office. I think this is where most people and businesses will settle.

Of course, things are different for our Melbourne-based staff and going forward it will depend on how well the virus is managed and contained.

LUCAS Is there a clear consensus on how many days per week in the office is optimal for collaboration?

■ **ROWE** We have run pulse surveys throughout the year.

At the start of the pandemic, some people wanted to work from home forever! As time has gone on, this has changed. We now get responses indicating around 5 per cent of people would still prefer to work from home all the time, 15 per cent want to be in all the time, and the bulk in the middle want to come in three or four days per week.

LUCAS If it eventuates that staff are only using offices 3-4 days per week will companies need the same amount of office space?

■ **WHITE** Density may reduce a little, where companies retain their space but have fewer desks. There is no doubt some will require less space, but I do not think this will be material in the broader scheme of things.

■ **PARKER** The CFOs we have spoken to believe enforced social distancing and working from home has proven successful. They have been able to continue operating and, in the longer term, see this as an opportunity to revisit their tenancy requirements and potentially reduce costs.

I hear the points about optimisation of staff time in the office, and this will be an enduring requirement of a lot of organisations. But there is evidence that heightened subleasing of space is occurring, and a view from some CFOs that they perhaps do not need as much space. This is a concern for the future demand for office space as the pandemic progresses.

The national code of conduct is making for a very extensive process of negotiations regarding rental relief, on a tenant-by-tenant basis. However, the deals that have been agreed with tenants are currently tracking better than what we provisioned for in June.

With the positive vaccine news we have had much more positive feedback from office tenants around staff returning to the CBD. Within the office sector, occupancy and rental collection has remained high but physical occupancy of our

buildings has declined as tenants implemented work-from-home arrangements. In places where restrictions were eased to a greater degree and earlier, such as Brisbane, we see office occupancy at 50-60 per cent and incrementally improving.

Block Interest rates are close to zero and will be for the foreseeable future. We also have a few data points on cap rates and from offices changing hands. Do these factors increase confidence in the outlook?

■ **WHITE** We have been selling a few assets ourselves and there is clearly still strong demand from investors. A lot of this is offshore money as Australia remains a very attractive place for capital. This provides additional support for valuations in the office sector.

There will be cash-flow challenges in the short term while people work out what they need, but we are not overly concerned on material weakness to wholesale valuations at this point given these dynamics.

CREDIT VIEW

Zaunmayr What is the S&P Global Ratings view on the REIT sector in the context of pandemic trends?

■ **PARKER** Determining how the Australian sector would cope with enforced social distancing was the great unknown – particularly how this would affect retail landlords.

Going into the pandemic, our rated portfolio was well placed within financial risk profiles and policy settings. No issuers were pushing the boundaries of their financial targets and therefore they all had capacity to deal with requested rent abatements and waivers.

Unlike other jurisdictions, the Australian sector had a commercial code of conduct to deal with SMEs while larger retail tenants were deemed big enough to negotiate directly with landlords. This methodology enabled tenants and landlords to deal with COVID-19 restrictions, albeit it put pressure on landlords' earnings.

We went into March and April running scenarios that removed three months' rent from landlords' future earnings and looked at how this would affect credit ratings. None of the Australian issuers faced an immediate downgrade, though in our global retail landlord portfolio some entities' ratings were lowered.

We put a number of Australian issuers on negative outlook. One was Vicinity Centres, which we resolved back to stable outlook when it did a sizeable equity raise. Other fund managers took protective measures to bolster their ratings, which I believe indicates a broad commitment to maintain current ratings.

The commercial-office sector did not face the same immediate earnings pressures, given its limited SME exposure. Our landlords mostly lease to large corporate and government

LENDING **LIQUIDITY**

The story of March and April in Australian institutional lending was one of borrowers scrambling to shore up liquidity and banks trying to keep pace with consequent requests. Even in the REIT sector, it was more the volume of enquiry than credit that posed the biggest challenge.

BLOCK How significant was the volume of requests for liquidity coming through to bank lenders at the height of the crisis, as well as requests for covenant waivers and other structural changes?

■ **KEATING** Banks generally maintained good provision of liquidity to the REIT sector even at the height of the crisis. The factors that play into banks' ability to lend to REITs are capital allocation and concentration to the sector, the bank's balance sheet and broader liquidity, and risk appetite for these borrowers.

On capital, Westpac Banking Corporation was well

positioned – as were most banks. Yield had been tight for some time and we had been adjusting for a long time around downside factors to our internal risk rating.

Through other cycles, there have been circumstances where concentration of capital has meant deliberate moderation in various books – keeping in mind these books are not just institutional but also business-bank exposure, where sometimes leverage is higher and cycles have more impact.

Westpac entered the crisis with a strong balance sheet, and while there was a short period of dislocation in debt

capital markets there was also a strong inflow of deposits.

From a risk-appetite perspective, institutional balance sheets were in a good position, being conservatively geared and well protected. This meant we were comfortable providing support, notwithstanding some of the commentary on valuation decline. This commentary probably affected the business-bank book more than the institutional book.

Early on in the COVID-19 crisis, we were asked to consider a wave of corporate liquidity requests. Some were to protect balance sheets but some money was also sought for

opportunistic situations. We responded positively as long as the purpose made sense.

We were also asked to consider a wave of covenant-relief scenarios, particularly in the retail sector where the commercial code of conduct hit hardest. These went through a triage process, but we were able to work through priorities cooperatively across the bank.

Internally, as a result of the forward outlook, we underwent some downward risk-rating processes. On the whole, even when covenant relief that would trigger a pricing discussion was required, we absorbed the cost and were only looking at the covenant relief rather than the pricing implications.

The challenging conversations during this period came mostly from the dislocation in debt capital markets increasing pricing.

tenants, which have kept paying rent. This said, longer-term structural concerns regarding the increasing prevalence of work-from-home arrangements and falling demand for office space remain.

The industrial sector has made hay while the sun has been shining. We recently placed Goodman Australia Industrial Partnership's rating on a positive outlook – one of our first positive moves in the REIT space globally since the pandemic began.

The wide range of actions taken by government in response to the pandemic appear to have worked. Meanwhile, foot traffic quickly returned to shopping centres and people started spending money once each respective state economy reopened. The lingering question is how many retailers will survive after the Christmas period. Also, the impact on the consumer when government assistance tapers off in early 2021 is still very much unknown.

■ **MASON** We are now seeing a good level of credit spread in retail but the question is whether investors will be comfortable with the sector's outlook. We are also asking whether retailers can survive after Christmas. There has been a lot of latent spending going on as lockdowns have eased but it is not clear how persistent this will be.

We know some shopping centres have pockets of vacancy coming through. There has been a shift going on in shopping

centres toward entertainment and living spaces, and it will be interesting to see how this pans out.

Zaunmayr How are investors approaching the sector given the trends being discussed?

■ **MASON** Prior to the pandemic our opinion was that spreads were becoming tight across the REIT sector. All asset classes were tightening significantly so we were investing more for carry than for anything else.

This meant we were in a good position to add credit after the initial pandemic impact – and we have been happy to do this in the property and infrastructure sectors.

We were surprised at how long it took some issuers in the sector to tap the local market after going to their banks to shore up liquidity positions. A lot of issuers were not confident that the market would be there, but there is a lot of capital floating around for corporates.

■ **CHRYSTAL** We were constructive on the REIT sector before the onset of COVID-19. Even so, in the office space we were keeping an eye on the emergence of sub-leasing and on forthcoming supply. Net absorption had started turning negative in Sydney and Melbourne.

There were also some headwinds in retail before the pandemic including some large department stores and retailers giving up space, and MAT [moving annual turnover] growth

and leasing spreads turning negative. We were a bit worried in the retail segment but technicals were very strong for corporates and the REIT sector more broadly. We participated in the Dexu 12-year deal at the start of the year, a tenor that is normally outside our comfort zone.

When COVID-19 hit, we were a little shocked at how quickly liquidity disappeared across the board. It also came back later in REITs than in other sectors. Liquidity returned to the office space first. While we were still cautious, we gained a lot of confidence from seeing the actions taken throughout the sector including equity raises, withheld dividends and delayed capex.

This got us comfortable to invest into the sector as early as May, albeit mainly at the front end as we still viewed the sector as volatile. We are still not quite there at the longer end.

■ **KENNEDY** We had not done a lot in the REIT sector prior to this year, other than a few positions in the USPP [US private placement] market. We made a play into the sector in January and February. Our structure and liability profile means we tend to be more competitive in longer tenors.

We do not typically invest into straight retail: our focus is office and industrial. We did the Dexu and GPT 12-year deals early in the year as well as a US dollar deal for Goodman in March, where we took most of the 10-year tranche.

When the pandemic hit, we took some time out to see the market impact and to recalibrate our models. We have a specific risk profile in that we have a lot of fixed liabilities and we only buy investment-grade credit. We made sure our capital position was strong and we have been investing conservatively over time so did not have any issues with the portfolio itself.

As we rolled through the pandemic, we saw relative value in the US – which has been maintained. We are also still constructive on the Australian sector, particularly in office and industrial.

Internationally, we have put US\$1.5-2 billion to work in REITs so far this year and a lot of it has been into the industrial sector. Most recently, we have seen GAP [Goodman Australia Partnership] and CPIF [Charter Hall Prime Industrial Fund] come to market. In each transaction, however, we struggled a bit with the pricing level relative to global comparisons and where we believe the market will head from a macro perspective. Everything in Australia we invest in must be compared with global levels.

We remain very constructive on the REIT sector and were impressed with what treasurers and CFOs did through the lockdown period in identifying the liquidity pockets they needed. I understand there were equity plays in the retail space, too, and I know a lot of borrowers have found very strong support from their equity partners.

Relative value is important for us and we have found it challenging trying to get money away in this market when we are comparing to levels in the US. For example, last week we did a 10-year deal in J.P. Morgan's flagship US fund, which is A-band rated – and this came at 170 basis points over US Treasuries. This gives a sense of why we may sit on the sidelines in Australia for some deals.

■ **MASON** We remain constructive on the REIT sector notwithstanding some of the issues around retail – which were present before the pandemic. We were positioned for these and were therefore still comfortable.

Industrial is very much the darling of the market and the only question is at what point in the cycle this may change. There is supply coming on board, particularly in western Sydney as the second airport is built. We are thinking about what this supply does to the sector.

We are generally comfortable with issuance pricing. We do rock-bottom spread analyses that give us a base case at which we are willing to invest given a particular scenario analysis. Of late there has been significant tightening but there is still some value across the curve, particularly given the high quality of issuers in the Australian market.

In residential, we are keen to see the effect of changes to stamp duty. Will this just be a price hike, or will it allow more first homebuyers to get onto the housing ladder? Meanwhile, we know immigration will be low in the immediate future but we also know development has come off significantly, particularly in the apartment space.

DEBT POSITIONING

Block There was some issuance from REITs in Australian dollars early in 2020, including at 12-year tenor. How well funded were borrowers heading into the crisis?

■ **WHITE** We sourced a couple of opportunities from banks in the early stages of the crisis when the trajectory for debt

"Because we did not necessarily need the liquidity, we received some feedback that it might be best if we came back later. Banks were going through a triage process, looking at their balance sheets and prioritising clients that really needed the liquidity."

LILLY CHEUNG GPT



Westpac Institutional Bank participants



GARY BLIX



PETER BLOCK



MICHAEL CHEN



TIM KEATING



MICHAEL LUCAS

markets was not so favourable. Banks were generally very supportive of issuers, although they prioritised businesses that were more challenged. In my experience, they were also more focused on assisting existing clients than on adding new clients at this time.

We managed to issue A\$500 million with 12-year tenor in the public market prior to the crisis, following a A\$200 million 10-year deal late in 2019, and were very pleased with the outcome. The strength and resilience of the domestic public market in 2020 has been very pleasing. This is also a testament to the quality of assets and their cash flows across Australia's REIT sector, which have given investors comfort.

The depth, tenor and price available in Australian dollars has been very strong and it remains a key market for us. Our preference is to issue in our home market, so developments in 2020 have been encouraging.

■ **ROWE** We did a total of A\$330 million equivalent in Hong Kong dollar issuance in January and March. This shored up our liquidity going into the crisis. Liquidity was like toilet paper – in short supply – for a brief period of time while everyone was trying to figure out what they needed to do to deal with the crisis.

We put additional liquidity in place at the request of the board to ensure we had sufficient funding if required. Debt capital markets seized up quickly, as did the commercial paper market. We also did not have the code of conduct in May, so we were in no-person's land with regard to the impact on commercial tenants.

The banks have been very accommodating with corporates on covenant waivers and understanding business needs. There was obviously a step up in pricing, which no treasurer likes, but in times like this you make a balance between the inherent risks

in your portfolio, the appropriate cost and the tenor we need to ensure we come out at the other end.

Markets today are very conducive. There is good trading and a lot of new issuance coming to market – although still not a lot from the REIT sector, including in USPP format. Spreads have contracted a lot, though, and we have had a lot of reverse enquiry from across the globe.

We let a USPP mature in July and we redeemed a domestic deal in late November. We have no plans to issue again in 2020. Our view is that we have shored up liquidity so we will get to our half-year results and then make calls on where we think the market and economy will be.

I have some nervousness around the slowdown of government stimulus and what this means after Q1 2021. We will not make any significant adjustments to liquidity until we start seeing economic numbers in Q1 and Q2 2021.

■ **CHEUNG** Similarly for GPT, going into the pandemic we were in a strong liquidity position that was further enhanced by our A\$300 million 12-year deal at the start of the year. When the pandemic started we were not in a position where we would be forced to do anything.

However, given how quickly liquidity dried up we thought it was prudent to undertake some bank extensions and to source some new facilities in our wholesale fund.

Banks were generally supportive of the process, but because we did not necessarily need the liquidity, we received some feedback that it might be best if we came back later. Banks were going through a triage process, looking at their balance sheets and prioritising clients that really needed the liquidity.

At the onset of the pandemic, some Asian banks used the opportunity to improve their exposure to the Australian market – using it as leverage to get into some of the corporates



"While we were still cautious, we gained a lot of confidence from seeing the actions taken throughout the sector including equity raises, withheld dividends and delayed capex. This got us comfortable to invest into the sector as early as May."

PAULINE CHRYSTAL KAPSTREAM CAPITAL

they have been chasing for a while. We have seen spreads come in quite well now and over the last couple of months we have done some Hong Kong dollar private placements at 10-15 years, for a total of around A\$200 million, at similar levels to before the pandemic.

It is good to see tenor in the Australian dollar market stay resilient through the crisis. At the beginning, I was worried that the progress made in 2019 and early 2020 would be pared back – but it was good to see some long tenor being executed in the last few months.

■ **SCHRETZMEYER** Our balance sheet was in very good shape coming into the pandemic but we were working through some open transactions during March and April. The banks held the terms and pricing on offer, and we closed these transactions. They should get significant credit for the way they acted during the crisis.

We did A\$6.4 billion of debt transactions in the six months to December 2019 and closed another A\$4.1 billion in the six months to June 2020. We still had access to debt capital during this period – and we had some interesting conversations because we were looking for growth capital. We had to spend time with our lenders on this, but liquidity became available once they understood our reasons and strategy.

It is now a very interesting time for liquidity. Six months ago, the banks were very focused on drawdowns and liquidity, now the banks prefer to be drawn because of the sheer volume of cash in the system. The extent of change within a short space of time has been very interesting.

■ **ROWE** One thing that caused some frustration when looking for liquidity was not understanding the process banks go through. We found it quite frustrating trying to get an outcome because it sometimes took a lot of time to get responses.

This is just a reflection of the market rather than any particular bank. Issuers need to understand where the banks are focused, what part of the process they are in, and how they are identifying and dealing with their clients. This is a good lesson for the future.

DOMESTIC TENOR

Zaunmayr How comfortable are investors with pushing tenor boundaries in the REIT sector?

■ **MASON** We do not have a hard stop at 10 or 12 years. It really depends on what we are trying to do with our mandates. Our

insurance mandates are trying to match assets so we are very comfortable taking extended tenor in higher-rated names.

Our comfort is of course sector-dependent, too. We may not be comfortable with a 15-year deal for a shopping centre REIT, for example.

■ **KENNEDY** We have previously considered the USPP market to be the only place we could go to get longer-tenor REIT exposure. The transactions we saw at the beginning of 2020 were a good start to lengthening out in Australian dollars.

We only started looking at the Australian dollar market in 2019 but we would be open to lengthening beyond 10-12 years. Given our level of conservatism and the way we like to invest, we would look at the more senior and highly rated names for 15-20 year deals.

We do not like to take a lot of credit risk, but once we are comfortable we like to take a longer-term view – in size. We can do this in the USPP market, the Australian dollar market and in straight loan format, which comes down to getting a bit more spread for illiquidity.

We match our assets to our liabilities so we have some regulatory constraints compared with local investors around make-wholes, prepayments, and clean-up calls.

■ **CHRYSTAL** Thinking about 15 years gives me cold sweats, I must admit. Our product offers absolute return with a focus on low volatility. We run spread duration around 2.5-3 years. Two years ago, our sweet spot was 3-5 years and now, given how the market has evolved, it is 5-7 years – though closer to five.

We need a strong incentive to take the next step and go beyond 10 years. However, we participated in the Dexus 12-year deal at the start of 2020. This was the first time we went that far, though.

We consider deals on a case-by-case basis. We have always liked Dexus as a well-managed business with a strong balance sheet and track record. Pricing for the 12-year deal was reasonably attractive so we were happy to participate.

In the current conditions, we would still extend to 10 years if it is the right deal. We probably would not for a retail REIT but we have taken part in some of the industrial deals that have come recently as the tenor makes sense for an issuer with longer WALE.

However, if we had the choice between buying a 15-year office REIT and a five-year retail REIT, all else being equal we would likely pick the retail REIT. A QIC Shopping Centre Fund 2025 maturity at the moment gives a spread of around

“We were surprised at how long it took some issuers in the sector to tap the local market after going to their banks to shore up liquidity positions. A lot of issuers were not confident that the market would be there, but there is a lot of capital floating around for corporates.”

HELEN MASON SCHRODER INVESTMENT MANAGEMENT



USPP MARKET APPEAL

US private placements (USPPs) have been a key source of debt for corporate Australia for many years, with the REIT sector providing more than its share of supply. The market was less active in 2020 but issuers say they expect it to remain on the funding menu.

BLIX If REITs can issue 12-year tenor in the domestic market where does USPP come into the equation?

■ **CHEUNG** There has not been much Australian REIT issuance in the USPP market over the course of 2020. We did one in 2019 but since the start of 2020 the domestic market has been very strong at long tenor so we have favoured it.

I still see a place for the USPP market in future, though, and yields have been coming back in. It is also still important for diversification of investors.

It is good to see the Australian dollar market extend to 12 years and it would be even

better to see it go toward 15 years – for which we traditionally had to go to USPP. Having multiple options for long tenor would be good.

■ **WHITE** USPP remains a relevant funding source for Dexu and it provides diversification. Smaller issuers may be able to get away with only issuing in Australian dollars, but larger REITs will always need to have offshore markets too.

The domestic bond market has performed well in 2020 but it has a history of coming and going. Hopefully this is not the case going forward and it is the first market we look to – but it is certainly not the only one.

It is more about diversification than tenor for us. It is great that the Australian dollar market has been able to go beyond 10 years, and Dexu has also been able to access tenors out to 20 years. In fact, in 2020 we had an enquiry for a 30-year deal. The demand for tenor in the Australian market is there at times, it is just not always at the volume available in the USPP market.

■ **SCHRETZMEYER** Bills-LIBOR has been compressing and US Treasuries have been increasing so a couple of market forces are positive for USPP issuance outside of where the bulk of deals are pricing. Some of these market dynamics could make

USPP more attractive for Australian issuers in 2021.

BLIX How have USPP investors responded to the Australian REIT sector through the pandemic?

■ **CHEUNG** It has been fairly similar to the domestic market. They are interested in understanding how the code of conduct works and what the impact on performance and outlook will be. We have had queries around the structure of leases and how these may change.

Despite what we see in the press, lease structures mostly remain as they were, with fixed rent and annual increases. Our investor base values this certainty of cash flow and we do not believe transfer of risk from retailers to landlords is appropriate.

■ **PARKER** The USPP investors I speak to are pretty switched on and know a lot about the Australian marketplace. For instance, investors looking at Scentre Group's 144A hybrid deal were keen to understand how the issuer could lock out tenants. This action is unlikely to occur in the US. They were very comforted to know that Australian landlords have legal backing to ensure tenants honour lease agreements.



"THE DOMESTIC BOND MARKET HAS PERFORMED WELL IN 2020 BUT IT HAS A HISTORY OF COMING AND GOING. HOPEFULLY THIS IS NOT THE CASE GOING FORWARD AND IT IS THE FIRST MARKET WE LOOK TO – BUT IT IS CERTAINLY NOT THE ONLY ONE."

DAVID WHITE DEXU

170 basis points, compared with a Dexu 12-year giving around 140 basis points.

There is still a lot of uncertainty and spreads have crunched in to a level that is not representative of the fragile economy. If there is even a little bit of spread widening, at such tight levels all our carry will be wiped out.

If there is a sell-off it will also be much harder to raise cash by selling long-dated bonds than by selling short-dated ones. Not much would motivate us to go out to 15 years at the moment. We would rather go shorter and down the credit curve, or to a less loved part of the sector.

Lucas At our last sector roundtable, covering airports and transportation infrastructure, Australian fixed-income investors suggested that part of the reason they have been more

accepting of long tenor is that if they are going to allocate for the challenging next couple of years they might as well take the premium available for a 10-12 year investment. Is it the same case for REITs?

■ **MASON** Absolutely. We are looking to extend tenor in all our portfolios because we still believe in this trade. With ongoing stimulus, I do not think there will be a cliff; there will probably be a tapering. At the moment there is no incentive for governments to step away from markets. There is a lot of money sloshing around and it will only do one thing, which is to tighten pricing.

Block Charter Hall debuted some of its funds in the domestic market in 2020, having previously been a prominent USPP issuer. What

was the thinking behind coming to the local market in 2020?

■ **SCHRETZMEYER** We had been working on our Charter Hall Exchange Finance (CHEF) transaction since August 2019, having sourced a rating for this fund. This process included giving some consideration to which investor base we would go to, given we had not issued in the Australian dollar market previously.

In considering the choice of market we had a preference for issuing domestically. For one thing, there are significant efficiencies in issuing bonds in Australian dollars rather than going to offshore markets for our transactions. This takes out the complications of currency swapping and also means we can meet local investors and have constructive conversations about our platform and future issuance.

In preparing for this deal we spent a lot of time with investors, including through a nondeal roadshow. They were very accommodating and gave good feedback on the bond and the structure, which gave us confidence to issue.

We were pleased with the CHEF result – so pleased that we followed up with another transaction for our industrial fund one month later. Hopefully the market remains conducive for issuance because we want to do more in Australian dollars, across multiple funds.

Australian REITs are a solid credit as a general rule. We have done a very good job maintaining solid balance sheets coming into the pandemic and those that have had to issue equity to shore up their balance sheets have done so. Australian REITs represent a good set of investment-grade credits for the domestic bond market.

Block Do the actions REITs have taken to shore up liquidity through the crisis change S&P's view on the sector's overall level of funding or credit risk?

■ **PARKER** We look at liquidity over a 24 month period. We also consider weighted-average debt maturity (WADM). In the REIT sector, we look for a minimum of three years WADM – unlike a traditional corporate, where it is two years.

We are mindful that the short-term debt rollover issues REITs encountered during the 2008 financial crisis, where liquidity dried up, need to be accommodated in their liquidity and debt maturity profiles. This is not a problem for our rated portfolio. All the issuers within it are all either A or triple-B

rated, and have the capacity and willingness to seek extended debt tenor.

All the fund managers within our rated portfolio were prudent in shoring up short-term liquidity. They were in unknown territory going into the pandemic and sought to draw down bank lines in case they needed to address unexpected funding needs.

It is beneficial if issuers have ready access to the Australian dollar market so they can avoid any cross-currency foreign-exchange issues they encounter when raising debt offshore. We want to ensure the foreign-currency amount they draw down is actually payable in a known Australian dollar amount in five, seven or 10 years' time.

ESG – ISSUANCE AND PRICING

Chen Australia's REIT sector has been one of the most active among local corporates when it comes to green-bond issuance, though those that have come to market still only represent a relatively small group of issuers. How engaged are issuers with green funding, and what would induce them to bring deals to market?

■ **WHITE** ESG [environmental, social and governance] continues to be a key focus for Dexus and it is integrated into our business operations. It is also an increasing focus for equity and debt investors. On the other hand, we want to avoid bespoke requirements. We consider all issuance if it is aligned with the processes we already have in our business.

From a bond-market perspective, we also need to consider any incremental compliance costs associated with diversifying into ESG-related funding.

■ **CHEUNG** It is similar for us: we are monitoring the green-bond space but we have not felt the rationale to issue a green bond to date as we have not seen a pricing benefit from doing so.

For some entities, issuing green bonds is good for changing internal behaviour. But GPT has strong practices and disclosure in place already.

One attractive thing about this type of funding is that green bonds appear to have a stickier investor base. There is also evidence that German sovereign green bonds are trading at slightly tighter levels than vanilla bonds with the same maturity. This is evidence of benefits coming through, so we will keep monitoring developments.

"The transactions we saw at the beginning of 2020 were a good start to lengthening out in Australian dollars. We only started looking at the Australian dollar market in 2019 but we would be open to lengthening beyond 10-12 years."

MATT KENNEDY ROTHESAY LIFE





"I have some nervousness around the slowdown of government stimulus and what this means after Q1 2021. We will not make any significant adjustments to liquidity until we start seeing economic numbers in Q1 and Q2 2021."

DAVID ROWE STOCKLAND

■ **SCHRETZMEYER** We are looking closely at a sustainability-linked loan (SLL). This has some attraction because bank debt is more flexible and terms can be amended if necessary.

This is important as methodologies often change. For example, we use GRESB [global real-estate sustainability benchmark] ratings, but if this methodology changes it potentially has consequences for a SLL.

At this stage we have not seen the pricing benefit of these loans, but the amount of capital that can be deployed into this type of finance will continue to increase.

A lot of banks have targeted the allocation of a certain proportion of their loan book to GSS [green, social and sustainability] finance. This unlocks additional sources of debt capital with a sustainability angle, which could be a powerful tool and also aligns with our funds' ESG strategies. The bottom line is that we have all seen the benefits of having access to deeper pools of liquidity in 2020.

Chen Stockland has a euro green bond maturing shortly. Has the company considered issuing green bonds in the domestic market or other types of labelled debt, for instance social bonds?

■ **ROWE** The real-estate sector has a long history of sustainability in business strategy, and the work we have done as corporate entities is very strong. The weakness has been linking this to debt capital markets.

We have a green bond maturing in November 2021 and are now doing work around the framework we put in place in 2014 and the new frameworks that capture broader ESG metrics as well, not just green.

We continue to do a lot of work with the investor community to understand what it is looking for. I think this can be a very good diversification play. If we can leverage the corporate-sustainability angle there are very good opportunities in capital markets.

Chen GSS bond pricing can be a function of supply-demand imbalance as more banks and investors want to participate, but there is also a growing belief that greener companies have better credit outcomes. To what extent are ESG factors being factored into core credit analysis and is this translating into pricing?

■ **PARKER** We have been incorporating ESG into credit ratings for a long time, particularly highlighting governance factors in ratings. In the REIT sector, governance risks have usually manifested in whether the REIT is externally or internally managed.

We address the environmental and social components in our assessment of business risk. Investors are demanding more feedback from us, so we have added a paragraph to our rating reports. Typically, we address the green credentials of a REIT's buildings, focusing on greenhouse-gas emissions and other elements.

Unlike a fossil-fuel company, the ESG assessment generally is not a credit driver for REITs. Environment and social elements are referenced throughout our credit assessments – to assist readers we have coalesced this into a dedicated section of our analysis.

Zaunmayr What about credit investors? What role does ESG play in analysis and what value do labelled GSS bonds have in the context of the way you look at issuers?

■ **CHRYSTAL** We integrate ESG into our analysis the same way we integrate any type of risk. If there is a significant ESG risk that has not been assessed by the issuer, we will have concerns that we want to translate into pricing.

The REIT sector is an ESG outperformer so we do not feel labels add anything to its bonds. We find green bonds trade a bit tighter than vanilla, so investors are giving up a bit. We need to consider whether this is worthwhile when ESG factors are already being addressed across the sector.

We potentially have interest in sustainability-linked bonds because this product is not just slapping on a label or greenwashing. It is making sure the company aligns its ESG targets with what we want to see, and then translating this into pricing when they are achieved.

■ **KENNEDY** We are beginning to look at ESG a lot more. One of the questions when we do our due diligence is how easy it is for issuers to satisfy their ESG targets. If it is very easy to set up a platform and an issuer is already meeting targets, our view is that there should not be a meaningful price differential.

If there is a real, strategic and meaningful linkage to sustainability, and it is something that both can be measured and for which there is accountability, we would be more supportive of a price differential. •

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THE ENCHANTED BALL

In light of the COVID-19 pandemic, the Enchanted Ball was deferred for 2020 and will take place on Friday 19 November 2021 at the Palladium at Crown Melbourne. The Enchanted Ball's voluntary committee is represented by members of the four major domestic banks, who donate their time to produce the event.

The Tombstone charitable bond issue, supported by ANZ, NAB, Westpac and CBA, together with members of the financial markets, was still held in 2020 and has raised **\$915,000** for our beneficiary – the Financial Markets Foundation for Children (FMFC). These funds will enable the FMFC to continue its vital work – funding research projects to improve the health and welfare of the future of Australia – our children. To date the Foundation, via its annual grants process, has allocated more than \$22.5 million to 260 projects.

The Enchanted Ball committee thanks the following contributors for their generous support of the 2020 Tombstone:

GLOBAL LEAD ARRANGER



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Further information on the Enchanted Ball and the FMFC can be found at
www.enchantedball.com.au and
www.foundationforchildren.com.au

This announcement appears as a matter of record only. © 2020 Financial Markets Foundation for Children (FMFC). The FMFC is a charitable trust whose purpose is the health and welfare of children in Australia. The trustee is a company of the same name incorporated under the Corporations Act 2001 (ABN 38 523 266 751 and ACN 050 033 835). FMFC is registered with the Australian Charities and Not-For-Profit Commission, holds charity tax concession status, and has a current authority to fundraise from the NSW Office of Liquor Gaming and Racing pursuant to the Charitable Fundraising Act 1991 (NSW).

Australasian retail REITs: pandemic leaves lasting pain

The fallout from COVID-19 will linger beyond lockdowns for rated retail REITs, according to **S&P Global Ratings** senior director, corporate ratings, **Craig Parker**, and associate, corporate ratings, **Rhys Corry**. In Australasia, COVID-19 containment measures are eroding retail REIT earnings and reducing asset value amid unprecedented structural disruption.

Faster take-up of online shopping and rising retailer defaults will weigh on demand for retail space, reducing rental levels and occupancy rates. Landlords' ability to replace vacating tenants and resist pressure for greater turnover-linked rents will be critical to defending the sector's credit quality. Greater differentiation in credit quality could occur as retail landlords with larger exposure to more vulnerable secondary-grade assets will be hit harder than those with superior assets.

For Australian and New Zealand retail landlords, revenues plunged over the past few months as stores were shuttered and tenants were unwilling or unable to pay their scheduled rents.

Still, S&P expects the fallout from the pandemic to extend well beyond lower rental collections over the next few months. The structural pain will go on as faster adoption of e-commerce and

changing consumption patterns continue to buffet the sector.

While online shopping has been a structural threat facing Australian retail landlords for some time, it has been a slow burn. The level of e-commerce sales as a proportion of in-store retail sales remains well below markets such as China, the UK and the US (see chart). However, the COVID-19 pandemic has fast-tracked growth in online sales, intensifying pressure on retail landlords.

The fundamental question remains whether the faster adoption of online transactions during 2020 is a temporary blip or something more permanent. Landlords are hoping for a rebound in fortunes as economies emerge from the pandemic.

We believe much of the shift online represents a more permanent change in consumption trends, although sales will meaningfully rebound in the short

term as shopping centres emerge from lockdowns. COVID-19 has driven previously reluctant consumers online and encouraged online take-up at a much faster rate than witnessed in the past.

Australia Post reported that 200,000 new households shopped online for the first time in April 2020. More interestingly, two-thirds of those 200,000 households have continued to shop online five months after their initial purchase.

Similarly, retailers have been forced to adapt rapidly or initiate online offerings in light of government restrictions. For example, hardware giant Bunnings pivoted from its traditional brick-and-mortar business model to "click and collect" during the government-enforced lockdowns.

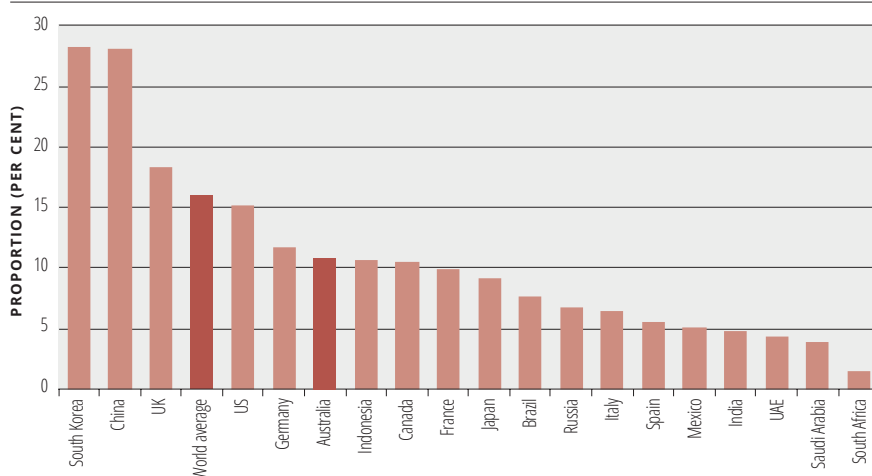
COVID-19 has also caught out some retailers that did not have an established, user-friendly virtual presence. Conversely, the e-commerce shift has benefited companies that manage their own distribution centres and were able to capitalise on the change in consumer spending patterns.

Rent structures

Retailer distress caused by the COVID-19 pandemic and online stresses have also triggered a fundamental debate on rent structures between landlords and tenants.

The Australian retail REIT market has traditionally employed fixed-rent lease structures with predominantly fixed or annual rent increases linked to CPI. However, retailers argue that sales-based rent agreements should be the way of the future because they share the risk between retailer and landlord, and put greater onus on landlords to drive customer footfall.

E-COMMERCE PROPORTION OF TOTAL RETAIL SALES (ESTIMATED)



SOURCE: ASSOCIATION OF INTERNET TRADE COMPANIES, BANK OF AMERICA, EUROMONITOR, S&P GLOBAL RATINGS, UBS 2020

Our ratings assume that REITs will resist any material changes to lease structures. To date, landlords from our pool of rated REITs have held firm against any replacement of these structures.

Nonetheless, risks remain that landlords of lower-quality shopping centres could succumb to tenant demands and allow sales-based leasing deals to maintain occupancy levels. This could reverberate through the sector, triggering competition for tenants among landlords.

In our view, this change in lease structures would likely precipitate further negative property revaluations and disrupt the predictability of fixed net operating income. More fundamentally, it would likely increase the cost of capital and worsen the debt capacity and credit quality of our rated REITs.

Tenant pool and defaults

Retailer defaults rose substantially in the first nine months of 2020. Despite significant government stimulus and other support programmes, many retailers, already under strain from online competition, were forced into administration or liquidation as shutdown measures decimated their remaining cash flows and liquidity.

Furthermore, an escalation in tenant defaults remains a material risk as government benefits and subsidies taper off, and the mandatory code of conduct for SME tenancies ends in early 2021 as currently scheduled. The code of conduct is designed to share the burden of a subdued trading environment during the pandemic between tenants and landlords.

In our view, the ability of shopping-centre landlords in Australia to use international retailers to fill vacating space is diminishing. These tenants – including retailers such as UNIQLO, H&M and Zara – had previously been eager to fill space, underpinning centre expansions. Since the pandemic, however, Zara and H&M announced the permanent closure of 1,200 and 250 stores, respectively, in their global networks as they turn their attention to e-commerce.

Given this challenging outlook for brick-and-mortar retailing, it is unclear

what the future tenant pool for shopping centres looks like. Since e-commerce emerged as a retail distribution channel, landlords have been moving away from traditional fashion retail into an experiential food and services offering.

While we think this transition has some room to expand, it is slowly becoming more limited as the segment matures. Scentre Group, for example, already has 43 per cent of its store portfolio designated as experience- or service-based. Moreover, the space requirement for experiential and service-based tenants is generally smaller than other retail formats.

New retailers that have entered the market have also showed that a physical presence is no longer needed to generate sales growth and customer brand awareness. The Iconic, Adore Beauty, Temple & Webster, Koala and Kogan use their social-media presence, customer following and delivery options to let them exploit gaps in the market without physical stores.

Still, not all online pure-play retailers can weather losses for what could be an extended period of ramping up their online capabilities without an omnichannel offering. These steps include developing distribution networks, management and returns policies.

Growth prospects

In our opinion, growth opportunities for retail landlords will be limited over the next 3–5 years at least. Over recent decades, shopping-centre developments and expansions were justified in an environment where rents were rising every year. Although the Australian market benefits from materially lower shopping centre space per capita than markets like the US, we expect the economics of future investment to prove more challenging as negative rental reversion takes hold and competition intensifies.

Nevertheless, we believe community shopping centres will continue as residential developments sprawl outside city centres, albeit tempered by slower population growth over the next 12 months at least.

We also expect to see greater differentiation in retail-asset performance. We believe destination centres will continue to attract footfall and tenants. These centres have positioned themselves not only as a retail destination but also as a social destination, driven by experiential offerings and services that are entrenched in their respective catchment areas.

However, we believe less well-positioned assets in the regional and subregional space are likely to bear the brunt of the fallout. Furthermore, CBD assets will be hit as flexible working arrangements become the new norm.

Despite these significant online threats, however, we believe shopping centres will remain an integral, albeit reducing, part of most retailers' strategies. While retailers are looking for a better mix of physical and online offerings, most continue to see physical stores as integral to their brand and growth strategy across a broad range of product lines. Accordingly, the main uncertainty remains the level of future demand for physical retail space relative to available supply.

The key challenge for landlords, therefore, is to understand and adapt to this changing landscape. This will include remixing their tenancies toward more experiential offerings that are not readily substituted online and matching supply to reducing retailer demand.

Digital integration into the physical shopping experience could help better merge the physical with the digital and drive consumers back into stores. In addition, significant opportunities exist for landlords to use their centres as a last-mile delivery node for retailers, given their proximity to residential populations.

For creditors, the key issue is not only whether landlords can adapt their business models to remain a central hub of community activity, but whether they can achieve this while also keeping their occupancy rates, rental levels and fixed rent structures intact. The most exposed are likely to be those with secondary-grade assets that are subject to strong competition and are unable to adapt their assets and tenant mix to meet this changing demand environment. •

2020 CHALLENGES RETURNED WITH INTEREST

Toward the end of a tumultuous year, leaders of **ANZ's** institutional business across a raft of sectors gathered at a *KangaNews* roundtable to discuss the impact of COVID-19, how they supported customers during this unprecedented period, how business has changed and the bank's role in resetting investment and growth on a more positive trajectory.

ANZ PARTICIPANTS

■ **Gavin Chappell** Head of Loan Syndications, Australia ■ **Jimmy Choi** Head of Debt Capital Markets, Global ■ **Andrew Hector** Head of Property and Health, Institutional Australia ■ **Tammy Medard** Managing Director, Institutional Australia ■ **David Plank** Head of Australian Economics ■ **Stella Saris Chow** Head of Sustainable Finance, International ■ **Katharine Tapley** Head of Sustainable Finance ■ **Christina Tonkin** Managing Director, Corporate Finance ■ **Lisa Vasic** Managing Director, Transaction Banking ■ **Paul White** Global Head of Capital Markets

MODERATOR

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

ECONOMIC IMPACT

Davison We have experienced the definition of a rollercoaster ride in 2020. What were the main inflection points for economic forecasting?

■ **PLANK** It has certainly been dramatic. We started the year in Australia with the bushfires – this was really the focus of attention in January. We were able to do some interesting analysis on ANZ's card spending data, from which it was clear that there was a real impact on economic activity.

By February, we were starting to hear about a mysterious flu-like disease that was affecting China and which quickly shut down travel between China and Australia. Again, we used our own data to look at the impact initially on airports – which was quite dramatic.

Within a few weeks we could see what was happening in Europe and that this was becoming a pandemic, with consequent economic shutdowns beginning. When it became evident that we would be shutting down, the level of uncertainty was quite extreme and we had to contemplate worst-case scenarios.

Australia's government initially rejected large-scale stimulus – it ruled out wage subsidies, for instance. Putting the absence of significant stimulus together with the pandemic and related shutdowns made for a really horrendous outlook. This included the largest-ever collapse in GDP, comfortably in double digits, and falling house prices.

The government effectively changed its mind on wage subsidies, quickly moving from rejecting them to implementing one of the biggest in the world. This, coupled with stimulus from the RBA [Reserve Bank of Australia], prompted a quite spectacular turn in sentiment that started around the middle of April.

Turning again to our own spending and confidence data, there was a collapse in consumer confidence and spending from late March to mid-April. Then the stimulus started to hit and, critically, health outcomes turned out not to be as bad as the worst-case scenario, or as the US or Europe.

As a result, the rebound in confidence was quite remarkable. It wasn't enough to stop GDP falling by 7 per cent in the June quarter but it took household spending above the level of a year previously by the end of June.



"We have regained three-quarters of the lost jobs and GDP is climbing again. There are still plenty of risks and business is clearly still reluctant to invest. But overall the outlook is very different from what we expected even a couple of months ago."

DAVID PLANK

The trend has continued. GDP fell a lot in Q2 and the effective under- and unemployment rate reached 20 per cent, but as things have opened up we have seen the economy rebound very quickly. We have regained three-quarters of the lost jobs and GDP is climbing again – it should have recovered all its losses some time in 2021, up to 12 months sooner than we initially expected.

There are still plenty of risks and business is clearly still reluctant to invest. But overall the outlook is very different from what we expected even a couple of months ago.

BUSINESS CONSEQUENCES

Davison How did coverage areas respond to the emerging impact of the pandemic? We will start in Asia, which was of course the first region to become aware of COVID-19.

■ **CHOI** There were already a lot of dynamics at play at the end of 2019, including the trade situation between the US and China – this was having an impact across the region. Once the pandemic broke out there was a lot of uncertainty and a flight to quality, with issuers and investors alike becoming very focused on the near term.

The change in sentiment really came down to the Fed [US Federal Reserve]’s actions. Its announcement toward the end of March prompted a dramatic shift in risk appetite and set a floor under the market.

It also provided issuers with confidence to come to market. Issuance volume in Asia was lagging at the beginning of the year, but once the market reopened companies were willing to move early to take advantage of better sentiment.

Year-on-year, Asian market volume is up by about 9 per cent. The theme has been risk-on for most of the year and local companies have taken advantage of it to pre-fund and refinance upcoming maturities including with larger, jumbo deals. There have been 45 deals of US\$1 billion or more – which is up by about 30 per cent.

Davison When did awareness of the pandemic’s scale of impact start to spread among ANZ’s institutional clients in Australia?

■ **MEDARD** Multinationals based in the US and Europe were the first movers, starting from late February. Companies started to draw down on unused facilities and place the cash on deposit.

There wasn’t any real need for them to do so – a committed facility is just that. But they were learning from the past, when there have been liquidity runs on banks, and getting on the front foot.

Rolling into March, when we first heard about border closures and airport traffic began to fall, we saw pretty much all our corporate clients thinking seriously about shoring up liquidity.

By the end of March, pretty much everyone realised this was not going to be a brief crisis but one that would likely go on for months. This is when clients started not just looking for liquidity but rethinking their approach to employees and other fixed costs.

I recall a client saying on a Monday that it needed A\$100 million (US\$73.8 million) in liquidity as a buffer, and by Friday the requirement had increased to A\$500 million and it was contemplating standing down the majority of its staff. Things were changing that quickly – clients were having this sort of realisation over the course of five days.

What also caught some of our clients by surprise was the approach to dividends. March is very close to dividend declaration and payment, and some corporates had already declared – but not paid – dividends. They had to engage their boards to explore options, because paying dividends at that stage – even declared ones – could have been quite detrimental to companies’ ongoing viability.

■ **HECTOR** Going back to when COVID-19 first hit, some sectors felt the impact immediately – for instance hotels, student accommodation and retail. The latter was the result of the lockdowns themselves and new codes being brought in that meant landlords could not collect rent from materially affected SME tenants.

There was also a fairly immediate impact on some parts of the residential-property market: open houses were banned, the auction process shut down and of course there was a tremendous amount of uncertainty.

The dialogue we were having was all about liquidity issues, whether in the form of funding lines – we did about a year’s worth of lending in the space of three weeks at one stage – or an ongoing process of supporting customers with covenant waivers, valuation waivers and deferrals.

March was a pretty crazy month, especially as we and our customers were also adapting to working from home. Even requests for information were clunkier than they would usually

“Year-on-year, Asian market volume is up by about 9 per cent. The theme has been risk-on for most of the year and local companies have taken advantage of it to pre-fund and refinance upcoming maturities including with larger, jumbo deals.”

JIMMY CHOI





"Even at the end of November, we are holding a roughly 20 per cent increment on what we'd consider to be a normal level of operational deposits. This is a significant volume, and it speaks to the conservative approach of our customers and their desire to maintain liquidity throughout this period."

LISA VASIC

be. But we got it all done, and I think we can look back on that period with great pride.

The vast majority of facilities we put in place at the time have now been repaid via capital markets or cancelled because they are no longer required, though we have seen some REITs hanging on to extra liquidity as an insurance policy.

However, I think the jury is still out on a return to normal at least in some areas of the property sector. History may show that the pandemic was the catalyst for change that had been coming for some time in discretionary retail, for instance. Some retailers that were struggling before COVID-19 have been unable to open and valuations in this area have been affected quite significantly in some cases.

On the other hand, there are green shoots in other areas. Some hotels are operating at close to full available capacity, on weekends in particular. We will need to see the return of corporate travel for CBD hotels to get anywhere close to normal, however – and it is not clear when this might happen. I expect it will still be quite challenged in Q1 2021.

The industrial and logistics markets have experienced a positive impact, by contrast, and banks and other investors have been keen to support this sector. The driver is the supercharging of online shopping and the consequent requirement for increased warehouse facilities.

A bit of money is coming into this sector and there may be some pain in the medium term, as the stronger players pull away and those without the same experience start to struggle. This is not unusual.

The big unknown is the office sector. There is no doubt that all companies with space coming up for renewal will be thinking carefully about their future requirements. We are watching closely to see what trends emerge.

Our office book is predominantly with REITs, which typically have strong liquidity support, low leverage and long

WALE (weighted average lease expiry). They have time to work through this evolution, in other words. Personally, I believe premium office space will remain a very viable asset class in future even as companies and employees increasingly seek flexibility.

Davison The housing market seems to have surprised a lot of observers on the up side as we have moved through 2020.

■ **PLANK** The housing market has been buoyed by the employment recovery and lower interest rates, as well as the enormous fiscal stimulus and the support the banks have provided with mortgage deferrals.

Our house-price forecast has gone from being down by 10 per cent to up by something similar over the next 12 months. This will flow through into credit growth, which we now expect to be positive from a fairly pessimistic outlook. It's not quite bust to boom but it is much more positive.

We are actually in the midst of what could be a quite remarkable structural change in the mortgage market. Because of the inversion of the mortgage curve, fixed rates are now at a record low – much lower than variable rates than has ever been the case in Australia.

The market is transforming from a variable-rate one to fixed rates as a result. Fixed-rate mortgages historically made up 15 per cent of total stock but have increased to more than 30 per cent in recent months – which of course means the flow is much greater than this. It wouldn't surprise me if more than half of all mortgages are fixed rate within the next year.

What this means is that we haven't yet seen the full impact of lower interest rates on the housing market. This is another reason for a more buoyant outlook.

■ **HECTOR** The combination of low interest rates and government-support programmes such as Homebuilder have



"If we have noticed any change in the nature of conversations with borrowers post-COVID-19, it has been an evolution from 'why should I do this' to 'I think I should do this because I am worried about long-term access to capital'. We see this particularly from borrowers in hard-to-abate sectors."

KATHARINE TAPLEY

"There was a period of three or four weeks in 2020 when it looked like liquidity could become a real issue. The government and reserve bank acted much more quickly this time, and things like the RBA's TFF alleviated a lot of concern very quickly – much faster than was the case in the financial crisis."

GAVIN CHAPPELL



certainly supported house and land development in particular. It is the incredible turnaround in sentiment – and, we suspect, to some degree the return of a number of Australian expats – that has supported the secondary housing market. This is reflected in ANZ revising its house-price forecast to a 9 per cent gain from a 10 per cent decline.

Apartments have had a tougher time, as a consequence of lower net migration and the absence of foreign students. Presales for high-rise apartments are still struggling while some luxury and 'downsizer' developments are still doing well. I think the recovery is going to be very selective in this space.

Davison How did client needs play out in the loans and transaction-banking areas?

■ **CHAPPELL** There was a huge increase in demand for 6-8 weeks, almost exclusively from corporates looking for liquidity. There was some tightness of appetite from a few banks at the time, primarily because of the time needed to turn transactions around. I believe we did well in supporting customers and how responsive we managed to be.

At the same time, things like M&A and other discretionary financing activity stopped. From there, we moved on to waivers and consents being the main agenda item, as borrowers sought to get their covenants in place through the June reporting period. This is ongoing for some companies but has slowed since the end of June.

Things have been starting to return to normal in the second half. It is more a story of regular refinancing flows and borrowers seeking to take advantage of conducive market conditions to extend tenor. M&A and event-driven financing are also occurring on a more normal basis.

Davison Was liquidity always available to corporate borrowers? It seems that there might

be a contrast with the financial crisis, where there was an extended period in which liquidity was all-but absent.

■ **CHAPPELL** There was a period of three or four weeks in 2020 when it looked like liquidity could become a real issue. The government and reserve bank acted much more quickly this time, and things like the RBA's term funding facility (TFF) alleviated a lot of concern very quickly – much faster than was the case in the financial crisis, when it lasted for a couple of years.

■ **MEDARD** Banks and regulators learned a lot about capital and liquidity in the wake of the global financial crisis. As a result, banks were in a stronger liquidity and capital position to support clients this time around.

■ **CHAPPELL** One of the bigger challenges banks faced was the transition to working from home, especially around timeliness of response to client requests. Offshore banks in particular had to go through international channels to make decisions, and I think this as much as anything else was the challenge.

Davison The move to home working must have been a big issue for the transaction banking space.

■ **VASIC** Absolutely. A few important factors really put what we were dealing with in context. The first is that we were actually the beneficiaries of the desire for liquidity and debt drawdowns we have been talking about. Then there were the operational considerations. Third is what I'd call 'digital acceleration' – a trend that was already going on and which got additional firepower in the pandemic. The final one is the impact on supply chains.

Going back to the liquidity story, customers were using muscle memory from the financial crisis – making sure to secure their liquidity very quickly. We saw significant flow

"I think the jury is still out on a return to normal at least in some areas of the property sector. History may show that the pandemic was the catalyst for change that had been coming for some time in discretionary retail, for instance."

ANDREW HECTOR



PROMOTING CONFIDENCE **TO INVEST**

Entering the last month of 2020, there is at least some reason for a more positive outlook in Australia than might have seemed likely a few months earlier. A robust recovery will depend on supporting confidence and willingness to invest within the private sector.

DAVISON Looking ahead to 2021 and beyond, we have already seen a substantial improvement in forecasts from where the Australian economy was in March 2020. Does recent positive news on COVID-19 vaccines further improve the picture, in the sense that we may be able to start thinking about a full 'return to normal' as opposed to a more mitigated reopening of the economy in 2021?

■ **PLANK** Everybody has a vaccine in their forecast already, I think, so the news really only confirms what we were already expecting. It might come a little earlier than expected and it is really important that the arrival of an effective vaccine

has been confirmed, but it's not really a game-changer.

For us, the game-changer has already happened: the combination of stimulus and health outcomes mean the economy has recovered much faster than we anticipated. The question we are thinking about for 2021 is whether the economy coming back leads to calls for a faster wind-back of stimulus. This question applies globally.

For instance, our forecasts currently expect the TFF [term funding facility] and QE to be extended beyond the middle of 2021 – perhaps in a slightly smaller form. If the economy is back to its pre-COVID-19 level by that point there

could be calls for QE to come to an end. We don't expect this, and the RBA [Reserve Bank of Australia] has made it clear that ending stimulus too early would be a mistake. The economy was performing well below trend even before the pandemic, with low wage growth in particular, so the RBA seems quite happy with the idea of letting it run hot.

The challenge for the RBA is what it would do if house prices are running at double-digit growth by mid-2021. I suspect we would end up with the return of macroprudential policy either late in 2021 or in 2022. At the moment, the RBA wants higher house prices: they are positive for inflation and the wealth effect. It is

possible this could become too much of a good thing, but I still don't think this would mean the end of low interest rates or even QE.

DAVISON We have discussed ongoing stimulus, better-than-expected health and economic outcomes, and a responsive landscape for rapid change and adaptation. Clearly policymakers would like bank lending to be the transmission mechanism for these factors to translate into corporate Australia being confident to invest again. Will this start to happen in 2021?

■ **MEDARD** There is going to be no shortage of willingness



"THE BANKS HAVE THE LIQUIDITY, THE CAPITAL AND THE WILLINGNESS TO LEND – WE WOULD BE QUITE HAPPY TO GET SOME OF THE DEPOSITS OFF OUR BALANCE SHEETS AND INTO PRODUCTIVE ASSETS. IT IS UP TO THE CORPORATE SECTOR TO START MOVING FORWARD, PUTTING 2020 AND COVID-19 IN THE REAR-VIEW MIRROR."

TAMMY MEDARD

through to customers' operational accounts in the March-April period.

At the same time, rates were coming down at an accelerated pace. Operational accounts are traditionally a point of value for customers but here we saw an inflection between the need to have surplus liquidity on hand and the deteriorating rate environment.

The challenge was that liquidity was needed but it wasn't earning a suitable return. Customers had to consider their approaches as they sought to get at least some value from their liquidity.

Even at the end of November, we are holding a roughly 20 per cent increment on what we'd consider to be a normal level of deposits. This is a significant volume, and it speaks to the conservative approach of our customers and their desire to maintain liquidity throughout this period.

Moving on to operational risk, this is never anyone's favourite topic but it came to the top of the priority list in this period. The first order of business was moving to working from home. This was an unprecedented task: ANZ itself, for instance, moved 40,000 people to home working over the course of three weeks. If you'd asked us before the pandemic I doubt we would have thought it was possible in six months – we would have thought we'd need that time just to plan.

This transition, and the subsequent need to prioritise tasks under the new working environment, really exposed the way customers operate and the way the bank supports them. In many cases, the way we were supporting clients did not lend itself to the new working environment.

This could be as basic an issue as e-signatures. Again, it may not be an exciting topic. But we saw a queue forming around provision of documentation in some jurisdictions in our trade

to lend on the banks' part. Our customers have plenty of cash on hand, though, so they probably don't need any more lending. What corporate Australia needs is certainty and confidence to invest in growth. Certainty is probably not going to be here for a while, but the economic and sentiment figures coming out of Australia are, encouragingly, showing signs of growth.

The banks have the liquidity, the capital and the willingness to lend – we would be quite happy to get some of the deposits off our balance sheets and into productive assets. It is up to the corporate sector to start moving forward, putting 2020 and COVID-19 in the rear-view mirror.

■ **CHOI** As a bank, this includes a willingness to do more in Asia-Pacific. We are taking a more holistic approach with our customers, by which I mean talking to them about providing bridge loans and short-term facilities and then, in time, refinancing via the capital markets when conditions are favourable. For example, we foresee an uptick in acquisition financing.

We also see a growing environmental, social and

governance opportunity. Companies that we would never have imagined doing so even six months ago are asking how to access this market – and I think the uptake will increase dramatically in 2021.

■ **TONKIN** Our approach to market, and market access, is that it needs to be carefully considered. While the outlook appears to be positive some of the challenges borrowers faced in 2020 are likely to remain in 2021.

ANZ's focus is on financing transition through our debt-advisory activities in renewables, our greenfields project and acquisition-finance capabilities, and sustainable finance in loan syndications and capital markets. We expect activity in this area to continue to accelerate in line with customer and investor demand

■ **TAPLEY** The focus in sustainable finance will

continue to be on the transition story, in bond and loan format, as well as sustainability-linked loans – right across the region, not just in Australia. There will be a need to match the ambition of net-zero tasks with funding strategies, and we will see more treasurers exploring this connectivity. We should also all keep our eyes on the regulatory sector – there is a lot more to come from there.

■ **HECTOR** Engagement with government is particularly relevant in the healthcare sector. When the full impact of the pandemic started to become clear – including the potential requirement for significant extra capacity in the healthcare system – there was a need for an effective nationalisation of the private-hospital system.

This incorporated excellent engagement from government on what the banks would need

to support that transition and underwrite the costs of private hospital operators noting elective surgeries would need to be deferred.

The only issue is this is, at best, earnings-neutral for private providers. They are now starting to rebuild their elective-surgery rosters, so they are back in growth mode. But there is an ongoing need for balance-sheet flexibility, which provides a role for the banks.

In aged care, a royal commission was in full flight when the pandemic arrived. This is a particularly vulnerable cohort, though with a few notable exceptions Australia's system has performed relatively well. But it is a sector where I expect there will be quite substantial consolidation as we get to the end of the royal commission. Again, there will definitely be a role for experienced banks in the sector, such as ANZ.

“OUR APPROACH TO MARKET, AND MARKET ACCESS, IS THAT IT NEEDS TO BE CAREFULLY CONSIDERED. WHILE THE OUTLOOK IS LOOKING POSITIVE SOME OF THE CHALLENGES BORROWERS FACED IN 2020 ARE LIKELY TO REMAIN IN 2021.”

CHRISTINA TONKIN



business, simply because some couriers were in lockdown and couldn't get documents to the right places. This also had an impact on supply chains.

We have seen industry groups pivot very quickly to put in place business-continuity plans to accept e-signatures. This was originally on a three-year timeframe but has obviously moved much more quickly.

How customers think about liquidity management now things have started to normalise is the biggest area of interest for us at the moment. This includes a view on liquidity as businesses start to invest again, and also how they plan to leverage liquidity to get better returns in this environment of perennially low rates.

Davison Technology and data are playing an ever-growing role in transaction banking.

What impact did the events of 2020 have on evolution in this respect and what are the focus areas moving forward?

■ **VASIC** Cyber is a huge topic. As a lot of our customers shifted to a home-working environment unfortunately it also became prime time for cyber-crime activity. We spent a lot of time focusing on ensuring customers had the cyber protection and awareness needed for the transition.

We did the same thing internally at ANZ, and it remains a key focus of our work with clients. We ran a cyber thought-leadership session just two weeks ago, and it was the second highest attendance we have had at any institutional event. This is a real change in awareness.

It's also no surprise that digital acceleration was a hot topic in 2020. The first aspect here is use of data, and how important that was in responding to a changing environment.



"In the region, we are seeing much more revolving, core funding incorporating ESG metrics to drive pricing. This is very prominent in Europe and it is now becoming more common in Asia."

STELLA SARIS CHOW

David Plank has mentioned using things like our own retail data. We were able to provide some of this data to clients – to give them the best insights in almost real time and, hopefully, help their decision making. This will become part of our operating rhythm and customers' expectations of us.

Payments is also relevant in this area. Australia has always been quite progressive in online payments, but the pandemic spurred another huge shift in this direction. We saw a 40 per cent drop in use of cash and a significant reduction in ATM usage. There will be some degree of reversion as things return to normal, but it has been a significant and at least semi-permanent change.

The last point I wanted to raise was the importance of supply chains. At the beginning of COVID-19, there was a lot of discussion about shifting supply chains. This isn't easy to do in the short term, but we have seen increasing focus on concentration risk and – importantly – access to data to aid decision-making across the supply chain. We are watching this area as our customers adapt to the pandemic experience and to risks that perhaps they had not previously fully appreciated.

SUSTAINABILITY FOCUS

Davison How hard was it to keep sustainability on clients' agendas in 2020? How has this market evolved over the course of the year, while market participants were also dealing with the pandemic?

■ **TAPLEY** With all the disruption that has been discussed from late February through to June, we certainly found that customers were focused on short-term liquidity. But at the same time, those that had already been pursuing sustainable-finance objectives generally kept them going in the background. We were quite surprised by this, actually.

From June onward, the pace of our workload returned to normal if not increased beyond it. We are certainly back to full capacity now in the volume of conversations and demand for transactions – on the buy and sell sides.

When it comes to how the conversation has changed, my view is that COVID-19 has been an accelerator for the ESG [environmental, social and governance] aspects of borrowers and investors.

I tend to agree with PIMCO's view that it has been "the wake-up call needed", certainly by investors, to understand the

correlation between climate change, pandemic and pretty severe social consequences.

What we are experiencing now, as well as increased demand from issuers and investors, is an acceleration of regulatory conversations. A very big theme in 2021 is the regulatory freight train on mandatory disclosure. We have seen the UK and New Zealand introducing legislation covering mandatory TCFD [Task Force on Climate-related Financial Disclosures] reporting and I think Australia will also give serious consideration to this. This would become a major focus for us and our clients on the buy and sell sides, because it will affect how capital is allocated.

Another big theme is the broadening of instruments in the market to incorporate transition and sustainability linkage, including appetite from multiple customer types wanting to be involved in this aspect of the market.

■ **SARIS CHOW** It has been a similar story in Asia. We have had about US\$75 billion in issuance to the end of Q3, dominated by China, Japan, Korea and Singapore. We definitely see north Asia as particularly strong in ESG uptake and we expect China, Japan and Korea will continue to be the biggest drivers of volume.

All three countries are making very public statements about net-zero emissions by 2050 or 2060. This will promote a focus on green transition projects in those jurisdictions, which aligns with the sustainable-finance theme of energy transition and investment in new technologies and renewable energy to support the transition.

We are seeing the same theme develop with our own clients. Companies are now actively investing in electric vehicles and battery plants in their supply chains, and have been able to finance this with green loans or bonds.

We are also seeing the emergence of new products including those supporting social issues and energy transition. The product suite is much broader, which is only going to make sustainable finance more mainstream in 2021.

To Katharine Tapley's point about regulation, the regulatory machine is very important in Asia and there is a whole infrastructure of think tanks and organisations looking at standardisation of verification and guidelines on how products are treated.

There is a huge drive from government to grow sustainable finance – it is a national priority in many countries. This has led to things like the broadening of the MAS [Monetary Authority of Singapore] bond grant scheme, which had only been available to issuance of GSS [green, social and sustainability]

“The market has been functioning very well since June, with the key themes being the amount of liquidity in the system, and investor demand for credit and tenor. The most successful credit deals we have seen this year have been at 10-year tenor while public-sector issuers have been issuing at 10-30 years.”

PAUL WHITE



bonds, to incorporate sustainability-linked and green loans. This should promote Asian borrowers’ willingness to engage third-party providers and issue in a manner consistent with international standards.

Davison ANZ was very optimistic about the level of interest in sustainability-linked loans (SLLs) in the wake of the first such transactions in Australia. Has the level of borrower interest been maintained or even grown in 2020?

■ **CHAPPELL** There was a small pause on the issuer side in the March-May period, primarily because everyone was too busy chasing down liquidity. But the interest was still there in the background.

My sense is that ESG will become increasingly integral to the process over the next year or two, to the point that issuing in some type of ESG format will become the norm and issuers may be excluded from some opportunities if they do not.

■ **SARIS CHOW** In the Asia-Pacific region, we are seeing much more revolving, core funding incorporating ESG metrics to drive pricing. This is very prominent in Europe and it is now becoming more common in Asia.

■ **TAPLEY** If we have noticed any change in the nature of conversations with borrowers post-COVID-19, it has been an evolution from ‘why should I do this’ to ‘I think I should do this because I am worried about long-term access to capital’. We see this particularly from borrowers in hard-to-abate sectors, and we have seen it emerging in availability of investor and bank capital.

CAPITAL-MARKET REBOUND

Davison The domestic debt capital market rebounded quickly after the worst of the crisis. How did this unfold?

■ **WHITE** We were certainly surprised at the pace of recovery. Offshore markets revived fairly quickly after the Fed stepped in, as the concern had mainly been at the front end – the US CP market came under stress straight away but bond investors were prepared to buy at term to fund corporates that had previously been quite reliant on CP. This gave the whole market confidence, as did central-bank support.

We saw some forced selling of credit in Australia, particularly in the front end where liquidity was available.

Selling of short-dated major-bank paper by superannuation funds actually led to an inverted curve for a period of time. But within a week or two of the RBA stepping in, the market regained confidence – helped by the improvement offshore – and we started to see new issuance from the public sector soon after.

This was followed in April by Australian dollar covered-bond issuance from Canadian banks, demand for which was also helped by TFF liquidity. Then in May we had new primary credit supply, from global banks like UBS followed by a large dual-tranche transaction from Woolworths.

The market has been functioning very well since June, with the key themes being the amount of liquidity in the system and investor demand for credit and tenor. The most successful credit deals we have seen in 2020 have been at 10-year tenor while public-sector issuers have been issuing at 10-30 years.

It was a fairly quick positive response and the market returned to good function in short order – though credit probably took a few months to see new issuance across the issuer spectrum.

Davison With the big-four banks historically making up the largest single component of local credit supply, how has their absence affected market dynamics elsewhere?

■ **WHITE** This clearly will be a big theme in 2021 – we are not expecting much major-bank issuance in the domestic market, at least not in senior format. There is about A\$65 billion of financial-institution redemptions due next year and our forecast is that we will be lucky to see half that volume refinanced domestically. This means A\$30-35 billion of cash looking for a home, and I think it’s likely we will see more local corporate issuance as a result.

This should also mean continued support for duration – not just at 10 years but potentially at 12 and 15 years, too. We have seen some corporate hybrid issuance recently, from issuers seeking to protect their ratings and balance sheets. I think this will continue into 2021 especially given the rates and credit cycle we are in. This could also support more subinvestment-grade issuance domestically.

There should also be opportunities for offshore credit issuers in Australia. By this I mean financials in senior-nonpreferred or TLAC [total loss-absorbing capacity] format and corporates. This could help fill the supply gap to at least some extent. •

LEADING FROM THE FRONT

European Investment Bank is one of the EU's primary vehicles for achieving its sustainability goals and is therefore at the vanguard of European and global sustainable debt markets. The supranational tells *KangaNews* it aims to use this position to provide a blueprint for itself and others to implement ambitious sustainable-finance strategies.

European Investment Bank (EIB) has been one of the world's largest financiers of renewable-energy projects for more than a decade. Its climate-awareness bond (CAB) programme, historically allocated to these projects, has grown in tandem with this role.

In 2018, EIB added the sustainability-awareness bond (SAB) programme to its suite of products, broadening the pool of assets that may receive allocations from issuance of dedicated bonds as its sustainability financing expands beyond climate action.

The EU's bank is ramping up its commitments to funding transition to a low-carbon, resilient economy in conjunction with the increasing urgency of the task and escalating European government commitments to meeting it.

In November 2019, EIB announced a four-pronged approach including aligning all financing with Paris Agreement targets by the end of 2020, the phase-out of new unabated fossil-fuel industry lending by the end of 2021, increasing the share of new EIB lending to climate and environmental outcomes, and mobilising €1 trillion (US\$1.2 trillion) for climate and environmental purposes by 2030.

In November 2020, EIB's board of directors approved the *Climate Bank Roadmap 2021-25*, which enshrines these commitments in bank operations with a focus on accelerating transition, ensuring a just transition, supporting Paris Agreement-aligned operations and building strategic coherence and accountability.

Dominika Rosolowska, sustainability funding officer at EIB in Luxembourg, says the commitments and roadmap are

indicative of the EU's desire for EIB to strengthen its role as the union's climate bank, putting the supranational at the forefront of sustainable finance in a region that is widely acknowledged as the global leader in the field.

"EIB has been asked to reinforce its role as a financier for climate and sustainability outcomes in the context of the European green deal. While we have already built vast expertise and experience in this area, it has now become increasingly relevant with the EU's focus on transition and the introduction of the EU taxonomy," she explains.

IMPLEMENTING AMBITION

Making bold commitments is just the first step in the process. The rubber hits the road in the bank's lending activities, but its funding book is increasingly aligned with the task at hand, too.

This is where the EU's taxonomy for sustainable activities comes into play. It codifies a range of environmental, social and sustainability objectives, activities and technical screening criteria. This is designed to help market participants understand if the activities underlying investments are sustainable – and why.

EIB contributed to various expert groups in the development of the EU taxonomy, including the high-level expert group on sustainable finance, the technical expert group on sustainable finance and the current EU platform on sustainable finance.

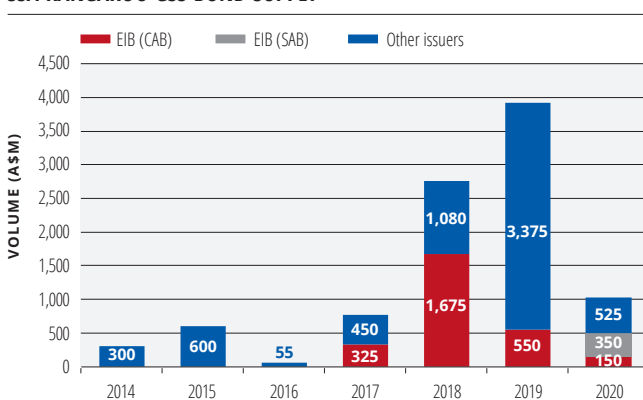
Rosolowska says, as the EU's bank, EIB follows guidance from the EU and is therefore bound to align its activities with the taxonomy. "In practice, this means we need to apply the taxonomy lens in the first instance to our lending – to look at how we can align definitions and measurement criteria for projects with the definitions of the taxonomy."

This alignment will be reflected on EIB's funding side through eligibility criteria for use of proceeds of the CAB and SAB programmes. EIB has been issuing CABs since 2007 to link funding to the lending it provides for climate-change mitigation. It has been issuing SABs to link funding to its lending for other environmental and social objectives.

"We want to service investors with specific demand for our CABs and SABs but also to continue providing regular issuance of vanilla bonds to fill investor needs for these. The products are complementary."

JORGE GRASA

SSA KANGAROO GSS BOND SUPPLY



SOURCE: KANGANEWS 15 DECEMBER 2020

The SAB programme launched in 2018 but only included water-related projects at the time. In 2019, the programme expanded to health and education, and in 2020 the health component further broadened to include emergency-response measures – which EIB has been prominent in providing during the COVID-19 pandemic.

Rosolowska explains: “This is possible because the documentation we devised for the bonds is like a shell, to which we can add components as long as they are devised in line with the EU taxonomy or, where the taxonomy is not yet available, with its structure and logic. We need to identify an objective, the economic activity that contributes to it and the technical screening criteria used to assess the substantiality of the contribution to the objective.”

EIB intends to continue mapping its lending to the taxonomy including further expanding its CAB- and SAB-eligible asset pools. For SABs, this could include areas like social housing, biodiversity and gender. For CABs, EIB would like to broaden eligibility to cover a larger portion of its climate action financing, Rosolowska reveals.

The implementation of this strategy is a process not an event, she adds, reflecting the schedule for implementation of the EU taxonomy. While the taxonomy regulation entered European law in July 2020, the technical details and screening criteria for assessment of activities and their contribution to objectives are still to be finalised.

On climate, the European Commission is expected to announce legislation by the end of 2020, that will come into force by the end of 2021. Criteria for other environmental objectives are to be implemented at the beginning of 2023. Social objectives are expected to be tackled, too – but at a later date.

Rosolowska says EIB will continue to be at the front line of adapting its lending and funding to the evolving criteria. “Until the technical screening criteria are available, EIB will rely on its project experts to apply the taxonomy lens, structure and intent to its balance sheet and map these to increase the eligible pools for CABs and SABs.”

FUNDING IMPACT

EIB is one of the world’s largest debt capital market funders, with an annual issuance requirement of €60-70 billion. As its lending to climate and other sustainability projects ramps up, it may be able to allocate an increasing portion of this volume to CABs and SABs.

Jorge Grasa, Luxembourg-based funding officer at EIB, says the bank’s approach to funding has not changed despite its greater sustainability commitments. To achieve such a large funding task, EIB needs to be active across all major and many supplementary markets, Grasa confirms. He adds that EIB has an increasing focus on building out CAB and SAB curves in various currencies to sit alongside vanilla curves.

“We want to service investors with specific demand for our CABs and SABs but also to continue providing regular issuance of vanilla bonds to fill investor needs for these. The products are



DOMINIKA ROSOLOWSKA



JORGE GRASA

“We have been encouraged by the level of Australian investor interest and understanding of what is happening in Europe. There was reciprocity of thinking around sustainability while investors were particularly curious about how the taxonomy can translate into market activity.”

DOMINIKA ROSOLOWSKA

complementary – and they help increase EIB’s presence in markets and diversify its investor base,” Grasa explains.

EIB has CABs outstanding in 11 currencies and SABs outstanding in four. Australian dollars became the fourth currency in which EIB issued SABs in May 2020, despite a challenging environment for supranational, sovereign and agency (SSA) borrowers in the Kangaroo market.

As well as unfavourable basis swap economics in the early months of the year, the various government and central-bank actions taken around the world in response to COVID-19 have made issuance for most SSAs more favourable in markets other than Australian dollars for most of 2020.

Even with diminished issuance possibilities EIB has remained one of the pre-eminent SSA Kangaroo issuers of green, social and sustainability (GSS) bonds (see chart). Grasa says EIB appreciates the support of its dealers and investors during a challenging 2020 and is keen to continue its commitment to the Australian dollar market in 2021 and beyond, in its vanilla, CAB and SAB bond curves.

Rosolowska says EIB is encouraged by investors in markets outside Europe buying into its CAB and SAB programmes, thereby subscribing to the robustness of EIB’s sustainability funding, its links to the EU taxonomy and its development of criteria.

She adds that EIB had strong engagement with Australian investors – that have been preparing for the release of a domestic sustainability roadmap – on the development of its CAB and SAB programmes when it undertook a virtual roadshow in the second half of 2020.

“We have been encouraged by the level of Australian investor interest and understanding of what is happening in Europe. There was reciprocity of thinking around sustainability while investors were particularly curious about how the taxonomy can translate into market activity. As more and more jurisdictions seek to classify what is sustainable, we are keen to exchange thoughts and experiences with market participants around the globe,” Rosolowska explains. •

Exposure cost

As environmental, social and governance issues become ever-more integrated with the credit investment process in Australia, the issue of pricing consequences for strong and weak performers is more relevant than ever. This is no longer just a question for direct emitters but also for companies with business models adjacent to emissions-intensive industries.

BY MATT ZAUNMAYR

The Australian debt market does not see much issuance from, for instance, coal miners or 'brown' energy companies. But the activities of plenty of capital-markets-relevant local companies are woven in with the fossil-fuel sector.

Australia's economy remains one of the most dependent on fossil fuels in the developed world. According to the Department of Industry, Science, Energy and Resources, coal, oil and gas accounted for 94 per cent of Australia's primary energy mix in the 2019 financial year. In the US the figure was 80 per cent, per the US Energy Information Administration, while the European Commission says the EU equivalent was just more than 70 per cent in 2018.

A 2020 report authored by Jeremy Moss, director of the Practical Justice Initiative at the University of New South Wales, concludes that Australia is also now the world's largest exporter of fossil-fuel emissions. Emissions from Australia's fossil-fuel exports in 2019 were, for example, 1.4 times greater than Germany's total domestic emissions.

Australian commitments to decarbonisation are a mixed bag. Every state has committed to achieve net-zero carbon emissions by 2050. However, the federal government has avoided such a commitment and has instead signalled its preference for natural gas as a strategy that it claims suits economic and emissions needs.

Meanwhile, Australian banks and institutional investors have been steadily expanding their commitments to phase out fossil-fuel investments or to engage meaningfully with hard-to-abate sectors on transition plans, for example how these companies plan alignment with Paris Agreement goals.

There is an increasing body of evidence that this process of investor engagement is manifesting in the Australian debt capital market, in the form of investors either not participating in deals or a pricing premium emerging for issuers linked with the fossil-fuel industry.

Aurizon is a case in point. The company derives a significant portion of its revenue from freighting coal, and this has not to date precluded its access to the local capital market. The company executed a A\$500 million (US\$368.8 million) 10-year deal in August 2020 with a nearly two-times oversubscription and a substantial price tightening from launch – indicating

plenty of demand despite the emissions intensity of the issuer's primary cargo.

However, Joyce Yu, Sydney-based credit strategist at Commonwealth Bank of Australia, estimates the issue price was 20-30 basis points wider than conventional fair value and believes environmental, social and governance (ESG) risk was the reason. The issuer itself has not shied away from its exposure to changing investor ESG preferences and has stated its willingness to engage with investors on the topic.

Moving a step closer to direct coal exposure appears to make Australian dollar market access harder still. Dalrymple Bay Coal Terminal opened discussion about a potential domestic deal in September 2020 but ultimately chose to execute a US\$550 million equivalent US private placement (USPP) deal across 7-12 year tenors instead.

Then thermal coal miner Glencore Australia floated a domestic deal in October. *KangaNews* is not aware of the deal materialising elsewhere, though the company's global funding counterpart has issued in euros and US dollars in 2020.

In both cases, market participants suggest the coal connection was a primary reason the issuers did not develop sufficient confidence to proceed. Lack of demand was certainly not a regular feature of the Australian dollar corporate market in 2020.

OPEN DIALOGUE

For investors, the key concept is transition. It now appears that having a credible transition strategy – either through other sources of revenue or plans to adapt the nature of a business – is a relevant component of buy-side assessment of corporate borrowers in Australia.

Investors *KangaNews* heard from in various forums throughout 2020 – including via surveys, roundtables and interviews, and at conference sessions – made clear on every occasion that divestment is not the best way to address borrowers' ESG issues. Rather, they tend to regard engagement on risks and transition strategy as the way forward.

Applying a catch-all term like transition to the investment process can involve engagement with one or more of the local and international standards, taxonomies and roadmaps to plot an issuer's commitments against an outline for best practice.

For instance, Francis Condon, sustainable and impact investing research analyst at UBS Asset Management in the Netherlands, says his firm begins its ESG analysis of each company by assessing alignment to the Taskforce on Climate-related Financial Disclosures, Climate Action 100+ and the Institutional Investor Group on Climate Change.

Some threads can be drawn from one jurisdiction to another. Condon says parts of the EU's sustainable-finance taxonomy could be relevant for the Australian industry, such as the recognition that adapting real-economy investment and decarbonisation take time, and that investment needs to consider the wider context of how governments plan for greater sustainability and lower carbon intensity.

But investors say they are also making their own standalone judgements on issuer credibility and commitment. In this way, the fixed-income market may be making steps closer to what has been the norm in the equity space for ESG and other corporate issues – of direct engagement with management on an ongoing basis, rather than a transaction focus.

This type of approach also means fossil-fuel connections are not necessarily a deal-breaker. If an issuer can outline clear and material plans for its future ESG trajectory, investors will often be comfortable with exposure even if it is currently, for instance, a relatively high emitter.

Matt Macreadie, investment director, global fixed income at Aberdeen Standard Investments (ASI) in Sydney, says: “We approach engagement with issuers linked to fossil fuels by focusing on how to help them reduce their reliance. Not all fossil fuels are equal, though. We want to steer companies toward setting ambitious targets and increasing capital allocation to low-carbon solutions.”

Macreadie adds that ASI has engaged with companies in hard-to-abate sectors, such as airlines, on aligning corporate strategies and investment plans with the Paris Agreement.

Meanwhile, Ashley Kopczynski, associate portfolio manager, credit and ESG at Janus Henderson in Melbourne, tells *KangaNews* the firm has a twofold approach to ESG engagement. The first pillar is regular meetings where issuer and investor discuss ongoing material ESG risks as part of the credit-risk conversation. Second, Janus Henderson requests a specific meeting if there is any particular ESG event on which it requires clarity.

Kopczynski adds that a borrower's sector does not change the method of engagement. “We are focused on the materiality

of ESG risks regardless of the sector. We define materiality as an ESG risk that can affect the credit profile of the company. The degree to which an industry will be affected by climate change or decarbonisation does not influence the manner in which we will engage with it.”

Condon says ESG engagement can also be a two-way street, in which borrowers also have air time to present their perspectives on how issues like transition should unfold.

“As investors, we can share our expectations for corporate management and encourage practices that could enhance long-term value. Companies, meanwhile, can explain to us the relationship between sustainability, their business model and financial performance,” Condon explains.

PUNITIVE ACTION

With ESG risk forming an increasingly inseparable part of credit analysis, the outcome on the buy side has moved on to a calibration of consequences for issuers that are falling short on sustainability considerations or do not have a credible plan on business transition. This can manifest through price or lower outright demand, and investors are taking varying approaches.

Kopczynski reveals that Janus Henderson's sustainable-investment strategy focuses on quality of ESG performance before price. “This means that if, in our eyes, a company is not stable and sustainable in its credit quality it won't be on our approved list of investments and won't be added to portfolios – regardless of price.”

However, outright exclusion appears to be reserved by most investors for borrowers in high-emitting sectors where there is limited scope for transition. Reliance on coal for revenue is perhaps the most significant such barrier in the Australian market and it has become a black-and-white issue: many investors simply will not allocate. There seems to be some leeway for metallurgical coal, but this is far from universal.

UBS AM excludes mining companies that derive more than 30 per cent of revenue from thermal coal from its investable universe, as well as any companies that are exposed to assets that are stranded or are likely to become severely impaired, according to Earl San Juan, Sydney-based credit analyst at the fund manager.

However, for many investors, pricing in the risk of companies remains a preferable option to divestment. Indeed, this is the case for UBS AM once a prospective investment target has cleared the

“If investments have material ESG risks that are reflected in a wider credit spread, the fact that spread exists doesn't necessarily mean the bond will outperform others over time. We are seeing the market consider companies that have widely acknowledged ESG risks differently.”

ASHLEY KOPCZYNSKI | JANUS HENDERSON





“Fossil fuel-linked companies that are transitioning should be able to lower their cost of funding over time. Those that do not transition, or do so slowly, will end up paying a higher cost of funding as political risk becomes a bigger issue.”

MATTHEW MACREADIE ABERDEEN STANDARD INVESTMENTS

negative-screen hurdle. At this point, the decision becomes one of assessing an appropriate premium for ESG risk.

San Juan says: “Our approach involves the assessment of ESG risk factors at the top-down and bottom-up level, and identifies the materiality of such factors when making investment decisions. We then assess whether the identified material ESG factors have been appropriately embedded within the risk premium for the given tenor.”

Condon explains that UBS AM’s sustainable investments team focuses on determining whether a company’s plans to address ESG risks are credible and on track. If it identifies issues it communicates them to UBS AM’s analysts, with potential implications for investment decisions. The firm’s preference, though, is for issuer engagement to generate value by crystallising alpha or reducing risk.

Macreadie says ASI’s engagements have so far not led to it withholding investment. “Generally, there is always a price for each issuer that factors in ESG considerations and concerns. Engagement with companies has led us to become more optimistic on the transition of some fossil fuel-linked companies than others.”

He continues: “Fossil fuel-linked companies that are transitioning should be able to lower their cost of funding over time. Those that do not transition, or do so slowly, will end up paying a higher cost of funding as political risk becomes a bigger issue.”

Dynamic pricing based on ESG risk is very much the holy grail of sustainable debt. It appears to be developing in- and outside the confines of the defined use-of-proceeds green, social and sustainability (GSS) bond space. Indeed, investors say the ability of a market to apply punitive pricing to poor ESG performers is just as important as a potential pricing discount for GSS bonds.

The application of a higher cost of capital to companies in high emitting sectors of the Australian economy could be far reaching, considering the country’s fossil-fuel dominated energy complex.

The critical question is at what point in a borrower’s supply chain punitive action should or could reasonably be expected to be taken. For example, scope-three emissions – those that occur indirectly across a company’s sphere of influence – are often not captured by investors in issuers’ reporting.

Some investors are now taking account of downstream and upstream emissions and factoring them into decision-making,

though quantitative data unsurprisingly suggests the focus is much tighter on issuer’s first-order emissions (see p54). Macreadie says ASI can now identify the highest-emitting companies in its portfolios, analyse their carbon footprint and incorporate this into the investment process. He adds that this process includes scope-three emissions.

The broader inclusion of scope-three emissions in investor considerations could be a game changer in Australia’s corporate landscape – and even more widely. There was some talk following New South Wales Treasury Corporation’s 2018 green-bond debut, for instance, about the credentials of a transaction used to fund light-rail assets overwhelmingly powered by brown electricity.

The bank sector is another where accounting for scope-three emissions could mean a seismic change. Banks tend to be low emitters in and of themselves, but scope three includes a company’s investments – which obviously make a massive potential difference to a bank’s footprint.

However, Yu says so far it is only in issuers linked to the coal industry where a discernible impact on cost of capital has been seen. “Given the strong demand for ESG issuance in Australia, it is more common for issuers to use ESG to gain a pricing benefit rather than being exposed to pricing penalties,” she says.

MICRO AND MACRO LENSES

One of the inherent difficulties for investors is gauging the appropriate level of ambition an individual corporate borrower should have, while also considering the baseline it is coming from and the industry it is in. Including the extent to which an issuer should be accounting for the emissions of its investments and in its supply chain only adds to the complexity.

An airport can relatively easily put solar panels on its roof, but it cannot easily change the fuel aircraft run on. Either way, the airport is exposed to risks such as people being more conscious of their own emissions profiles, and therefore taking less carbon-intensive transport options or just flying less. This issue has been thrown into harsh relief by the pandemic.

There are also fundamental economics to consider. Companies that are heavily linked to the production and export of coal – particularly thermal and coking coal – tend to have bearish outlooks based on ever-growing commitments from countries seeking to reduce consumption, in their energy generation if not manufacturing. This is leading to structurally lower long-term coal prices and a weaker sector outlook.

"As investors, we can share our expectations for corporate management and encourage practices that could enhance long-term value. Companies, meanwhile, can explain to us the relationship between sustainability, their business model and financial performance."

FRANCIS CONDON UBS ASSET MANAGEMENT



Yu says the fundamental trend for coal prices is negative, and for Australian producers and companies linked to the industry perhaps even more so given restrictions being placed on imports of Australian coal by China.

Many Australian coal producers and companies with revenue linked to its export pin the future of the industry on the development of economies in south and south-east Asia, which are forecast to have increasing need for thermal coal for energy production and metallurgical coal for infrastructure. However, investors are still demanding credible transition strategies and levying a premium if they are not forthcoming.

Macreadie says companies that have exposure to thermal and metallurgical coal should focus on five-year strategies to diversify away from thermal coal to more intermodal freight and other business activities.

"I expect a full thermal-coal exit target before 2030. As evidence of the viability of such a strategy I monitor customer-base change through the percentage of thermal versus metallurgical coal miners and against other commodities, capex spend on diversifying into other segments such as cargo, bulk and agriculture, and five- and 10-year targets supported by interim milestones," Macreadie explains. He adds that issuers with thermal-only or growing thermal exposure represent the highest transition and stranded-asset risk.

While borrower-level plans can influence investor decision-making, climate change is increasingly becoming the foremost issue in domestic and international politics. This could have a drastic influence on the medium-term future of industries such as coal.

With the widespread international uptake of goals such as the Paris Agreement and net-zero emissions by 2050, the financial risks related to fossil fuels are becoming more material even if the pathways for most countries to achieve these targets remain ill-defined.

Kopczynski tells *KangaNews* the macro trends provide a trajectory for where society is heading, and as such Janus Henderson's expectation is that high-emitting companies will have to commit to a transition approach if they are to remain a viable part of economies in the long term.

THE CRUCIAL YEARS

The coming decade is likely to be a crucial one in abating the worst effects of global warming. There is undoubtedly a long way to go to decarbonise the Australian corporate

landscape, and probably even further to go to decarbonise its exports.

Investors are playing an increasingly active role in ensuring companies are on a sustainable path by using their ability to price long-term capital in a way that encourages or even mandates transition.

Macreadie says: "The tenor for investments in these industries is not capped. However, we are focused on how issuers are transitioning to reduce their reliance on fossil fuels. The pricing consideration is important and, all else being equal, we require exponentially higher pricing on fossil-fuel-exposed investments the longer the tenor of the bond."

There is a clear impetus in most countries around the world aggressively to transition from fossil fuels. In this environment, if companies do not follow suit they risk their business models becoming unviable. However, in the wake of COVID-19 there are also drivers for countries, companies and investors to lock in short-term gains.

Yu estimates that as market conditions normalise the premium debt investors charge to companies linked heavily to high-emitting fossil fuels will be around 10-15 basis points, and that fewer investors are likely to be willing to provide capital to the industry.

However, she adds that this premium could itself serve to attract certain groups of investors given the low yield on offer in most asset classes. For instance, Yu says, Aurizon's 2020 transaction has outperformed in secondary trading since issuance.

Given the sheer volume of liquidity in the global financial system, the impulse for companies and investors to maximise short-term gain could slow efforts toward economy-wide transition. The risk, in effect, is that the consensus drive towards long-term ESG-based pricing is simply overwhelmed by the volume of funds seeking return from what remain relatively safe assets – at least in the near term.

However, Kopczynski says the more robust trend is that of clients, consultants and the broader investment community wanting to fund more sustainable investments, and that this should trump the desire for short-term returns.

He comments: "If investments have material ESG risks that are reflected in a wider credit spread, the fact that spread exists doesn't necessarily mean the bond will outperform others over time. We are seeing the market consider companies that have widely acknowledged ESG risks differently, and investors are voting with their feet." •

WHAT THE BUY SIDE WANTS IN ESG

As the sustainable debt market evolves at a quickening pace, the most important factor for issuers to keep abreast of is what investors want from them – what is considered best practice on a transaction basis and as ongoing environmental, social and governance (ESG) commitments. In December, *KangaNews* polled Australasian investors to ascertain their up-to-the-minute thinking.

BY HELEN CRAIG AND LAURENCE DAVISON

K*angaNews* designed the survey with one goal in mind: to uncover information issuers can use to help guide their alignment of debt funding and ESG principles. More than 40 institutional investors responded, covering the Australian and New Zealand institutional fixed-income funds-management community.

As well as the quantitative results, *KangaNews* spoke to a number of investors to hear their perspectives on the responses and to learn more about the strategic thinking behind contemporary buy-side preferences.

One of the clearest findings from the survey is that investors are more focused on issuers' ESG behaviour as a whole than on the specifics of debt programmes or securities. More than 70

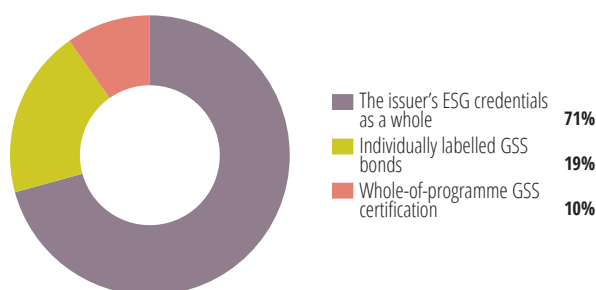
per cent of survey respondents name issuers' ESG credentials as a whole as the "gold standard" for ESG in the bond market (see chart 1).

LABELLED BONDS

This holds true even when investors are looking at a specific debt transaction. Again, more than 70 per cent list issuer credentials as a very important factor in assessing individual deals – significantly more than place the same importance on security-level or whole-of-programme labelling (see chart 2).

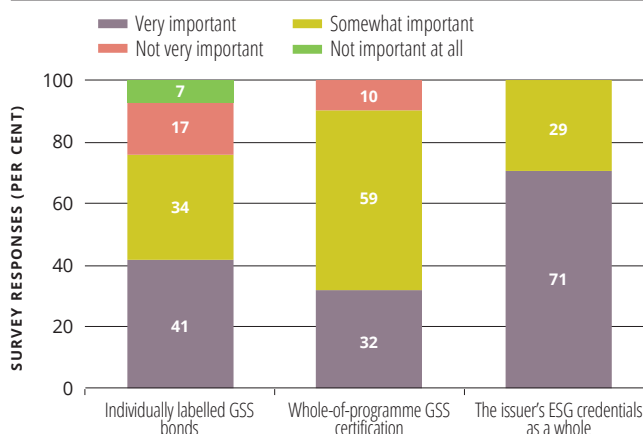
Darren Langer, head of Australian fixed income at Nikko Asset Management in Sydney, comments: "To us, the issuer is the primary concern. The only reason for considering a label is if there is a special purpose for the funds. We can get comfortable if we're

CHART 1. WHAT DO YOU BELIEVE TO BE THE GOLD STANDARD/ BEST PRACTICE FOR ESG SPECIFICALLY IN BOND ISSUANCE?



SOURCE: KANGANEWS 10 DECEMBER 2020

CHART 2. HOW IMPORTANT DO YOU CONSIDER EACH OF THE FOLLOWING WHEN ASSESSING A BOND TRANSACTION'S ESG CREDENTIALS?



SOURCE: KANGANEWS 10 DECEMBER 2020

certain the money is ringfenced for a particular project, but what we don't want is issuers using ESG as a marketing tool."

More than one investor mentions the potential for greenwashing as a major reason why issuers' overall credentials are the most important factor in ESG analysis. The view seems to be that labelled green, social and sustainability (GSS) issuance is good as far as it goes, but the rest of the borrower's assets should be relevant even so.

"The issuer's ESG credentials as a whole remove any suggestion of greenwashing and cut to the core of what an investor is looking for," explains Simon Pannett, director and senior credit analyst at Harbour Asset Management in Wellington. "We want to know what an issuer is actually doing and get a good sense of its corporate behaviour more generally. It is more important to know what is behind the label than it is to focus on the label itself."

In fact, Pannett says Harbour would actually be just as, if not more, concerned about an issuer's poor ESG behaviour outside the asset pool for a GSS bond even when it has assets suitable for this type of issuance.

Investors also have to keep an eye on their own portfolio-level allocations in a more dynamic way than just holding some labelled bonds. Marayka Ward, Brisbane-based senior credit and ESG manager at QIC, explains that research and guidance from Europe suggests that while it is appropriate for investors to report on the emissions avoided or the impact of GSS bonds they invest in, it is not appropriate to use this to offset the carbon emissions of the rest of their portfolios.

For investors to help clients achieve their Paris Agreement commitments, they need organisations across the portfolio to focus on reducing their overall emissions. For this reason, Ward says she favours the sustainability-linked style of bond – because it makes the targets company-wide.

"This is not to say we don't see value in labelled bonds," she continues. "If we have carried out credit work on the company

and it has a vanilla bond as well as a green or social bond, like-for-like we probably prefer the labelled bond. We also think there is a technical reason to hold labelled bonds as our research shows they either outperform, or perform in line with, vanilla bonds. But, at the most basic level, the company issuing GSS bonds must pass our credit requirements first."

This speaks to the wider trend of ESG integration with the credit-risk analysis process, which is becoming more prevalent across the Australian market (see p50).

In QIC's case, the firm's analysts incorporate ESG considerations into their credit work and ESG transgressions can trigger a decision not to invest – any of environmental, social or governance issues can be the driver of an investment decision. Ward says it would therefore be unusual to find a company with very poor ESG practices from the outset in one of QIC's investment portfolios.

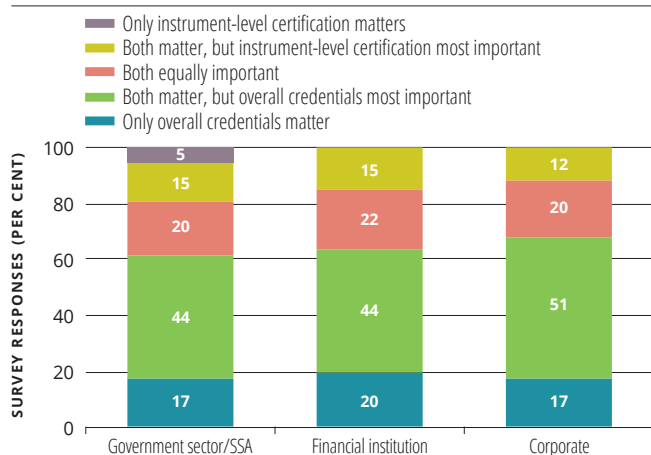
It is not a set-and-forget screen, either. QIC has a dynamic exclusion list that can come into play if a transitory ESG issue is identified that the firm believes is temporary but needs to be addressed. "This can cause us to put the company on a short-term investment ban – until such time as the issue is addressed," Ward reveals. "For us, first and foremost, it is the issuer's own credentials that drive the initial credit assessment."

ISSUER SECTORS

There is also no apparent difference in investors' preferences by issuer sector. Whether they are looking at a government sector issuer – including supranational, sovereign and agency (SSA) names – a financial institution or a corporate borrower, investors place significantly greater weight on a borrower's overall credentials than the characteristics of individual deals (see chart 3).

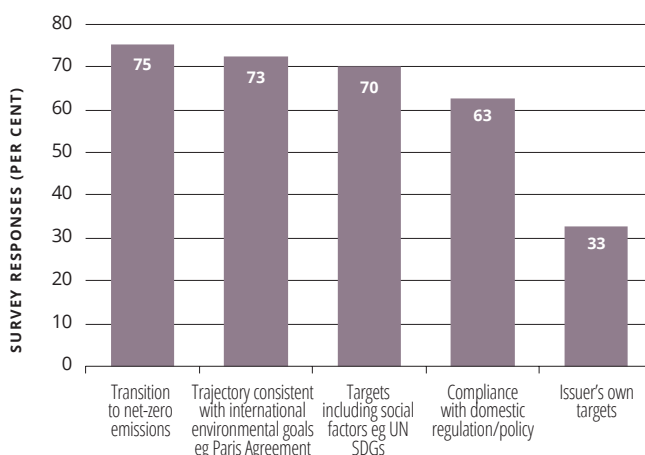
In this case, though, the data may not tell the full story as several investors report that they consider the context of an issuer's purpose. For instance, Pannett argues that ESG considerations

CHART 3. WHAT IS THE RELATIVE IMPORTANCE OF WHOLE-OF-ISSUER SUSTAINABILITY CREDENTIALS VERSUS LABELLING AND CERTIFICATION OF INDIVIDUAL DEBT INSTRUMENTS?



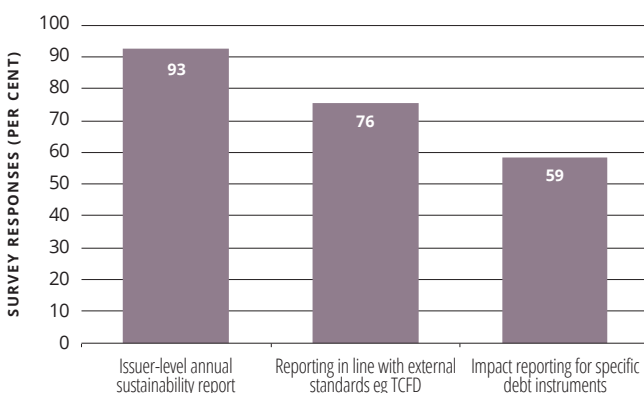
SOURCE: KANGANEWS 10 DECEMBER 2020

CHART 4. WHAT TARGETS DO YOU WANT ISSUERS TO BE AIMING FOR IN THEIR SUSTAINABILITY STRATEGIES?



SOURCE: KANGANEWS 10 DECEMBER 2020

CHART 5. WHAT TYPE OF SUSTAINABILITY REPORTING DO YOU WANT FROM ISSUERS?



SOURCE: KANGANEWS 10 DECEMBER 2020

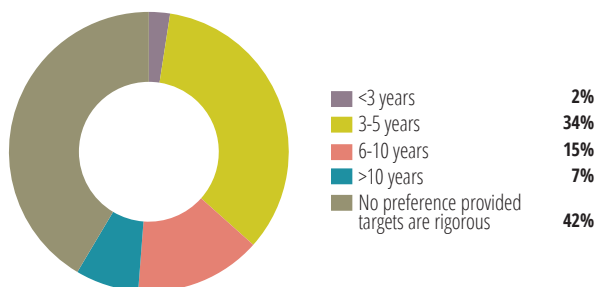
are baked in to “the whole *raison d’être* of an SSA”. As a result, he adds: “We prioritise our time and effort where we have greater concerns, which is predominantly industrial corporates.”

Ward adds: “SSAs have a natural advantage in the ESG space because they are predominantly focused on funding the social good. These issuers are therefore the one exception we make when looking at green- or social-bond deals in relation to requiring independent certification.”

It may not be the majority opinion, but at least some investors take this view as far as a conclusion that government-sector issuers would be better issuing on a whole-programme basis than focusing on GSS asset pools.

“While I acknowledge issuers have taken time and effort to create an ESG framework, it is far better if the organisation as a whole seeks to have ESG credentials,” says Terry Yuan, credit analyst at Antares Capital in Sydney. “Rather than packaging up and issuing particular assets it would be better if governments as a whole were to make it clear that it is about all their activities.

CHART 6. WHAT IS YOUR PREFERRED TIME HORIZON FOR AN ISSUER’S SUSTAINABILITY STRATEGY?



SOURCE: KANGANEWS 10 DECEMBER 2020

In my view, this would make more of an impact – and it would make their bonds more attractive.”

MEASURING COMMITMENTS

The *KangaNews* survey also asked investors for detail on what type of ESG credentials they want issuers to display. There is no universal preference but it is clear that an articulated plan to meet measurable, externally defined targets is crucial.

The most commonly named single target is a net-zero emissions transition plan, while meeting international-agreement targets or specific goals with a social component – including the UN Sustainable Development Goals – also features heavily (see chart 4). By contrast, there is relatively little interest in issuers’ self-set targets.

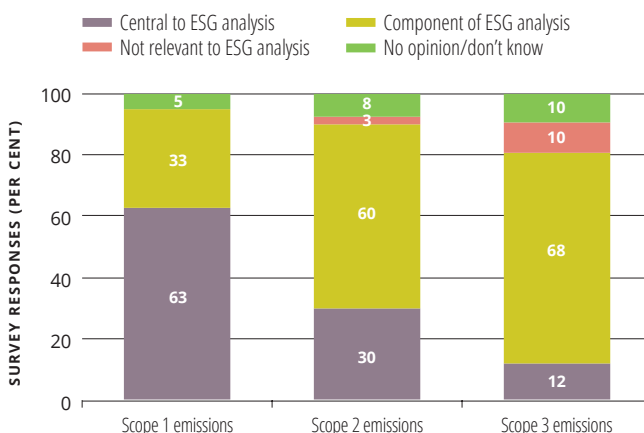
“We want companies to tell us what they are doing and we want as much data as possible,” Langer says. “The more quantitative data the better, because in the end we’re trying to understand whether the company has a policy it is adhering to. This information should be coming through in the annual report but also external standards and reporting.”

Three-quarters of investors responding to the *KangaNews* survey agree that reporting in line with external standards – such as the Task Force on Climate-related Financial Disclosures (TCFD) – is desirable. Even more want to see issuers producing annual standalone sustainability reports (see chart 5).

“Our clients want to know about TCFD metrics, modern slavery and a number of other external regulatory requirements they need to comply with,” Ward reveals. “Some countries – including New Zealand, the UK and Switzerland – are mandating TCFD reporting over the next few years. The regulatory environment is driving our response and causing us carefully to consider what our clients are asking us to provide and why.”

The survey uncovers at least one area where investor views appear to diverge. While the buy side clearly prefers issuers to have

CHART 7. HOW FAR INTO A BORROWER’S SPHERE OF INFLUENCE DO YOU CONSIDER ITS ENVIRONMENTAL IMPACT?



SOURCE: KANGANEWS 10 DECEMBER 2020

rigorous and measurable targets in place, its view on the horizon for achieving them is less uniform. A third of investors responding to the *KangaNews* survey want issuers to be working to a medium-term horizon, but slightly more say they do not require a timeframe at all “provided targets are rigorous” (see chart 6).

There may be scope for future evolution in this area. The same can be said for investors’ view on sphere of influence. At present, only scope-one emissions – the ones most directly created by an entity, including fuel consumption and company vehicles – are considered “central to ESG analysis” by a majority of investors (see chart 7).

Even so, a majority of investors say scope-two emissions – things like purchased electricity – and even scope-three emissions – which include employee commuting, investments, and purchased goods and services – are at least a “component” of ESG analysis.

Yuan explains that the three levels apply differently depending on sector, and need to be considered in the context of investment risk. For example, he suggests, if governments were to adopt very stringent climate-change policies there would be significant risk for auto manufacturers but these would only be captured in scope three. He also points to bank investments in coal-fired power plants as an activity that would not be captured under scope-one or two emissions.

FUTURE EVOLUTION

The survey paints a picture of an investor base that is evolving in its understanding and deployment of ESG principles. There is a strong belief that this trend will continue in the future, as nearly three-quarters of survey respondents say ESG will become “much more important” in fixed income over the next 3-5 years (see chart 8).

Yuan suggests ESG integration simply makes sense on the issuer side, as something with both a sound economic rationale and which provides a solid PR benefit. “Companies are aware that

the ESG activities they are engaging in could ultimately result in cost savings, as well as boosting employees’ morale and offering reputational enhancement. There is not much down side to adopting ESG policies and actions,” Yuan suggests.

Despite all the talk about whole-of-issuer analysis, investors also still expect a growing role for labelled bonds. More than three-quarters believe this asset class will claim a greater share of the fixed-income market in the medium term – even when asked if evolving investor approaches could marginalise GSS product to at least some extent (see chart 9).

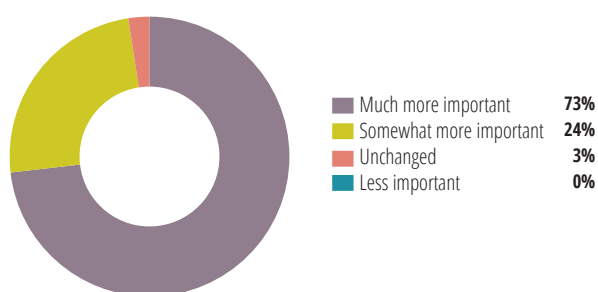
Fund managers seem to believe that the market as a whole may not have progressed as far toward holistic analysis of issuers as they themselves have. For instance, Pannett says: “My view is that the market will continue to favour labelled issuance in the medium term even though my own preference is for a whole-of-issuer approach. However, I think the whole-of-issuer approach will prevail further out along the horizon.”

Ward, meanwhile, suggests that over time the market could bifurcate. High-grade issuers will either issue GSS bonds or stand on their sustainability credentials as a whole, while private-sector issuers may in time migrate to issuance linked to overall sustainability performance.

“If the market can get comfortable with sustainability-linked instruments, this is where I think we’ll see growth in the next few years,” Ward comments. “My view is they will become a very good corporate-wide motivator and address the gap for companies that do not have a ready pool of assets or projects to fund.”

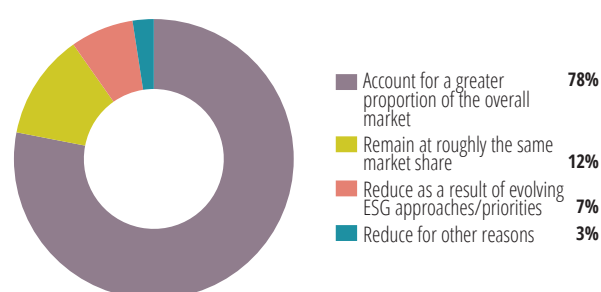
The main thing is that ESG evolution continues in some form. Langer explains: “We don’t think the market sees what is important in quite the same way as we do – in other words, issuer credentials versus individual bond credentials. Overall, though, our view is that ESG is becoming more important, full stop. How this eventuates is not as important as the fact that ESG is much more significant than it was even a year or two ago.” •

CHART 8. OVER THE NEXT 3-5 YEARS, DO YOU BELIEVE ESG IN FIXED INCOME WILL BECOME:



SOURCE: KANGANEWS 10 DECEMBER 2020

CHART 9. OVER THE NEXT 3-5 YEARS, DO YOU BELIEVE ISSUANCE OF LABELLED FIXED-INCOME PRODUCT (EG GSS BONDS) WILL:



SOURCE: KANGANEWS 10 DECEMBER 2020



AUSTRALIAN CORPORATE CREDIT ON THE REBOUND

Investment-grade corporate Australia has weathered the COVID-19 crisis better than could have been expected as the pandemic accelerated in March and April 2020, according to participants at a **Fitch Ratings-KangaNews** roundtable at the end of the year. A supportive local debt market was just one of the factors behind this resilience.

PARTICIPANTS

■ **Sonia Baillie** Head of Credit AMP CAPITAL ■ **Matt Brassington** Chief Executive AQUASURE ■ **Michael Larkin** Group Treasurer LENDLEASE
■ **Sophia Li** Treasury Manager AGL ENERGY ■ **Paul Macfarlane** Group Treasurer DOWNER GROUP ■ **Ben Nolan** Head of Treasury and Financial Control
PACIFIC NATIONAL ■ **Andrew Vandeligt** Treasurer PORT OF MELBOURNE ■ **Terry Yuan** Credit Analyst, Fixed Income ANTARES CAPITAL

FITCH RATINGS PARTICIPANTS

■ **Sajal Kishore** Senior Director and Head of Asia-Pacific Infrastructure and Project Finance ■ **Vicky Melbourne** Senior Director, Industrials
■ **Mervyn Tang** Senior Director and Global Head of ESG Research

MODERATOR

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

PANDEMIC HITS

Davison Can each of the issuers describe how their business has been affected by COVID-19 and, in particular, how this performance has played out over the year, relative to base-case and worst-case scenarios they might have envisaged in March?

■ **MACFARLANE** Performance has not been as dire as we expected given the volatility and severity related to the impact of extended lockdowns on the business. The issue for us was we had a number of capital transactions in play at the start of

the year, and when COVID-19 first hit those quickly fell away. We had made clear our intentions to divest some noncore businesses and we were very well progressed with discussions. But they dropped off as buyers were unable to find capital, or capital at the right price.

The board made the decision to withhold dividends and withdraw our earnings guidance. There was general uncertainty at the time, as was probably the case with all the borrowers at this discussion.

Our businesses are back up and running and we have had some wins on the sale of some of our noncore assets – there are signs of confidence in the market. This has helped us reposition

our business and to have a more cautiously optimistic outlook for the year ahead.

■ **VANDELIGT** We had very resilient performance over the period. Operationally, the port was not affected at all – it is an essential service, which means there were no disruptions to operations as a result of the lockdown restrictions. Financial-year 2020 results were a little weaker than we had budgeted for prior to the pandemic but overall it was a solid performance given the environment.

Going into the disruption, we stress tested a range of scenarios and ultimately the business performed at the upper end of the spectrum of outcomes. This was driven in large part by our rental-revenue stream, which is not exposed to trade performance, as well the performance of import containers.

We experienced a softening in cargos such as motor vehicles and petroleum products, but the relatively good performance of import containers largely offset the decline in other cargo types and mitigated the decline at total trade level.

We suspect the reason import containers performed relatively well is that people who were able to retain their income found themselves sitting at home unable to spend on services. This meant many Melburnians began building up cash and actually increased their spending on goods for the home. The majority of these goods would have been imported from overseas via the port.

■ **NOLAN** Volume held up well under the circumstances for us, too. The various state and territory governments consider rail to be an essential service.

The containerised-freight side of the business benefited from restocking and also when restrictions eased. It slowed down after Easter and has then rebounded in the last few months, in which we are seeing volume 10 per cent higher than the prior year. While the early part of this rebound looked like it was due to restocking, we now see it as demand driven and the lead up to Christmas looks positive.

Elsewhere, our metallurgical- and thermal-coal volumes were affected more by customer production issues than by the pandemic itself – though we have seen some demand softness come through from India and China.

Our bulk activity, which is largely led by construction, is down significantly – but this was apparent before COVID-19 as well. The grain part of the business is very much weather dependent and we are gearing up for good volume across the next 12 months.

■ **LI AGL Energy** is also an essential business, which meant we felt the impact of COVID-19 to a lesser extent. We saw a drop in demand from our commercial and industrial customer bases but this was partially offset by more residential demand.

We have done a lot of scenario analysis on the effect of COVID-19 on our business and have created an additional support programme for affected customers, which has affected the bottom line.

But, overall, the worst-case scenario did not eventuate, especially as we came into the pandemic with ample liquidity: we reported more than A\$1 billion (US\$737.5 million) of undrawn cash at the end of our last financial year.

■ **BRASSINGTON** We have not been affected a whole lot. We were in production toward the end of March, at the very end of 2019/20 water delivery. We finished on 8 April, which gave us a six-week window before we had to think about starting up for 2020/21.

During this period, the operator brought in additional accommodation units and worked on ensuring segregation of work teams and getting everyone comfortable operating under these sorts of controls. We really haven't had any issues since.

There were a couple of disruptions to our chemical supplies as most of our chemicals come from interstate, particularly from New South Wales (NSW). When the border between Victoria and NSW was closed for a very short period at the end of June, there was a small kerfuffle about truck drivers who were allowed to come into Victoria to deliver but were then told they had to quarantine for 14 days when they returned to NSW. However, this was sorted out in a couple of days.

From our point of view, most of the disruption has been the irritation and inconvenience of operating under restrictions. But compared with so many others it is hard to complain.

Davison Lendlease has a global profile. How have Australian businesses performed relative to jurisdictions that have been less successful in managing the pandemic?

■ **LARKIN** There have been three main impacts on our business. There have been delays to activity, productivity impacts as we have had to implement social-distancing measures on our sites and, finally, valuation impacts on our investments.

We are, however, seeing activity coming back in residential and in retail. While we have seen some transactions delayed, we have still been able to bring capital partners into projects.

"Pricing brought tears to my eyes relative to where margins were at the tail end of 2019. But having been through the financial crisis and other crises, I was not going to complain about a few basis points. My role is to ensure liquidity and mitigate refinancing risk."

PAUL MACFARLANE DOWNER GROUP

We had a range of scenarios in March and we are in a better position than the more pessimistic cases. There is reason to be cautiously optimistic.

It is a diverse picture globally. Australia has been able to operate throughout the crisis. China has recovered the most quickly and had the fewest subsequent disruptions of any of our offshore markets. Elsewhere in Asia – meaning Singapore, Malaysia and Japan – the experience is broadly comparable to Australia.

Europe and the US have been the most challenged from a public-health perspective. Again, apart from brief shutdowns where we had to put new ways of working in place, we have generally been able to continue operating.

While there have been some significant impacts socially and in the economy in Europe and the US, it has not been as quite as bad for our operations as perhaps it has for other industries.

■ **MACFARLANE** We performed better than initially expected in New Zealand, given the level-four restrictions reduced our business operations by around 70 per cent. Initially we were unclear how long this would last, but it ended up being a short and sharp lockdown. New Zealand ended up recovering quite strongly and so did our business – no doubt helped by the government's wage-subsidy scheme.

Similarly, most of our Australian businesses performed better than expected because of their reliance on government clients. "Urban services", as we call this area, has a large proportion of local-, state- and federal-government customers. Their efficiency was reduced by social-distancing requirements, but things turned out better in the 2020 financial year than expected and these businesses have continued to improve since then.

Davison How have the sectors and individual issuers covered by rating analysts performed relative to expectations in 2020?

■ **MELBOURNE** Fitch took a portfolio approach to assessing the impact in March and triaged it from there. Right off the bat there were sectors we knew were going to be severely affected, such as tourism, air travel and autos. We took immediate rating actions against a lot of issuers in those sectors.

Following on from this, the group of issuers next in line was those that went into the pandemic with limited rating headroom. This was not necessarily sector-specific – it was

companies that had balance sheets that were levered in March because of investment or M&A activity. Then the other bucket was all the other names.

Looking at Australia relative to all the Asian issuers I look after, Australian corporates performed relatively well. There were four rating actions in Australia in H1 2020 versus 18 or 19 in each of China, Indonesia and India.

There were second-order impacts, though. While construction continued, social-distancing measures slowed down a lot of projects and this had a knock-on effect. We saw a slowdown across the steel sector, for instance. Early on, our view was that it was going to be a V-shaped recovery but as the weeks passed it increasingly looked like a U-shaped recovery.

■ **KISHORE** At the outset of the pandemic we revised rating cases for demand-based assets in the infrastructure and project-finance space because they were the most affected. We set rating cases in March to be broadly aligned with the international outlook the Fitch global economics team produced.

We also recognised that the downturn could be prolonged, so we produced stress-test reports for each demand-based asset and mapped its recovery profile. We looked at a recovery all the way out to the end of 2024, largely to provide a worst-case scenario to investors and to provide a view of how ratings would be affected under these scenarios.

Since then, airports have tended to perform below our expectations globally because lockdowns have been prolonged and there have been additional phases of the health crisis in some countries. But we have seen a fairly strong recovery in markets where there is a higher share of domestic air travel such as China and, to an extent, India.

Toll-road performance reflected domestic conditions and the economic measures taken by governments in their respective countries.

China, for instance, had a very short period of restrictions and traffic has rebounded strongly. In Australia, Transurban and its offshoots have had a mixed performance. The assets in Sydney have performed better than Melbourne, reflecting the extended lockdown in the latter. Broadly, we expect performance will be down for the calendar year.

Ports have outperformed compared with what we were expecting in March. This reflects the essential nature of their operations. Port volume in offshore markets benefited from shortage of critical goods in some countries – for example, Indonesia needed to import medical supplies.



"The containerised-freight side of the business benefited from restocking and also when restrictions eased. While the early part of this rebound looked like it was due to restocking, we now see it as demand-driven and the lead up to Christmas looks positive."

BEN NOLAN PACIFIC NATIONAL

Power utilities have generally had stable performance and their ratings have held up. Energy demand has been muted in a lot of markets but it is picking up as economic activity resumes.

Governments are now trying to avoid going into a severe lockdown to avoid the economic impact, even during a second round of infections. We therefore see energy demand gradually picking up.

INVESTOR RESPONSE

Davison Australian credit investors as a group went long cash in the early stages of the crisis but there has been very strong support for new issuance throughout the second half. How did investors respond to the emerging pandemic and how has 2020 tracked relative to their expectations at that stage?

■ **BAILLIE** Spreads were quite tight at the start of the year and we would have described the market as reasonably late cycle. Then the pandemic reared its head and we saw extreme market moves in response to the lockdowns occurring overseas. Australian iTraxx, as a proxy, was trading at a historic low but in short order it was almost back to the decade-long wide level seen in the euro sovereign-debt crisis of 2011-12.

A few factors were behind this, including liquidity dynamics and the high correlation of Australian dollar spreads to equities and high-yield bonds. We also saw significant liquidity challenges in the risk-free markets including wide bid-offer spreads.

The market was cautious about asset-allocation rebalancing, currency revaluations and also the impact of early access to superannuation that could have seen flows out of credit and fixed income. Investors in general were trying to build up cash buffers to manage these risk factors.

The real catalyst for the peak in spreads came when the Fed [US Federal Reserve] announced its corporate bond-buying programme. This got investors out of the blocks and spreads began to retrace accompanied by an improvement in trading dynamics. Not long after this, the RBA [Reserve Bank of Australia] announced its term-funding facility (TFF), which was also very supportive of market-making from a technical perspective.

The combination of fiscal and monetary policy was key to investors gaining confidence to take advantage of wide spreads

based on realistic expectations of global default rates and rating transition for investment-grade credits.

■ **YUAN** When the outbreak was starting in China in January, we began scenario planning for what could potentially happen and we reduced risk exposure from that point.

We were trying to reduce risk in two stages. The first was exposures related to China and the second was exposures that would be affected by a global outbreak. We got through most of the China-related credits but by the time we tried to reduce risk globally the March sell-off came – and very quickly. Liquidity completely dried up.

When regulators and central banks around the world put a floor beneath things and markets started to buy risk assets, we also started buying risk assets in select credits.

However, we were cautious following the rally in April because markets began to run hard in some sectors. We tried to keep price discipline even if it meant missing out on deals. Markets have been a lot stronger than most participants have anticipated.

LIQUIDITY CONSEQUENCES

Davison How did issuers find the availability of liquidity during the crisis, in particular compared with previous events like the financial crisis?

■ **MACFARLANE** The situation was completely different. In 2020, the issue was around price. At the height of the global financial crisis, it wasn't just price – it was an absolute lack of liquidity.

We were able to complete a material refinancing of A\$500 million in April, with strong support from our existing bank group. I understand there were challenges finding new money but our existing group was very supportive. Liquidity remained sound during the April-May period and it has rebounded further since then. So we have been able to successfully close a number of refinancings this year.

The pricing brought tears to my eyes relative to where margins were at the tail end of 2019. But having been through the financial crisis and other crises, I was not going to complain about a few basis points. My role is to ensure liquidity and mitigate refinancing risk.

■ **VANDELIGT** I agree. The port is in a strong liquidity position so we had no requirement to access funding during the peak of

"While construction continued, social-distancing measures slowed down a lot of projects and this had a knock-on effect. Early on, our view was that it was going to be a V-shaped recovery but as the weeks passed it increasingly looked like a U-shaped recovery."

VICKY MELBOURNE FITCH RATINGS



SUPPLY DYNAMICS AND **CREDIT-INVESTOR STRATEGY**

In the absence of senior supply from domestic banks, Australian credit investors have more capacity than ever for alternative supply. This should provide a supportive environment for corporate issuance – though the focus is likely to remain on high-quality issuers.

DAVISON How have credit investors responded to the absence of the historical anchor of the Australian credit market – bank senior issuance? Is the support that has been in evidence for long-dated corporate deals a product of low yield and lack of competing supply?

■ **YUAN** The TFF [term funding facility] makes things very difficult as bank yield has tightened aggressively. Some financial bonds are trading at levels similar to semi-government and other higher-rated issuers.

The net result is lower yield across the board. But there is not much investors can do in an investment-grade credit

mandate completely to offset lower yield. The support to date for long-dated corporate deals seems to be a product of low yield and limited supply of quality issuers.

We have not changed our approach too much, though. We are still trying to buy high-quality companies while maintaining price discipline. These bonds are multiyear investments so if we join the herd to buy a low-quality issuer it just creates a ticking time bomb in our portfolio further down the track.

■ **BAILLIE** We went into the pandemic with low credit-risk exposure relative to our medium-term risk budgets and the way we responded has been slightly different.

At first, we leaned into the excessive illiquidity premia that were available. We picked up some very short-dated paper, at 12-18 months, some of which was trading at spread of around 300 basis points. Despite the uncertain outlook, we had enough visibility to know there was sufficient liquidity to meet the bonds' shorter-horizon maturity profile.

Even after the announcement of the TFF, spreads are still relatively wide to historical levels and an element of liquidity premium is embedded in this. Credit premium is still quite wide on a historical basis, relative to the expected loss experience over time. We think credit still looks attractive despite the uncertainties.

We have been able to extend our credit duration by moving up the curve to target the 5-7 year bucket and beyond for names we have high conviction in. This is about taking advantage of curve steepening to earn slightly higher carry for our portfolios.

Central-bank activity is hugely supportive of the Australian dollar market. We are looking at a hole of up to A\$40 billion (US\$29.5 billion) of credit supply that will not be there in 2021; the RBA [Reserve Bank of Australia] is taking out about A\$32 billion of major-bank senior-unsecured maturities alone. This technical factor will be an overwhelming influence despite the economic outlook.

Added to this is the low-yield environment, which we think will be supportive as investors reach for yield. It is a slightly different story down the credit curve, especially for 'cuspiers' low-triple-B companies and high-yield issuers – the latter because they are not direct beneficiaries of any of the central-bank buying programmes out there.



"WE ARE STILL TRYING TO BUY HIGH-QUALITY COMPANIES WHILE MAINTAINING PRICE DISCIPLINE. THESE BONDS ARE MULTIYEAR INVESTMENTS SO IF WE JOIN THE HERD TO BUY A LOW-QUALITY ISSUER IT JUST CREATES A TICKING TIME BOMB IN OUR PORTFOLIO FURTHER DOWN THE TRACK."

TERRY YUAN ANTARES CAPITAL

the disruption. But my sense was that it was readily available if it had been needed.

There was a week or so in March-April when liquidity generally was the tightest it had been since the financial crisis. On this basis, it would be wrong to say there was no stress in the market in early 2020.

■ **LARKIN** Liquidity has been much better in 2020. Monetary authorities moved quickly, decisively and innovatively compared with the financial crisis. It is astonishing to look back and think that Lehman Brothers was allowed to fail – it was a choice. We did not see any such thing this time around and I think this was a big part of the experience we have had over the last six months.

Funding has been available even if it is a question of at what price and with what terms and conditions. One of the

main challenges in dealing with banks is around the volume of requests and the deal flow the major banks have been facing.

In April and May, we found the major banks were swamped and were prioritising clients they felt really needed support. Sometimes this made it difficult to get things done, not because lenders did not want to be supportive but because of the volume of requests coming through.

Taking it all together, though – and considering the scale of impact to economic activity – the way financial markets have handled it has been pretty amazing.

■ **LI** There was divergence of pricing between domestic and international banks. Prior to COVID-19, we saw comparable pricing between the two but this quickly reversed in April and May when we were looking to refinance a facility. It also seemed to be the case that banks restricted lending to new

names. There was a lot of support for existing clients but lenders seemed to concentrate it on those that really needed the help. They would ask questions about whether we really needed the liquidity, and whether it would be revolving credit or a liquidity buffer.

We don't do much project financing – it is more “general corporate purposes” – so there were a lot of questions about how we planned to use liquidity and whether we wanted it for buffer purposes.

■ **MACFARLANE** I agree. In recent years we have seen convergence on price for a typical 3-5-year bank loan, by which I mean all the lenders come in within a 5-10 basis point range.

My experience on pricing for larger deals in 2020 was that there was a significant gap between the international and domestic banks, and also between domestic banks depending on how their balance sheet was structured and what sort of pressure they were feeling from their residential and middle-market customers. This has definitely settled since June but it was a feature earlier in the year.

OUTLOOK FOR 2021

Davison To what extent, if at all, have vaccine announcements sparked a change in outlook for corporate credit? In particular, how different will the outlook be if we are talking about a genuine return to the ‘old normal’ in 2021 as opposed to the type of mitigated reopening of the economy, including ongoing social-distancing restrictions, that might otherwise have been expected?

■ **KISHORE** The production of vaccines is yet to start and we don't know what sort of timeframe it will take for them to be commercially available in sufficient quantity for most of the world. Vaccines are still some way from having a meaningful impact on the behaviour and shape of the recovery, in other words.

There is a lot of discussion about the destructive nature of the pandemic in changing consumer preferences including a more permanent shift to working from home. This may mean a reversal of the trend of millennials moving closer to city centres, too. We are yet to see if this will lead to a long-term shift in behaviour patterns but we believe there will be greater flexibility for employees to work from home in future.

These longer-term structural shifts could have some impact on the performance of toll roads and air travel. Having said this, we have seen evidence that not everything works as well in the virtual world. Education is a good example. There is still a strong preference to be back in schools, colleges and universities.

■ **MELBOURNE** We have not adjusted our forecasts because of vaccines. However, as a rating agency we are constantly reviewing our forecasts and our assumptions – and in fact they are changing more frequently than before.

The pandemic has effectively brought trends in some sectors forward. A lot of retail companies, for instance, were already under pressure but the impact of the pandemic has led to them closing.

This has flow on effects for REITs, and it leaves a question about what these companies are going to do with vacant spaces. Some are quite forward-thinking, had seen these trends coming and have adjusted their business models.

The other space is commercial. A number of the banks and large financial institutions are now hot desking – because office space is a significant component of their operating costs. People have been working more at home than in the office so any concerns about productivity have largely been put to bed.

Davison Are businesses planning for a fundamentally different future?

■ **LARKIN** There are a few potential themes but I think it may be too early to be definitive. Our development pipeline has a lot of mixed-use projects and we have the ability to repoint or respond accordingly. But yes, we think there will be behavioural changes.

The two sectors everyone seems to be keen on at the moment are ‘beds and sheds’, meaning residential and industrial. Of particular interest to us is build-to-rent and affordable housing. We have a significant presence in both these asset classes offshore and we are seeing interest in Australia.

It is too early to tell how all the factors will influence office space. We think there will be more focus on flexibility, and there are clear signs that employees like the flexibility working from home offers. But it depends on how this plays out against the need for more space per employee and maybe a move away from ‘agile’ workplaces.

We are still hearing that capital partners are interested in putting money into commercial and office. It will continue to be an important sector.

One way of looking at COVID-19 for bricks-and-mortar retail is that it will accelerate the trend toward experience – major centres as hubs rather than just shopping. Across our business and in some of our funds, we think this creates potential for mixed-use opportunities. Again, we are expecting change but markets, industries and corporates do not always turn on a dime so the shape of the future might take a while to figure out.

I'd also like to add a point about vaccines. I agree that vaccines may take some time to be manufactured and available, and I agree that they are not going to produce a return to normal quickly.

But the most important positive thing about vaccines is that they reduce the tail risk of extended shutdowns and the stop-start threat to the economy. This will provide confidence for investment decisions and activity levels should respond as a result. Even if vaccines take time to roll out, which is a reasonable assumption, it is still a significant step toward closing off a lot of the downside of a world without a vaccine.

"Prior to COVID-19, we saw comparable pricing between [domestic and international banks] but this quickly reversed in April and May when we were looking to refinance a facility. It also seemed to be the case that banks restricted lending to new names."

SOPHIA LI AGL ENERGY

■ **BRASSINGTON** In the US, the subject of vaccines is a highly politicised issue. I think I saw a statistic that 40 per cent of the US population would not take a vaccine if it was offered to them. That is clearly going to be an issue faced by a lot of countries.

The other point is that about 150 countries simply cannot afford to vaccinate their population. The vaccines might be great but they could be a while off, worldwide.

Once they are readily available in first-world economies we shouldn't see a repeat of the knee-jerk reaction we saw in South Australia this week. If that kind of response is possible over the next couple of years, it would be enormously challenging for everybody.

ESG SPECIFICS

Davison How would participants sum up the evolution of the sustainable debt market in 2020? Let's start with the global market, where there has been development in structure as well as in the sources of new issuance.

■ **TANG** Across the world, green-bond issuance dropped off in 2020. The growth was from social bonds, of which a big chunk was pandemic bonds and 90 per cent were in China. It was a very specific type of issuance.

We heard mixed views from investors on their willingness to accept pandemic bonds. A lot of them were loosely tied to COVID-19 relief programmes and there were also issues with tenor. Some of the bonds would be for 10 years whereas the proceeds were going to programmes that were only a few years in length – and there was not much clarity about the use of proceeds afterwards.

One of the more positive developments in 2020 has been the push by sovereign issuers, including in SDG [UN Sustainable Development Goals] and social format, such as from Mexico and Ecuador. The importance of sovereign issuance is that it sets a benchmark for the market.

There have been a lot of questions around the liquidity of green bonds and here the German sovereign green bond was particularly interesting. Germany has committed to issuing matched bonds – for every vanilla bond there is a matched green bond with the same coupon and maturity, creating a pricing anchor. This can help with liquidity issues and it makes it easier to capture the green premium.

Germany has committed to building out a whole green curve and a number of European countries are following suit. This government push and some of the green-linked packages we have seen, such as in the EU and certain parts of Asia, have provided a supply boost.

Davison In Australia, it looked like sustainable debt had been sidelined by more pressing concerns for much of the first three quarters of the year, but it now seems the market has regained its momentum. Is engagement still growing and what are the main developments?

■ **TANG** We went from A\$7.5 billion of issuance in 2019 to A\$150 million in first half of 2020. But we now have a rush of transactions including from New South Wales Treasury Corporation, Lendlease and Brighte. We expect this to continue in 2021 even though there is not the same national-government push as in other jurisdictions.

We are seeing further development in sustainability-linked loans (SLLs), sustainability-linked bonds (SLBs) and other variations. Australia was one of the leaders in SLL adoptions and now we are starting to see SLBs pop up around the world, including from Enel, Chanel, Suzano and Novartis.

A lot of SLBs were initially focused on reaching emissions targets but are now broadening. For example, Novartis's bond links to metrics related to its healthcare programmes. We expect this type of bond issuance to increase in various locations. Whether these include Australia is another question. I would be interested to hear what the issuers have to say about SLBs as a concept.

■ **MACFARLANE** The SLL format made sense to us given the way our balance sheet is funded. We did not have specific assets to which to apply green-bond proceeds, which have to be ringfenced for a particular asset. The general portfolio approach of an SLL was far more relevant for the group.

We have always had a strong ESG [environmental, social and governance] strategy. We publish an annual sustainability report that focuses on things like emissions, diversity, training and governance.

The issue for us was that we had not aligned this ESG strategy with our financing strategy. The SLL provided the ideal opportunity to bring the two together.

Importantly for us, we had a head start given the maturity of our ESG function. But there was still quite a lot of work

“Longer-term structural shifts could have some impact on the performance of toll roads and air travel. Having said this, we have seen evidence that not everything works as well in the virtual world. Education is a good example. There is still a strong preference to be back in schools, colleges and universities.”

SAJAL KISHORE FITCH RATINGS



to be done landing on the suite of KPIs and targets, and we worked closely with our bank group to develop something that would resonate strongly in the market and within the company itself.

The final structure combines environmental and social KPI metrics relating to Downer’s greenhouse-gas emissions reductions and social sustainability – being cultural awareness, and the mental health and wellbeing training of Downer employees.

These social KPIs were already well developed within Downer but their inclusion in the SLL provides an additional level of stretch or ambition over the life of the facility.

We have more than 50,000 employees across the group, so these KPIs are very relevant to our employees and tools like the SLL will hopefully provide further momentum internally.

■ **LARKIN** Echoing some of these themes, we announced new sustainability targets for the group prior to launching our green bond. Lendlease had been doing some work on refreshing its sustainability strategy for some time.

The issue for us had never been a lack of assets or projects that could be eligible but how we tie the financing and sustainability strategies together. There was momentum on both internally and from there it was a question of what role treasury could play to support this.

Work was needed to prepare to go to market, including putting together a framework and getting it assured. But our view is that the effort to take a green bond to market was well and truly worth it. Offering the deal in green format enabled us to have a different kind of conversation with investors and focus on a key strength of Lendlease’s.

We had a similar experience to Downer in that the internal interest in this transaction has been unlike anything I have ever done at Lendlease. We’re a fairly regular borrower for Lendlease itself as well as for our managed projects and funds,

but the internal reaction to the green bond has been night and day when it comes to capturing engagement within the organisation. The interest and engagement will no doubt help deliver on some of the business’s objectives.

We are very happy with the outcome. Given the nature of our business, it is not difficult to imagine a significant amount of our funding in the future will be green in some shape or form, in line with the business strategy.

Davison Would investors support an SLB with or without two-way pricing?

■ **YUAN** The detail of the pricing would be key. A vanilla bond pays a particular return and – assuming the issuer has an ESG plan, publishes ESG reports and has regular discussions with us – we know what the return is and what the ESG risks are. It is a known quantity.

With an SLB, if the best-case scenario for the issuer and the lowest-return case for us is a yield lower than the plain vanilla bond, why would investors buy it instead of a responsible ESG issuer? On the other hand, it would also be a poor outcome if the issuer of the SLB was not punished sufficiently for breaching its ESG promises.

Davison Is it appropriate for investors to benefit financially from poor ESG performance by an SLB issuer?

■ **YUAN** We would be benefiting financially but would have to explain poor ESG performance to clients. They would ask why we are investing in such a poor ESG performer. In a way, we don’t want to be paid for that sort of behaviour.

The big picture is that ESG is rapidly becoming mainstream. Fitch and other credit rating agencies and data providers have embedded ESG into normal analysis. Most of our end investors are now asking for ESG analysis, reporting,

“There has already been a ‘greenium’ in some of 2020’s new issuance. It appears to us that there is a 20-25 basis points discount for triple-B-band issuers with greater exposure to thermal coal given concerns around supply-demand dynamics and refinancing risk.”

SONIA BAILLIE AMP CAPITAL



AN EVOLVING TAKE ON **THE DOMESTIC MARKET**

The domestic bond market has supported local corporate issuers with impressive volume and duration for most of 2020, notwithstanding pandemic-related volatility. Most – but not all – borrowers are confident there has been a genuine step-change in capacity and consistency dynamics.

DAVISON Do issuers feel the Australian dollar market has become more reliable or that there has been a step-change in its maturity over the past year?

■ **LARKIN** Undoubtedly, yes. The key to this is your perspective. Looking back over five years or more, we are in a vastly different world. The local market is more sophisticated, there are more investors, it is deeper, and it is more active in looking down the credit curve and at longer tenor.

Of course there will always be ups and downs. But I think there is a very clear trend that sees the Australian market continue along this trajectory. Often over the last several

years it has comfortably been a better choice on value as well. It is never going to be as deep as Europe or the US, but it has matured enormously.

■ **BRASSINGTON** It has been a while since we issued – in fact, in two weeks' time we are repaying our domestic bond. I still watch the market, though, and actually I disagree with Michael Larkin. I have been very critical of the AMTN market over a long period of time.

As someone who borrows money, having a viable alternative will always be beneficial but it does not strike me that the market has really developed or changed too much over the past five years. I think it was in 2019 that we did

not see any domestic corporate issuance until about May.

It is great if the market genuinely has changed. If it can consistently support issuers at 10 years and longer, and with scale, borrowers will definitely find it attractive.

We are in a different place now – we are on an amortising path to the end of our concession. We have 19 years left to run but we only have one refinancing left to do, in 2027. So we will be sitting on the sidelines for a little while longer.

■ **NOLAN** I have sounded like a broken record in my support for the AMTN market. I think it has been in good shape over the past few years

and it has proven able to support issuance at 10 years.

The development to 12 years is also welcome. We haven't had the luxury of issuing in 2020, but I have watched from the sidelines and it appears to have developed well from what I can gather.

■ **LARKIN** For really sizeable volume and longer tenor, I think you are always going to get different results in the US and European public markets.

But the experience has changed. Lendlease came to the domestic market in 2013, for the first time in many years, and the transaction process was a bit like a club deal rather than putting together a distributed



"LENDLEASE CAME TO THE DOMESTIC MARKET IN 2013 AND THE TRANSACTION PROCESS WAS A BIT LIKE A CLUB DEAL RATHER THAN PUTTING TOGETHER A DISTRIBUTED BOND OFFERING. BY CONTRAST, THE PROCESS WE WENT THROUGH MOST RECENTLY FOR OUR GREEN BOND OPERATED AND FELT JUST LIKE ALL THE OTHER INTERNATIONAL BOND MARKETS."

MICHAEL LARKIN LENDLEASE

filters and feedback on new mandates. We are more worried about poor ESG performers than we are looking to benefit financially from them.

■ **BAILLIE** I agree. The question we have to ask is what the ultimate destination for SLBs may be. The complexities of SLBs are not necessary for us to achieve our objectives, and the other thing to keep in mind is that market dynamics could overwhelm the benefit or the penalty in these structures.

I struggle to get my head around this, because where we are in the credit cycle can change how we view the benefit or penalty. What is the right quantum of step-up or step-down if spreads have blown out 50 or 100 basis points when the penalty or benefit is only 10 basis points? Does it really affect the overall cost of capital and issuer or investor behaviour?

For me, the focus still needs to be on the appropriate engagement model for investors and issuers to see the transition to more sustainable business practices, models and frameworks. The use-of-proceeds method seems, at this point, to be the most effective way to encourage and change behaviour.

Another factor worth noting is that there has already been a 'greenium' in some of 2020's new issuance. It appears to us that there is a 20-25 basis points discount for triple-B-band issuers with greater exposure to thermal coal given concerns around supply-demand dynamics and refinancing risk, particularly around longer-dated paper.

This will become a distinguishing factor as analysts are already incorporating ESG into their ratings and risk assessments more than ever. We have seen an explosion of

bond offering. It was quite a stark difference from the way most international bond markets operate.

By contrast, the process we went through most recently for our green bond operated and felt just like all the other international bond markets. We are very happy with the result, which included good demand and a diverse group of investors.

■ **NOLAN** Some very good analysts work in the investor base in Australia and progress has only been helped by the strength of the Asian bid coming through the domestic market.

■ **VANDELIGT** I agree that the local market has developed a lot over the eight years since I started in a corporate treasury. There are still periods of no supply, but eight years ago I would have been very hesitant to put a deal in the market unless there had been recent corporate issuance.

Nowadays, I would be confident in putting a deal into the market even if there has been no recent corporate supply – provided it was a manageable size somewhere in the range of A\$200-500 million (US\$147.5-368.8 million). There would obviously be a price-discovery process to go through but I am confident

investors would support a transaction and a deal could be executed successfully.

■ **LI** We are actively looking to issue in the AMTN market. We have a A\$600 million maturity late in 2021 that we will be looking to refinance. Tenor is a key consideration for us when looking to access capital markets, as we want to lengthen our maturity profile. So we hope the support would be there given we are a big domestic name.

■ **BAILLIE** Since the early primary deals from the likes of Telstra and Lendlease in the late 1990s, there has always been investor appetite for greater issuer diversity in our domestic market. But we have always been up against the banks in the 3-5 year bucket, especially for volume, while the US dollar market has provided a happy hunting ground for issuers of tenor of 10 years and longer.

It has been encouraging to see the amount of true corporate issuance that has printed domestically in 2020, and the dearth of supply from financials should further support this as investors look to stay allocated.

Hopefully, the market can consolidate this trend and it proves to be an opportunity to get the diversity this market has been seeking for so long.

consultants and clients wanting to understand our ESG philosophy and process. It certainly accelerated after the bushfires at the start of 2020 and while this eased with COVID-19 the wave is pretty powerful.

Davison What role does ESG funding play for more 'coal-adjacent' credits like AGL and Pacific National? AGL has a clear transition plan but is Pacific National's future indelibly linked to coal?

■ **LI** We completed an SLL last year and we are certainly interested in pursuing further issuance and structures in this space. The challenge for us is to understand investor appetite given we are a carbon-intensive company – we are Australia's largest emitter.

Most green and dark-green investors would simply screen us out because of the nature of our business. If we were committed to showing a structure where financing cost is linked to sustainability KPIs, I would be interested to understand investor feedback and demand on such a debt instrument. The two bespoke KPIs we had in our SLL were carbon-emission intensity and percentage of renewable generation.

It is a long journey to transition and unfortunately we cannot just exit coal overnight. We have to ensure we can provide reliable and affordable energy, and transition responsibly. We have to bring investors along with us on this journey. It is a question of whether a structure would encourage investors to come with us.

We cannot, unfortunately, commit to an emissions-based target because there are so many uncertainties in the regulatory space and many factors could move the dial.

To what extent it would be considered ambitious by investors, what mechanisms there are, whether it is a targeted approach, and whether it is like our SLL – where we had year-on-year improvements – are all questions we don't have answers for. But we are certainly keen to explore the options.

■ **NOLAN** We have a very interesting business with two strong parts – freight and coal. We are focused on the containerised-freight component of our business and believe it has huge growth potential in future, particularly getting containers off road and onto rail.

There are massive ESG benefits to this. Rail produces 16 times less emissions than road freight per tonne kilometre, for instance, while road-freight crash costs are 14 times higher than rail freight per tonne kilometre. These are huge statistics and put a compelling story for rail freight.

Touching on our coal business, yes, we move both metallurgical and thermal coal. There is no substitute for metallurgical coal in the production of steel and we see this as a sustainable product for us going forward.

Australia produces the world's best thermal coal. It has the highest energy content and – given the growth of coal-fired power station capacity globally, particularly in Asia – the industry has many years to run. The world would also be better off consuming high-quality Australian thermal coal at the expense of Indonesian and Chinese coal, so it can work toward a more sustainable position in the future.

We talk to investors about ESG often. We are in the final stages of our first ever ESG report and a lot of these messages will come out in it.

■ **LARKIN** We have given some thought to the idea of issuing an SLB. However, the views we have heard from investors today are consistent with what we have heard in other discussions. As a product, it does not feel like something that has a lot of interest.

As an issuer, one-way pricing also does not really make a whole lot of sense. If we are going to try to use a price signal to spur behaviour it needs to be two-way, but this is not the way the market works. It is perhaps why we are seeing a more



"We heard mixed views from investors on their willingness to accept pandemic bonds. A lot of them were loosely tied to COVID-19 relief programmes and there were also issues with tenor. Some of the bonds would be for 10 years whereas the proceeds were going to programmes that were only a few years in length."

MERVYN TANG FITCH RATINGS

vibrant SLL market. But it is a new product and maybe the market will evolve.

Davison Could SLBs turn into a white elephant given analysts will increasingly look to take into account, and price, ESG risks without the need for sustainability performance to appear in debt terms and conditions? Do we need labelled debt instruments at all, in other words?

■ **TANG** ESG is an umbrella term for a lot of things and, similarly, it is a term for investors trying to achieve different remits. Some might be trying to incentivise a particular issuer to

undertake an action and be willing to pay a premium for it, and then there is purely assessing how ESG issues around climate and emissions regulation actually affect credit risk.

We integrate ESG issues into our credit assessments – and in a more and more detailed way, including coordinated views on how global climate regulation is tracking and what is happening with carbon pricing.

Issuer considerations are the core premise of sustainability-linked instruments, which were partly born from concern about use-of-proceeds-based green bonds if issuers' activities are not all sustainability-aligned. Some investors wanted an instrument that tied to an issuer's activities, not just the use of proceeds. •



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t. +61 2 8256 5577 e. jmasters@kanganews.com

Reflect and reposition

After hopefully overcoming the worst of the COVID-19 pandemic, the Australian securitisation industry is taking stock of a period of resilience and a reshaped competitive landscape. Top of mind for market participants are the way crisis response has changed the cost of funding unevenly for different issuer types and mooted changes to responsible-lending rules.

BY CHRIS RICH

In mid-November, the Australian structured-finance industry gathered online at the Australian Securitisation Forum (ASF) Virtual Symposium 2020 to share perspectives on the year and discuss the outlook. There is no doubt the market has changed, with a near absence of bank securitisation issuance and a new environment for lending the most notable developments.

A key theme running through the symposium was the resilience of the securitisation market in response to the COVID-19 economic crisis, including a stark contrast with how it performed during the financial crisis. Where things like the policy response were developed on the fly in 2008-9, the lessons of that crisis allowed the Australian Office of Financial Management (AOFM) quickly to assess and act on the economic consequences of the pandemic as events unfolded in March 2020.

The establishment of the A\$15 billion (US\$11.1 billion) Structured Finance Support Fund (SFSF) – deployed via warehouses, and primary and secondary transactions – and, subsequently, the AOFM's forbearance special purpose vehicle (FSPV) are key measures underpinning market confidence. Many speakers at the symposium identified AOFM support throughout 2020 as integral to a functional securitisation market, particularly in the first half.

There is less certainty, however, on the two most significant issues facing the market heading into 2021. One is the disparity between funding costs offered to banks by the Reserve Bank of Australia (RBA)'s term funding facility (TFF) and what nonbank lenders can find in the private-sector securitisation market – even with SFSF support. The second is the federal government's mooted changes to responsible-lending obligations.

Two weeks before the symposium, on 3 November, the RBA used its statement on monetary policy to unveil a suite of new measures to support Australia's economic recovery (see p22). It elected to cut the cash rate and the interest rate for TFF lending to banks, to 0.1 per cent from 0.25 per cent.

The rate cut came after the RBA in September made a new supplementary funding allowance to all authorised deposit-taking institutions (ADIs) available to 30 June 2021, fixed at 2 per cent of each bank's overall credit. This amounts to A\$57 billion across the sector, now with an extended deadline for drawdowns of the additional funding allowance.

FUNDING GAP

Panellists from nonbank issuers argued throughout the symposium that the funding-cost differential has been materially dislocated. The SFSF's mandate is not to distort price discovery in the open market, whereas the TFF is an explicit price-maker at a fixed 0.1 per cent for three-year funds.

Securitisation spreads performed reasonably well in a challenged year and bank funding in 2020 was driven at least as much by a buoyant deposit market as by the TFF. But a clear gap has opened between banks' funding costs – particularly the big four – and what is available to nonbanks.

James Austin, Brisbane-based chief financial officer at Firstmac, pointed out: "There will be a dwindling supply of origination for prime nonbank underwriters. The reality is we cannot compete with a 10 basis point funding cost when we are paying 130 basis points."

Nonbank lenders – particularly in the prime mortgage space – are already experiencing competitive pressure through a significant

"Unless there is an offering to the nonbanks that complements the cheap funding available to ADIs it is difficult to see how this pricing dynamic will change in the first half of 2021. The ability to offer a competitive prime rate is currently skewed in favour of the banks."

TONI BLUNDELL AUSTRALIAN FINANCE GROUP





“The RBA’s and the government’s policies are focused on lowering the funding cost for lenders and this is being passed onto borrowers – that includes the AOFM support for securitisation by non-ADIs. The outcome is that we are getting pretty strong competition for high-quality borrowers.”

CHRISTOPHER KENT RESERVE BANK OF AUSTRALIA

increase in conditional prepayment rates, as customers refinance to take advantage of the low fixed-rate mortgages being offered by the major banks. In many cases these include substantial cash-back offers.

“Unless there is an offering to the nonbanks that complements the cheap funding available to ADIs it is difficult to see how this pricing dynamic will change in the first half of 2021,” said Toni Blundell, manager, securitisation at Australian Finance Group in Perth. “The ability to offer a competitive prime rate is currently skewed in favour of the banks, which means we will have to drive growth from other avenues – such as our nonconforming products.”

There seems little immediate prospect of further direct support coming for Australia’s nonbank lenders – at least not from the RBA. Christopher Kent, assistant governor, financial markets at the RBA in Sydney, suggested at the ASF event that the reserve bank is relatively comfortable with the state of competition in the lending market.

He said: “The RBA’s and the government’s policies are focused on lowering the funding cost for lenders and this is being passed onto borrowers – that includes the AOFM support for securitisation by non-ADIs. The outcome is that we are getting pretty strong competition for high-quality borrowers and this is helping support economic activity.”

He added: “But many factors affect competition. It is not clear how consistent the experiences are among the non-ADIs and part of the difference may be some of the customers they service are being harder hit than others during the pandemic.”

Asked for detail on the “many factors”, Kent maintained that though the TFF benefits the funding costs of ADIs, it is having a strong effect only on their marginal cost of funds and not their – relatively unchanged – average cost of funds.

“My understanding for average funding costs for ADIs and non-ADIs is that there has always been a gap and I don’t think the

gap has opened up particularly since our efforts through 2020 to lower funding costs across the economy as a whole. Remember, what we are doing is lowering everyone’s funding costs by keeping interest rates low right across the yield curve,” Kent explained.

Speaking on an ASF panel shortly after Kent’s address, Michael Starkey, Sydney-based cofounder and chief operating officer at Athena, questioned this argument. “Our view is that the TFF does represent a material distortion in competition. The RBA’s comments seemed to imply that on average the funding differential isn’t that much. But what is relevant here is the marginal cost of new funding,” he said.

Starkey added that the market price of lending clearly illustrates the cost-of-funds gap. “The large banks are getting basically ‘free money’ from the RBA and it is translating into very sharp fixed-rate offers. They are not repricing their back books, they are competing on margin with their very cheap cost of funding. It is a material distortion and all statistics show that market share has swung well and truly back to the banks.”

The TFF was initially planned to expire in March 2021 but its extension to the end of H1 2021 has caused consternation. Now that the impact is clear, Starkey suggested, it would be appropriate for the RBA to tweak the intervention to be more competition-neutral.

RESPONSIBLE LENDING

More changes are coming to the Australian lending landscape. On 25 September, federal treasurer Josh Frydenberg revealed proposed changes to responsible-lending rules, with the goal of encouraging credit supply to maximise the economic impact of ultra-low rates.

The government wants to remove responsible-lending obligations from the *National Consumer Credit Protection Act 2009* while ensuring banks continue to comply with the Australian Prudential Regulation Authority (APRA)’s lending



“The large banks are getting basically ‘free money’ from the RBA and it is translating into very sharp fixed-rate offers. It is a material distortion and all statistics show that market share has swung well and truly back to the banks.”

MICHAEL STARKEY ATHENA

standards. At the same time, the government wants to incorporate elements of the same APRA lending standards to the nonbank regulatory regime.

Nonbanks will continue to be regulated by the Australian Securities and Investments Commission (ASIC), but with some elements of APRA's lending standards imposed.

However, speaking before APRA announced its consultation on revisions to APS 220 on 9 December, Renee Roberts, executive director, policy and advice at APRA in Sydney, told delegates at the ASF symposium that the proposed changes will not result in any major adjustments for the regulator.

"It will still be ASIC that regulates the non-ADI sector. But we are cognisant of the fact that the new regime is based on our prudential standards. We are working closely with ASIC and Treasury to ensure it is well placed to regulate the non-ADI sector and applying the way we would do things," she explained.

The impetus for the changes is weak credit growth, which persists despite record low interest rates and incentivised term funding made available to banks via the TFF. In effect, banks can fund and lend cheaply but the government still wants further to promote credit-supply growth.

Relieving some of the burden of verification of loan applications from ADIs by replacing a "lender beware" principle with "borrower responsibility" is the government's plan to achieve this.

The main problem, the government says, is a one-size-fits-all approach to credit assessment that makes lenders responsible for verifying information provided by prospective borrowers. By shifting the responsibility for providing correct information to the borrower, the government hopes to cut application and verification time and thus ease constraints on the flow of credit.

This could be going against industry practice. A lot of lenders say they actually tightened their credit underwriting processes due to uncertainty about the pandemic's economic impact. At the same time, banks are generally flush with liquidity and more than happy to lend where they believe risk is appropriate.

ING Bank Australia's Sydney-based deputy treasurer, Peter Casey, said on a panel at the ASF event that ING will be taking a gradual approach to reversing its underwriting changes. "Just as there was no template for the way into this pandemic, there is not really a template for the way out either," he explained. "We don't want to be chopping and changing when it comes to credit policy and we will look for some certainty before we unwind any of the changes we have implemented."

With the government's JobKeeper scheme and the already reduced COVID-19 supplement to the JobSeeker payment scheduled to end in March 2021, lenders say they are already ultra-cautious about Australian households' financial health.

In any case, Dylan Bourke, portfolio manager at Kapstream Capital, does not believe the proposed changes will materially weaken credit standards. He argued that the banks still have an obligation to verify information under APG 223. "The proposed changes seem to me like more of a superficial change rather than a deep, fundamental one," Bourke said.

Casey confirmed that ING does not foresee any major changes to its credit underwriting from responsible-lending changes. While there have been suggestions that nonbanks' operational advantage may be eroded by a lighter-touch regulatory approach in the bank sector, Starkey also does not expect any change to underwriting approach.

Having said this, the changes could help streamline processes in a way that preserves quality but removes some of the hidden costs in the verification process. "It should not be up to the lender to make sure the customer is not lying," Starkey added. "This sort of verification step, where it not relevant to the credit decision, is an unnecessary burden that results in a large hidden cost."

Market participants are also wary that vulnerable borrowers need to be protected from predatory lending. Lillian Nunez, executive director, debt investments at IFM Investors in Melbourne, said as environmental, social and governance considerations have become increasingly important, investors will be on the look-out for any signs of dubious lending if the changes go ahead.

Needless to say, asset managers will also be monitoring any impact the changes have to credit quality. "IFM's concerns in this area, including any changes to responsible lending, will always be regarding the impact on the performance of the assets within securitisation trusts. Any modification to rules is adapted by each lender so we assess what each lender does in this environment and how they translate what changes can do to their portfolio," Nunez said.

All the discussion may be a moot point. The government introduced responsible-lending legislation into Parliament in the final sitting week of 2020, but with the opposition ruling out support it will have to negotiate with the Senate crossbench for its passage in the new year. Already, though, several crossbench senators have expressed reservations about watering down responsible-lending obligations. •

"We don't want to be chopping and changing when it comes to credit policy and we will look for some certainty before we unwind any of the changes we have implemented."

PETER CASEY ING BANK AUSTRALIA



KangaNews DCM Summit bank treasurers webinar

One of the most popular annual sessions at the **KangaNews Debt Capital Markets Summit** is the big-four bank treasurers panel. There was no shortage of discussion topics at the 2020 videoconference iteration, even though the majors have had minimal wholesale issuance to do and there is little chance of a 2021 rebound.

PANELLISTS

■ **Joanne Dawson** Group Treasurer WESTPAC BANKING CORPORATION ■ **Catriona Meharry** Group Treasurer NATIONAL AUSTRALIA BANK
■ **Kylie Robb** Head of Funding and Liquidity COMMONWEALTH BANK OF AUSTRALIA ■ **Adrian Went** Group Treasurer ANZ

MODERATOR

■ **Gerard Perrignon** Managing Director, Capital Markets RBC CAPITAL MARKETS

ASSET QUALITY

Perrignon Major-bank loan deferral data paint a very positive picture about the resilience of asset quality in 2020, in particular the lower level of deferral and forbearance – and quicker return to payment – across loan books than might have been expected. However, questions remain about the default picture in 2021. Where are deferrals today compared with expectations in March?

■ **DAWSON** Asset quality has been more resilient than we thought it was going to be six months ago, and certainly better than we expected in March. Mortgage and SME deferrals have reduced significantly over the last few months, which has been pleasing. Mortgage deferrals peaked at around 12 per cent

of our book and they are now around 3 per cent – clearly a massive improvement.

Government and central-bank stimulus measures have allowed many businesses and consumers to see out COVID-19 restrictions and return to repayments quicker than we were expecting in March and April.

There is still some uncertainty as we look at the book going forward, though. Stress has emerged in sectors that have been severely affected by COVID-19.

■ **ROBB** Commonwealth Bank of Australia (CBA) peaked at 11 per cent for home-loan deferrals and as of 31 October is at 4 per cent. SME-loan deferrals peaked at 28 per cent, largely driven by the fact that we auto-deferred large segments of our book. We have seen this come down to 3 per cent.

We have been encouraged by the transition but I agree that there is still a way to go. The June quarter 2021 will be key, as



“We expect another reduction of deferrals in November and we are pleased with how they are progressing – 90 per cent of those that have exited deferrals are expected to resume payment or have resumed payments. But it is hard to make a call that we are completely out of the woods until the June quarter 2021.”

CATRIONA MEHARRY NATIONAL AUSTRALIA BANK

this is when we will see the fiscal stimulus and deferral packages wrap up. We are already working closely with our customers to help them through this process.

Over the past year, we have doubled the number of people in our financial-support team. We now have an additional 700 employees helping customers to figure out the best path forward for them. There is certainly a lot of work to do but we are encouraged by the outlook versus expectations six months ago.

■ **MEHARRY** There was a much bigger proportion of deferrals referred to hardship coming from Victoria, as one would expect as a result of the harsher lockdown – 40 per cent of home loans referred to hardship and more than 50 per cent from businesses referred to hardship came from Victoria.

There has been a rebound in the economy since Victoria has opened up over the past five weeks but, again, it is probably too early to know what is going to play out in 2021.

We are positive, though. We expect another reduction of deferrals in November and we are pleased with how they are progressing – 90 per cent of those that have exited deferrals are expected to resume or have resumed payment. But I agree that it is hard to make a call that we are completely out of the woods until the June quarter 2021, when we see the removal of some stimulus.

■ **WENT** There is no doubt the performance of the deferral cohort has been better than we were anticipating. For us, 80 per cent of these mortgage customers have returned or will return to normal payments while approximately 20 per cent have sought the additional four-month extension.

Around 50 per cent of those seeking an extension were in Victoria. It was still in lockdown when a lot of the initial deferrals were coming up to maturity, so this is not surprising.

The SME and commercial space is also on a positive trend. Around 10 per cent of those who applied for an initial deferral have sought an extension, heavily weighted toward Victoria. The trends in New Zealand have been even better in this space.

The other thing to point out is that the institutional book has been resilient. When we announced our results in April-May 2020, we were anticipating well over 100 basis points of risk-weighted-asset migration including from downgrades of our institutional customers.

At our most recent update, it is probably about half that – and a lot of this is due to improvement in the institutional space. These clients have managed their businesses well and

have in some cases raised equity if needed – it feels as if they are in good shape.

CREDIT GROWTH

Perrignon Credit growth was already challenged pre-COVID-19. Where do the banks think future demand will emerge from, if anywhere? What are the challenges in building loan books despite cheap liquidity being available, either from deposits or the TFF [term funding facility]?

■ **WENT** Credit growth is subdued at the moment. Mortgage loan growth is about 3 per cent year-on-year – though we have been tracking slightly above this – and credit growth in the business sector is close to flat. Our view is that, in line with improving conditions and confidence, we should see a bit of a pick-up in business and household credit demand. But overall it will remain subdued.

We also think the institutional source of growth will remain subdued, thanks to the massive amounts of liquidity out there and good direct access to debt capital markets for high-grade borrowers.

The other area to highlight – although it is not a big component of our portfolio – is credit cards. They are down 13 per cent year-on-year and we are seeing this impact in customer behaviour.

■ **MEHARRY** We don't expect a surge in credit growth across the economy though the housing market may start to pick up with such low rates. Looking across to New Zealand, the house-price surge is indicative of what we might expect to see here. I am not expecting double-digit-type growth in credit, but we feel housing growth will be stronger than business growth – which to date has been quite subdued.

It is a little like what we have seen offshore, in the sense that taking rates all the way down to zero or even negative does not necessarily generate extra growth in credit. I think we need to see things play out to find out where demand comes from, but expectations remain relatively muted.

■ **ROBB** Our economists' view is also that we will see very low single-digit credit growth in 2021. This was a theme pre-COVID-19 and the pandemic has exacerbated it because of the uncertainty that exists right now. There is little confidence to borrow and in many cases credit is not needed.

"There is little confidence to borrow and in many cases credit is not needed. We have strong liquidity and capital positions so we are looking to work with customers to extend credit, but we are seeing limited customer interest. We are not expecting this dynamic to change in the near term."

KYLIE ROBB COMMONWEALTH BANK OF AUSTRALIA



TIER-TWO BUILD-UP CONTINUES

Most big-four bank issuance in wholesale capital markets since the pandemic began has been tier-two additional capital – even as the local regulator has eased capital requirements to facilitate credit supply.

PERRIGNON To what extent have the banks taken advantage of eased capital requirements? How useful a tool has this been for facilitating ongoing lending to the economy?

■ **WENT** APRA [the Australian Prudential Regulation Authority]’s position on capital-buffer use was very sensible and it was the right thing to do at that point in time. In reality, we all have stronger capital positions than we anticipated thanks to some of the drivers we have been talking about.

Migration has been lower, overall credit growth has been lower, dividends have been lower and, in our case, our capital ratio is the same as it was 12 months ago despite everything. We have

not done an equity raising, which has been pleasing.

It was the right thing for APRA to do, but because economic conditions and credit performance have been better than we anticipated we haven’t had to consider using the ‘unquestionably strong’ buffers. It has been a good outcome.

■ **MEHARRY** In March, we discussed with the board what we wanted to do – which was to be strong coming through this period given the enormous uncertainty ahead. The capital raise we did was absolutely the right thing to do at the time. We have the strength of our capital ratio to continue to lend to our customers.

But every bank had to deal with it differently. Determining

how quickly we were going to have to rebuild, considering the buffers and what the right level would be, was an important conversation internally. For us, the decision was to be strong and get through it.

PERRIGNON We are 18 months into Australian major-bank TLAC [total loss-absorbing capacity] build up. Since July 2019, we have seen roughly A\$30 billion (US\$22.1 billion) equivalent benchmark of tier-two issuance. Where are the banks with regard to the ramp up and what has investor reception to the issuance been so far?

■ **DAWSON** We are all well progressed with the TLAC transition. Westpac’s tier-two ratio was 3.1 per cent at the

end of September and our plan for this financial year is A\$5-7 billion of issuance, including refinancing and some management buffer. It is manageable and reasonable based on what we have seen in the market.

Our early November tier-two deal in US dollars raised US\$2.5 billion across two tranches and was very well supported. There was a good market backdrop at the time and we were overwhelmed by the support. The peak orderbook was more than US\$16 billion. The number of participants we saw across the deal was as good as we have seen: more than 300 investors from all parts of the world. For us, it was a good signal that there is support for the product and Australian bank issuance in this format.

■ **ROBB** From July 2019, we have issued a little over A\$6 billion equivalent of tier-two. Considering maturities and the growth trajectory, we estimate about A\$4-5 billion per year

It’s an interesting dynamic because, in appropriate situations, the bank is keen to extend credit. We have strong liquidity and capital positions so we are looking to work with customers to extend credit, but we are seeing limited customer interest. We are not expecting this dynamic to change in the near term.

■ **DAWSON** We are seeing housing respond to low rates – it is a very competitive market. As everyone says, it certainly seems that business confidence is more subdued and we are not seeing any pick-up in demand there.

Perrignon How has the deposit situation played out across bank books in 2020 and how do you expect it to evolve into the new year, assuming we see reduced government stimulus?

■ **DAWSON** The deposit growth we have seen has been pretty broad-based. When the pandemic started in March the early deposit growth was really coming from the corporate and high-end sectors of the market. Some of it was drawing down on committed lines and putting that liquidity on deposit with the banks.

Following this, we saw deposits increase in response to the government stimulus packages that flowed through to

the SME and household deposit books. The early release of superannuation, which we saw around the same time, was also a factor – but it was more about conservatism and a reduction in spending elsewhere.

Looking forward to 2021, I expect deposit growth will remain strong with the continued QE coming into the market supporting it.

■ **ROBB** This has been a big focus for us in 2020 and I think it will continue to be a major theme in 2021 too. Understanding the dynamics about where the cash in the system is going and the formats that will make sense – what is going to stick and be maintained in the medium term – is key.

For example, our customer deposit ratio is currently at 74 per cent, up from 69 per cent in 2019 – equating to more than A\$60 billion (US\$44.3 billion) of deposit inflows in 2020.

From here, we have been doing analysis of the monetary system and supply expectations to assess how fiscal and monetary stimulus could continue supporting deposit inflows. Initially our growth was also mainly from corporates and large fixed-income investors, but now it is very focused on the retail segment.

With these large deposit inflows, at a time when asset and credit growth isn’t really there, the dynamics for wholesale funding have massively changed in the past six months.

of issuance to meet the 2024 requirements. We certainly feel this is very manageable.

It is probably worth highlighting that we have done about 20 per cent of the A\$6 billion through private placements, which has also been a very strong and attractive option. It provides relatively long-dated, cost-effective Australian dollar funding in the tier-two product.

The note of caution I'd throw out here is that we had been planning on issuing a tier-two deal in the first half of 2020, and obviously with the backdrop of crazy volatility it made perfect sense to sit out in that period. There are periods when markets will absorb these deals well but it is a high-beta product and we want to have enough flexibility in our preparation schedule to allow the organisation to step back from markets when need be.

The US investor community has been very supportive and

I think the low interest-rate environment will continue to support Australian major bank tier-two paper.

But it is also worth saying that while we were delighted with the domestic tier-two transaction we did in September 2020, it was a good reminder that there isn't unlimited depth locally.

Our transaction went well with a lot of investors waiting for our return and keen to support us. But there were a number of deals in relatively close succession, which then required some time for the market to digest.

The nature of tier-two means we have to be cautious about timing – we do not want to saturate the market, particularly when it does not have appetite. We have done well collectively in the last 18 months but there is still a long way to go. We will manage it appropriately but being careful with timing will be important.

FUNDING OUTLOOK

Perrignon There is clearly a fundamental change in the liability set up for Australian banks and as a result the funding gap that has existed for years could be changed irrevocably. This will certainly be the case in the medium term. How are banks thinking about this change?

■ **WENT** Deposit growth has been the single biggest driver of balance-sheet changes to the funding gap over the last eight months. I believe the system funding gap has shrunk by around A\$200 billion since February. This is a product of QE and fiscal stimulus, so in a way it is not surprising.

We do a lot of thinking internally about these changes and we have concluded that they are structural. The Australian system had a big funding gap and large issuance requirements offshore. Now it has flipped around and we are all looking for ways to deploy liquidity.

We think it is going to stay this way for a while. The nature of government stimulus will change in the coming months but, overall, it is still expansionary – and so is monetary policy.

■ **MEHARRY** While we have low rates, the structural changes are here to stay. It has been hard to have the conversation about deposits without looking at the TFF and CLF [committed liquidity facility], and how they all play out together over the next few years.

Like the others, we have done a lot of thinking in this space because if it is structural change it means different things to all of us. If it isn't structural, 2023-24 becomes interesting especially when considering refinancing.

Audience question Canada has a similar banking setup to Australia. What does support for the banking sector look like there?

■ **PERRIGNON** It is pretty similar in respect of the significant liquidity provided by the Bank of Canada to the short end of the market. There has been no TLTRO [targeted longer-term refinancing operations] setup given to the Canadian banks – so no TFF equivalent that would provide them the ability to fund at term. But a significant amount of short-term funding has been given to the Canadian banks.

■ **WENT** Last time I looked, Royal Bank of Canada had C\$100 billion (US\$77.3 billion) sitting with the central bank in the exchange-settlement account. This gives a sense of how material the numbers are in Canada.

■ **PERRIGNON** They are huge numbers. But without term support, the desire to maintain a term-funding presence via their normal course of business – in external term markets – remains in place. This is of course different from the Australian market, where we have not seen any senior major-bank issuance.

Audience question How are the banks thinking about the TFF exit? Will they be looking to refinance the maturity spike as soon as possible to smooth it out, even if market funding is more expensive?

"In all likelihood the refinancing task will be largely covered by deposits. The amount of refinancing needed and the banks' annual wholesale funding tasks should be lower than they have been historically."

JOANNE DAWSON WESTPAC BANKING CORPORATION





“Looking three years out, it obviously depends what happens between now and then. If we find ourselves in an over-funded position, like we are now, I suspect there will not be too many issues with exiting from the TFF – we can simply allow it to roll off.”

ADRIAN WENT ANZ

■ **WENT** Bringing it back to deposits, given how material the changes have been, I suspect the amount of issuance we required would have been limited anyway – even without the TFF. The TFF obviously helps, but it is not as material as the excess deposit growth we have experienced.

Looking three years out, it obviously depends what happens between now and then. If we find ourselves in an over-funded position, like we are now, I suspect there will not be too many issues with exiting from the TFF – we can simply allow it to roll off.

If things change in a way that funding needs increase, we will be sensible about it and some pre-funding may be required to manage the maturity profile. But overall it is hard to see us going back to the situation of issuing A\$25 billion per year. Maybe we will get there eventually but I think it is many years away.

■ **MEHARRY** The interplay is between the deposit piece and whether we believe it will be maintained over the next couple of years. The TFF has offset wholesale funding. We have accessed approximately A\$14 billion of the TFF to 30 September 2020, which is almost identical to our runoff of wholesale funding. We will also be looking to access the TFF in 2021 and it will probably result in a similar dynamic.

It is likely beyond the end of our financial year when whether we need to pre-fund or repay maturities starts to become clearer. We are working through all these things but it is a little too early to say. What happens with the CLF also plays into the outlook.

■ **DAWSON** I think it is important to recognise how the balance sheet has changed recently. It certainly feels as if there is more flexibility in the system from a wholesale-funding perspective – both short term and long term. The capacity we have allows us a lot more flexibility in how we think about refinancing.

I also reiterate that you cannot underestimate deposit funding. I agree with Adrian Went: in all likelihood the refinancing task will be largely covered by deposits. Our deposit-to-loan ratio is now greater than 80 per cent and in fact, all the banks are at quite strong levels.

The amount of refinancing needed and the banks’ annual wholesale funding tasks should be lower than they have been historically.

■ **ROBB** Our TFF access is about A\$40 billion currently, including the initial access of A\$19 billion. We are still working

through the supplementary and additional allocations but, given we are just not seeing asset or credit growth, we are minimising our wholesale funding needs.

This includes short-term wholesale funding. From the peak earlier in the year, we are down by A\$40 billion of short-term wholesale funding and we still have considerable excess liquidity globally and locally.

At this stage, we are not too concerned about the refinancing component and I would also say it does not feel like we are going to go back to issuing large volume.

It is probably also worth remembering that part of the issuance we did when volume was much higher was in preparation for the NSFR [net-stable funding ratio]. It feels like a long time ago now, but the switch from short to long stabilised and I think we are in a new normal from an issuance perspective, even as this balance-sheet adjustment settles.

Perrignon The majors have done an enormous amount of work with investors, over a long period of time and across the world, on the assumption of programmatic and large issuance. How will issuers maintain investor relations and engagement in this period of massively reduced wholesale issuance?

■ **ROBB** Investors are still very engaged. They have considerable exposure to the Australian banks and to CBA, and many of them are interested in our tier-two issuance requirements.

We have asked investors if they want to hear from us less because we are not going to be issuing as much, and they understand the supply story – but they are still very keen to stay in touch.

We have tried a few different ways of doing so, obviously it being a different world as we are not getting on planes anymore. We put out a video for bite-size engagement to see if this would be preferable for some investors, particularly offshore, and we have continued to offer group calls and one-on-ones. In the vast majority of cases, investors have been keen to take these up. I have been surprised by the level of interest in engaging with us.

Our investor engagement efforts have positioned us well for a time like this. Investors really do not want to see the degree of connection reduce despite the Australian banking sector’s lower issuance requirements. •

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or need your details confirmed, contact Jeremy Masters.**

**jmasters@kanganews.com
+61 2 8256 5577**

KangaNews DCM Summit capital issuance webinar

Australia's credit market has seen a pickup in supply of capital instruments, including a clutch of corporate hybrid transactions. The **KangaNews Debt Capital Markets Summit 2020** webinar series included a session on additional capital, which focused on supply dynamics, demand drivers and the ever-present tension between retail, wholesale and true institutional participation.

BY LAURENCE DAVISON AND CHRIS RICH

The panel convened on 3 December, after the issuance of a flurry of additional-tier one (AT1) capital and tier-two deals by regulated financial institutions in the prior few months, and just days after Ampol printed the local market's second benchmark corporate hybrid of the year – after a long quiet period for this type of supply.

Market fundamentals seem strong for additional-capital issuance from regulated entities and corporate issuers. The impact of the pandemic is causing many issuers to explore ways of shoring up their capital positions and credit ratings that are more palatable than issuing additional equity. On the buy side, the low-return environment is causing investors of all stripes to seek higher-yielding income instruments. Meanwhile, the ongoing absence of major-bank senior debt supply has created a vacuum in the Australian credit market that issuance of all types can seek to fill.

After a pricing lurch at the start of the pandemic period, the hybrid market was well supported in 2020 and eventually provided a more than satisfactory outcome for investors that held their nerve.

Steve Anagnos, co-head of income strategies at Shaw and Partners in Sydney, described a margin rollercoaster for bank hybrids – but one that resolved quickly and positively. From historic tight spreads of less than 300 basis points over bank

bills coming into the new year, some forced selling saw bank additional tier-one (AT1) notes widen even more when the first pandemic lockdowns came into effect than they did in the financial crisis.

Unlike the financial crisis, however, it did not take long for demand support to re-emerge. Anagnos said the price drop, to around 80 cents in the dollar in some cases, “did not make much sense at the time” based on the soundness of the banks issuing AT1 securities in Australia.

DEMAND FACTORS

He added: “We were pleasantly surprised by the strong demand, not only from equity and credit investors but also new income-seeking investors that came into the asset class. These investors looked at rates of return and made the assessment that the underlying issuers are of sound quality, which translated into fantastic buying opportunities.”

Over the course of 7-8 weeks, Anagnos continues, Australian AT1 recovered most of its losses on the back of a significant secondary-market dynamic. “The short time over which this all played out gave investors confidence in the underlying structure of the market,” he concludes.

The investor support extends to wholesale buyers, according to Nick Chaplin, head of hybrids and structured capital origination at National Australia Bank (NAB) in Sydney.



“The wealth managers, who are a huge component of the distribution of hybrids, are wholesale qualified and professional – but they need the listing, which is important from a behavioural perspective. I completely agree that a listed transaction is the best supporter of volume and execution certainty.”

NICK CHAPLIN NATIONAL AUSTRALIA BANK

Traditionally a listed market, the last few years have seen the emergence of sporadic AT1 issuance in a format that precludes the participation of retail investors.

NAB itself issued two such deals in the past year. Chaplin said this was primarily to give institutional accounts access to paper they can miss out on in retail-format deals, which are often well covered by retail reinvestment and shareholder offers.

In fact, the asset class as a whole has taken on a much more wholesale flavour. “I believe 95 per cent of today’s hybrid buyers could invest in a wholesale issue – they just prefer the listing as it shows the trading position daily and very clearly. In reality, all the work we do on prospectuses and the related due diligence is largely for the benefit of about 5 per cent of buyers,” said Chaplin.

The greater prevalence of wholesale investors in hybrids may not represent a genuine shift in the buyer base so much as an evolution and maturing of the asset class. “The type of investor buying hybrids now is by and large the same as it has always been. What happened is that they are able to use them in a lot of different areas of their portfolios and as a result have increased allocations to this asset class. Access to well-diversified hybrid portfolio strategies has also made a difference,” Anagnos argued. In particular, the wholesale market has migrated from ad-hoc use of hybrids within equity or fixed-income portfolios to a greater prevalence of hybrid-specific strategies.

On the other hand, issuers are wary of committing to pure wholesale issuance. For instance, AMP Limited issued an unlisted AT1 instrument in 2012 – the first such deal in about a decade – and found the process relatively hard going. “The challenge we had back then was that the pool of investors was a third of what it would have been for a retail, listed transaction,” Jason Bounassif, Sydney-based treasurer at AMP Group, revealed during the webinar. “This means facing a market with genuine execution risk and where volume is materially smaller.”

This poses a problem for infrequent issuers in the format, as many banks are. AMP is a relatively prominent AT1 issuer yet still only expects to be in the market every two years on average, Bounassif explained. With an overwhelming motivation of avoiding execution risk, it may take time for issuers with this sort of profile to be convinced of changing demand dynamics.

Retail AT1 investors’ willingness to roll their holdings in reinvestment provides another compelling reason for issuers to stick with the status quo. Adam Parry, funding manager at Suncorp Bank in Brisbane, said: “We have enjoyed a long period of support from our retail investors and the reinvestment offer is something we consider we should continue to offer. Retail currently suits our needs from a volume perspective.”

Indeed, while Chaplin emphasised the increased scale of wholesale demand for hybrid product he also maintained his support for the listed format. In an ideal world, he argued, the prospectus process would be eased for issuance into what he insists is an increasingly sophisticated investor base. But either way, a retailable product is still the best option for most hybrid transactions in Australia.

“The wealth managers, who are a huge component of the distribution of hybrids, are wholesale-qualified and professional – but they need the listing, which is important from a behavioural perspective. I completely agree that a listed transaction is the best supporter of volume and execution certainty,” Chaplin said.

CORPORATE RESURGENCE

The main driver of hybrid issuance in Australia has historically been banks and, to a lesser extent, other regulated entities like insurance companies. Supply from non-regulated entities, specifically corporate issuers, has been patchier. In fact, the Australian dollar market had not seen more than A\$1 billion (US\$737.5 million) of annual issuance for nearly a decade until the new deals broke that barrier in 2020.

AusNet Services printed A\$650 million in a hybrid deal priced in September, which was followed in November by a A\$500 million transaction from Ampol. Australia’s intermediary community believes the use of equity-credit hybrids to enhance rating positions is likely to become a more regular feature of the local capital market moving into 2021.

“Corporate issuers that use equity hybrids do so to achieve some level of flexibility through the rating support – this is clearly an important motivation and one that was certainly prevalent with Ampol and AusNet,” Chaplin confirmed.

The credit benefit is marginal but material. Moody’s Investors Service rated both the Australian corporate hybrids issued in 2020, affording them both 50 per cent equity credit. Patrick Winsbury, associate managing director, corporate finance and financial institutions groups at Moody’s in Sydney, says this is supportive but not transformative.

“Hybrid issuance is unlikely to take an issuer into a higher rating category given the additional equity credit is a relatively modest component of the overall capital structure – it is much more likely to be something designed to provide some flexibility at an existing rating level,” Winsbury explained. “With the Ampol transaction, for instance, the amount of equity credit we gave the issuer covered an ordinary-share buyback it was doing. This enabled Ampol to create a more efficient capital structure within the parameters set for its rating.”

Despite the relative lack of issuance in recent years, Winsbury also revealed that the type of transaction structures Moody’s is seeing is relatively uniform. One development is the use of very long final maturity dates beyond the typical mid-tenor call date, as was the case in the 60-year non-call five maturity profiles of the AusNet and Ampol hybrids.

There is every reason for the market to continue to attract regulated and non-regulated hybrid issuers, Winsbury said at the KangaNews webinar. “Strongly rated corporate and bank issuers’ instruments will also be investment grade, but the close to 4 per cent return on offer has to be very attractive to a whole new set of investors. From a rating agency perspective, it is long-dated funding – which is credit-positive. It is easy to see that there are a lot of benefits to this asset class.” •

KangaNews DCM Summit duration webinar

The development of long-dated liquidity is a massive agenda item for the Australian debt market, as sovereign issuance soars and yield at the front end stays anchored. Local and global market participants shared views on how duration has evolved internationally and what might be in store for Australia, at a November **KangaNews Debt Capital Markets Summit 2020** webinar.

BY LAURENCE DAVISON

Issuance at long and even ultra-long tenor is of course nothing new globally, and even the traditionally mid-curve-focused Australian dollar market has increasingly ventured out along the curve in recent years – led by the sovereign, but also with deepening footprints from semi-government and credit issuers.

The Australian Office of Financial Management (AOFM) extended its nominal curve to 20 years in 2013 and to 30 years in 2016. But its long-dated issuance ramped up in 2020 along with its overall programme. It issued nearly A\$24 billion (US\$17.7 billion) of 20-year and longer bonds in 2020 to mid-December, compared with just A\$2.4 billion the previous year.

The year also saw notable semi-government issuance at the long end and the local corporate market consolidating the availability of 10-year liquidity for investment-grade credits.

This clearly matches a global trend. Alex Anderson, head of US syndicate at TD Securities in New York, described 2020 as “a year unlike any other” thanks to the impact of COVID-19, including “quite astounding” consequences for duration. In part this was a result of the nature of the stress the unfolding crisis placed on markets.

“The immediate impact of the pandemic, back in March, was on the very short end – money-market instruments – and

the front end remained almost entirely inaccessible even as the market started to thaw later in March,” Anderson explained. “There was almost no demand for new issues at five years and shorter, whether for highly-rated issuers, high-yield, asset-backed or anything else.”

The theme lingered long after the immediate shock of COVID-19, however. Indeed, Australian semi-government issuers returned to the market in the time-honoured fashion of seeking liquidity at short tenor. The growth in long-dated issuance is a trend with deeper foundations than a market crisis.

The primary driver is the actions of governments and central banks to stimulate struggling economies with ultra-low rates and QE programmes that include direct funding to sovereign- and private-sector borrowers. This has the dual effect of encouraging borrowers to lock in low rates for as long a term as they are comfortable with and forcing investors to look for yield including by pushing out duration.

“There is a huge push-and-pull dynamic across the rates market that is creating real distortions not only within yield curves but across them,” said Laura Ryan, head of research at Ardea Investment Management in Sydney.

For much of 2020, the Reserve Bank of Australia (RBA) focused its market intervention on controlling yield at three-



“Duration has been the name of the game, and issuers have been encouraged by low interest rates to go longer and lock in low-cost, long-dated funding. The search for yield and spread has forced even the investors we were used to seeing gravitate toward shorter tenor to extend along the curve.”

ALEX ANDERSON TD SECURITIES

year tenor while leaving the rest of the curve to float within the bounds of acceptable market function. This provided a further near-term impetus for investors to go long.

Ryan explained: “The RBA has pinned the three-year part of the yield curve while the AOFM has been issuing a record volume of sovereign bonds. This level of issuance is pushing yield up beyond the anchored point, which is why the Australian yield curve has been, hands down, the steepest across the globe. This has presented a lot of relative-value opportunities for us.”

Other jurisdictions have drivers of their own, though. In Europe, the creep of negative yield has continued to move the tenor at which investors can get a positive return from high-grade issuers. For instance, Andrea Dore, Washington-based head of funding at World Bank, said the supranational’s euro deals hit zero yield at around seven-year tenor in late 2019 but by mid-2020 it had to issue 15-year bonds to achieve the same level. By early November that point had extended to 20 years.

On the other hand, investors say it is not as simple as a blanket requirement for positive return. Ryan explained, for instance, that Ardea buys on a relative-value basis and therefore outright rates are not a primary driver.

Andre Severino, global head of fixed income at Nikko Asset Management in London, added: “Negative yield at the front end of the curve certainly contributes to the hunt for yield and therefore the demand for duration. But we don’t buy duration blindly – we consider factors like our view on interest-rate direction and try to position to maximise return. The lack of inflation in forecasts and the expectation of muted growth, as well as ongoing QE, all support a long-dated bid. Investors are willing to add duration because they believe the ECB [European Central Bank] is, and will be, there.”

There is no magic formula that triggers long-dated evolution beyond the combined weight of low rates and policymaker intervention squashing the short end. Anderson told webinar delegates that exactly the same phenomena have been playing out in the US through 2020.

“We have seen a tremendous shift in the composition of the US primary market,” he said. “Duration has been the name of the game, and issuers have been encouraged by low interest rates to go longer and lock in low-cost, long-dated funding. The search for yield and spread has forced even the investors we were used to seeing gravitate toward shorter tenor to extend along the curve to pick up extra yield.”

ISSUER CAPACITY

The availability of low fixed-rate funding at long tenor is naturally a positive factor for issuers and many are more than happy to access it. “Investors’ search for duration is a welcome situation for World Bank,” Dore confirmed. “We have been focused on extending the duration of our portfolio for the past three years, purely from an ALM perspective – we want to reduce the concentration of refinancing while pushing out funding maturity to be a better match with the duration of our loans.”

For World Bank in 2020, this included issuing two 10-year US dollar transactions for a combined US\$7 billion. The larger of the two, at US\$4 billion, is the issuer’s biggest ever in the currency having historically leant more on the euro market for duration.

In euros, World Bank’s long-dated issuance included a €2 billion (US\$2.4 billion) 30-year benchmark in October that Dore said illustrates the evolution of the long end. Specifically, she explained, the book for this deal featured a degree of diversity akin to what the issuer would historically have expected to see for 10-year euro issuance.

The euro market was also the venue for Treasury Corporation of Victoria (TCV) and other Australian state issuers to dip toes in the water of long-dated issuance. TCV printed €150 million of 2050 maturity bonds in April 2020 and Paul Kelly, the treasury corporation’s Melbourne-based senior risk manager, revealed that it was “inundated with demand” afterwards.

It has since added €200 million to this line as well as issuing A\$560 million across a trio of 2050 syndications and filling various gaps in its domestic curve from the late 2030s to late 2040s.

Kelly said: “The availability of long-dated demand is fantastic for Victoria and the other states. It allows us to align the funding profile somewhat more with the assets on our balance sheet. We are a big borrower for infrastructure and have a significant volume of long-term assets.”

Issuer capacity and willingness to keep fulfilling long-dated demand is not infinite, however – even for high-grade issuers outside the sovereign sector. Most have portfolio-based funding approaches rather than match-funding loans, which makes tenor extension a valuable goal – to an extent.

Dore said: “Our senior management would like us to fund as far out as we possibly can! Our portfolio obviously contains

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ANDRE SEVERINO NIKKO ASSET MANAGEMENT





"While for us it is more a case of going from five to 10 years than going to 20 years and beyond, there is no doubt very long-dated issuance is now a normal part of the market and will become more so with the EU's new funding programme."

PETRA WEHLERT KfW BANKENGRUPPE

some long-dated assets. In particular, IDA [International Development Association] loans are much longer – they can be 30- or 40-year fixed-rate facilities. IDA is now an active issuer and its appetite for duration is therefore even longer than that of World Bank."

Overall, though, World Bank is not looking materially to shift its funding strategy to much longer duration. Dore continued: "When we fund, we also do so for liquidity – so we will still issue in the short part of the curve despite our overall goal to extend the duration of the portfolio. Plenty of investors still have demand at the five-year point and the size of our funding programme means it makes sense to provide issuance to meet that demand."

It is a similar story for European Investment Bank (EIB). Eila Kreivi, EIB's Luxembourg-based director and head of capital markets, told webinar delegates the supranational's average loan duration – and thus its natural preference for funding-portfolio duration – is actually somewhat longer than those of its peer group. But, at seven years, it is still not likely to prompt a flood of very long-dated supply.

"It is very attractive for governments to borrow for 20 or 30 years with a negative interest rate, but we have very little need beyond about 15-20 years," Kreivi commented. "We have capacity to do one 15-year benchmark every year and perhaps €1-2 billion total in ultra-long dates – though these will not be benchmark transactions. The LIBOR curve also tends to be quite steep so we would be paying up for long-dated funding that we don't really need."

Subsovereign issuers – in Australia and globally – have the same type of constraint. Petra Wehlert, first vice president and head of capital markets at KfW Bankengruppe in Frankfurt, echoes Kreivi's view that the sovereign sector is likely to be the most natural source of substantial volume at the long end.

She explained: "We definitely see investor demand moving further out along the curve in this interest-rate environment and we have also moved out to meet them. While for us it is more a case of going from five to 10 years than going to 20 years and beyond, there is no doubt very long-dated issuance is now a normal part of the market and will become more so with the EU's new funding programme."

There are technical challenges, too – especially for cross-currency issuance at the long end, and even for the highest-grade issuers. Dore revealed that World Bank has received reverse enquiry out to 100-year tenor and is exploring

opportunities at 40 years, but also that swap liquidity is challenging for ultra-long dates. Kreivi said benchmark-volume issuance is hard to support in the swap market even at 30 years.

"Realistically, the supply of 15-year-plus debt is not endless – we are not going to change the way we approach the market completely," Kelly concluded. "What long-dated issuance gives us is protection against future interest-rate rises for a lot longer."

LIQUIDITY AND OPPORTUNITIES

Perhaps the biggest question for Australia is whether there will be enough supply to support the development of liquidity at longer tenor. Market participants tend to agree that, historically, Australian dollar liquidity drops off much beyond the 10-year government bond futures contract basket. AOFM issuance out to 30 years has helped but there is still much less liquidity in the 20-year futures contract, for instance.

Kelly believes things have improved already. "I have thought since at least early 2019 that we were pretty close to having a liquid curve out to 12 years in Australia and that extension to 15 years was not impossible," he suggested. "I think we have probably reached that point now. I think it's possible that Australian semi-government issuers could have a liquid curve out to 20 years, and though we are not there yet we are all starting to have a lot of long-dated bonds outstanding."

The evolution of liquidity in global markets may not be a path Australia naturally follows, given the larger and more diverse nature of the investor bases in global core currencies. For instance, Anderson said while the US market has developed strong liquidity across the curve this is helped by the presence of disparate investor groups at different tenor points.

In fact, some of the longer dates are among the most active in the US. Anderson commented: "The deepest pool is 10 years, because there is money at this tenor from almost the full gamut of investors: pension funds, insurance, hedge funds and others. The 30-year tenor is probably the next most liquid, and actually we are seeing growth in liquidity at 20 years."

Ryan added: "Long-end liquidity depends where you are and on market conditions. Liquidity dried up during the worst of the COVID-19 crisis, of course – but this was the case in all sectors. We are now back to more normal conditions, though there is definitely less liquidity at the long end. It is all relative, though: while the long-dated high-grade market is less liquid than the short end, it is still much more liquid than credit." •

KangaNews and DIVERSITY

Ninety-six per cent of respondents to the **KangaNews Women in Capital Markets Survey**, conducted in 2020 for the inaugural *KangaNews Women in Capital Markets Yearbook*, believe giving profile to female leaders in media and industry events supports gender diversity in financial services.

As the only media and events business devoted to the Australasian debt markets, KangaNews is keen to use its voice and the forums it provides to further industry diversity. This includes promoting female voices in its editorial coverage and on its event agendas. The *KangaNews Women in Capital Markets Yearbook* is one sign of this effort coming to fruition.

If you have any suggestions about how KangaNews can help progress toward a more diverse industry, please contact **Helen Craig** on +61 2 8256 5533 or via hcraig@kanganews.com.



KangaNews DCM Summit US election webinar

On 12 November, just a week after the most contentious and controversial election in US history, a panel of US-based market participants convened to discuss the fallout as part of the **KangaNews Debt Capital Markets Summit 2020** webinar series. The conversation covered the impact of a divided government, monetary and fiscal policy, and the US's place on the world stage.

PARTICIPANTS

■ **Nigel Lake** Founder and Executive Chair POTTINGER ■ **Mark Lindbloom** Portfolio Manager and Head of US Markets WESTERN ASSET MANAGEMENT
■ **Tom Porcelli** Managing Director and Chief Economist RBC CAPITAL MARKETS

MODERATOR

■ **Richard Franulovich** Head of FX Strategy WESTPAC INSTITUTIONAL BANK

DIVIDED GOVERNMENT

Franulovich Let's start with the likely shape of US government, noting that the Senate – even with a double run-off in Georgia – now seems likely to remain in Republican hands. Will this mean an ineffectual government as Senate leader Mitch McConnell maintains the goal of blocking all Democratic legislation, or could a 'hands across the aisle' Joe Biden presidency be at least somewhat effective?

■ **PORCELLI** We should not assume the Georgia Senate run-offs are a foregone conclusion, though my sense is that the Republicans will probably win one of the two races. If the base case is for the Republicans to win at least one of the seats we can work from there. We have heard a million times that gridlock tends to be good from a market perspective. History is on the side of this argument.

There is a narrative that Biden has worked with folks on the other side of the aisle, but I would make a cautionary remark on

this. Biden was never a president trying to reach across the aisle. He was also not reaching across the aisle with a vice president who, whether it be perception or reality, is assumed to be extremely left leaning.

I think the Republicans may be loathe to give the Biden administration many wins over the coming year or two while the composition of Congress looks as it does today. In the back of their minds they will already be thinking about 2024.

This means I do not think a lot will get done. There is the theory of low-hanging fruit on an infrastructure bill, for instance – but I would not put high odds on this being achieved.

I do think there will be some stimulus, though – and it could even happen during the lame-duck session. COVID-19 is already resurgent and this could push stimulus across the line before Biden's inauguration. Either way, there will be a stimulus plan at some stage. But it may be a lot less than what is currently being talked about.

■ **LINDBLOOM** We'll need to wait for just more than a month to see the final outcome in the Senate, but our base case is also that Republicans win one of those seats and retain a majority.



"I think the Republicans may be loathe to give the Biden administration many wins over the coming year or two while the composition of Congress looks as it does today. There is the theory of low-hanging fruit on an infrastructure bill, for instance – but I would not put high odds on this being achieved."

TOM PORCELLI RBC CAPITAL MARKETS

We are somewhat cautious on recent market sentiment. Perceptions of the ability of Democrats and Republicans to work together have been close to euphoria since the election. The idea of reaching across the aisle and the fact that Biden and McConnell have worked together in the past sounds very good. But the reality of what we have been through in the past four years could intrude upon this.

We have a 'prove-it-to-us' attitude on this, particularly given the valuations in markets recently. We also need to see who some of president-elect Biden's cabinet selections are, which will play a very large role in the potential willingness of the parties to play nice.

If Georgia does not turn out the way we think and the Senate flips to the Democrats it will be a very different outcome. All in all, our base case is that we are likely to get a fiscal package. The question is whether it comes before year-end or after. I am relatively optimistic, but a lot of optimism has already been priced into markets.

Franulovich The market's capacity to see the glass as half full is remarkable. We considered a Biden presidency with a divided Congress to be the least favourable outcome of the election for risk assets, but the reaction once we had confirmation of a Biden presidency was effectively the same as if there had been a blue wave.

■ **LAKE** A lot of people spoke about a possible blue wave before the election and are now talking about how it did not emerge. The reality is it did emerge – there was a huge amount of support for Biden. But there was also a red wave, and the two have collided. The blue wave is bigger, but the victory by Biden is not exceptional by any means compared with results throughout US history.

This goes to the political motivations in the Senate and the House [of Representatives]. The Senate is where we are focused at the moment because it could end up remaining in favour of the Republicans. Either way, if you are a Republican in the Senate or the House you have probably won more votes than you have ever seen before – and this was because of Donald Trump.

Some of the behaviour going on now from the White House is strange to say the least, but we are not seeing Republicans coming out to contradict it. This does not bode

well for bipartisanship and I agree that it is difficult to see a lot being achieved.

It is possible to imagine a stimulus bill happening during the lame-duck session and this would be very important. A lot of people are hurting and there has not been anything like the level of support rolled out in Australia and elsewhere. This pain is significant.

The health crisis in the US is escalating across the midwest, where COVID-19 numbers are miles higher even than countries in Europe. One has to wonder whether this, combined with worsening jobless figures, will drive action. I can only hope – but I think it is incumbent on both sides of politics somehow to get a bill through as soon as possible.

It may be that not much happens in the next administration, but one thing that could happen – and that we are already seeing – is a level of basic order. Things like announcements coming in a press release that is coherent and spelled correctly.

This level of basic predictability is important. The single thing that chief executives and chairmen I have spoken to in the last six months have found hardest is that there does not seem to be much rationale driving political decisions.

Whether it is a left- or right-wing government, if it is following a particular strategy you can understand it and make educated assumptions about what will happen. A return to order and boring processes in Washington will be welcomed.

STIMULUS REQUIREMENT

Franulovich McConnell is already making noises about only needing a relatively small stimulus. Are panellists starting to think the Fed [US Federal Reserve] may have to do more of the heavy lifting on stimulus than might be the case with a unified government? Could this bring negative rates back into the conversation despite the Fed's expressed opposition to the concept? And how does Pfizer's recent vaccine announcement factor into assumptions about the need for stimulus?

■ **PORCELLI** Pfizer's news will be greeted warmly by US households. Harris Poll has been doing a weekly COVID-19 poll since March and has a lot of data. One of the questions it asks is: if you catch COVID-19 do you think you will die? As

"Basic predictability is important. The single thing that chief executives and chairmen I have spoken to in the last six months have found hardest is that there does not seem to be much rationale driving political decisions."

NIGEL LAKE POTTINGER



GLOBAL INFLUENCES

Market participants are hopeful of a more rules-based foreign and environmental approach under the incoming US administration, though policy outcomes may not change dramatically.

FRANULOVICH With the US now likely to re-enter the Paris Agreement as just one sign of a more positive approach to environmental issues, will sustainable finance in the US start to come up the curve more in a Biden administration?

■ **LAKE** There is a lot of talk about a “green new deal” but I do not think it will go anywhere, and this is probably not a good label for it anyway. We know significant underlying shifts are happening in the energy sector and that these require a substantial amount of investment. A lot of this is driven by economics – we do not have to get into an argument about whether it is greener or cleaner, we can just have a lower-

cost source of energy.

A lot of countries are now committed to net-zero carbon emissions by 2050, which increases the demand for and volume of all the things needed to drive this, and in turn improves the economics.

With this backdrop, Joe Biden will sign the Paris Agreement again as soon as he can. I understand the incoming administration has a detailed plan for its energy policy and it is bringing a level of professionalism to the COVID-19 response. I suspect the energy administration will be put in place quickly.

There will be all sorts of activity in green and social bonds. But there will probably

be even more flow around vanilla investment in large-scale infrastructure, whether it is solar and wind farms or grid upgrades. This will go on for a long time.

In some ways, the signing of the Paris Agreement is a political statement that does not really have any effect on these things, which are driven by simple investment decisions.

In Australia, there has been much controversy around renewable energy but a lot of money has been spent on it. Much activity is driven by economics and to me this is more important than the political signals.

FRANULOVICH Holding China to account seems to have bipartisan backing in the US. Biden has a protectionist streak but is also very pragmatic and I understand he has signalled a review of US tariffs on China. What do panellists expect to

change on the foreign-policy and trade front?

■ **PORCELLI** Anyone who thinks Biden will be soft on China has not read enough of what he and his policy advisers have said. I think a firm hand with China will remain in place. We can expect, though, that it will be done in a more diplomatic way than under the prior administration. I think the cabinet seats will be key in determining the degree to which the new administration goes down this path. This will give us a sense of how it will be tackled.

■ **LINDBLOOM** We agree on China – that the policies will largely remain although they may be delivered more softly. As for the rest of the world, we are more optimistic on relations, the return of the rules-based order and the US returning to some agreements and forums. Therefore we think the election will be positive for developed and emerging debt markets.

one would expect, early on only a small percentage of people thought they would die if they caught the virus. This rose quickly, to around 50 per cent, and has gradually risen further, to around 55 per cent.

We all see images in the media of people out without masks and not practising social distancing, but for every one of those pictures there are probably five that show desolate store fronts, streets and roads. There is a massive fear factor still associated with the virus – as there should be.

We all knew a vaccine would come, but I think few people appreciated there would be one that is potentially this successful. From a behavioural perspective, I think it will have a big impact on consumers over the coming couple of quarters.

The proof of the pudding will be in the savings rate. The US savings rate is still incredibly elevated at near 15 per cent, which is unprecedented in modern US history. If the feel-good notion continues, as I think it will, the rate will drop.

We all recognise the vaccine will not be widely distributed for months if not years, but I do not think distribution is the thing that will change behaviour. Knowing there is a backstop could immediately change some consumer behaviour.

The economy could gather momentum from Q1 to Q2 2021, but here we are in Q4 2020 with the virus resurgent. It will still be a struggle, in other words. We are predicting around

6 per cent growth in the US for full-year 2021. That would be unprecedented, and a lot is base effect from a poor 2020, but we expect it to generate momentum.

Franulovich How much optimism around the vaccine is baked into economic and market projections?

■ **PORCELLI** We do not have a vaccine explicitly in our numbers so there may be some more juice if a vaccine is available. We will see how the savings rate unfolds and we will not rush to a judgement on our numbers.

We recognise some upside risk. Every time I go into a meeting I am asked whether there is more up- or downside risk relative to forecasts. I think the risk to our 6 per cent forecast is definitely to the upside.

Franulovich What are the other panellists' growth outlooks, and how do fiscal stimulus and a vaccine factor in?

■ **LINDBLOOM** I think we all agree COVID-19 was a game changer. We have never before seen governments treat businesses and the economy as a patient by putting them in a coma, with the hope that we can get through the pandemic and then bring them out of the coma.

"We are not losing a lot of sleep in the near term about the possibility of inflation running substantially higher. Markets are predicting an inflation rate in the high-1s for break-evens at the long-end of the curve and we are in line with this in the near term."

MARK LINDBLOOM WESTERN ASSET MANAGEMENT



One reason we were optimistic early, from a market and asset-allocation perspective, was our expectation of monetary policy – from the Fed and globally – as well as fiscal policy being able to keep the patient alive.

We have continued to debate exactly what we need to see from the Fed and from fiscal policy. Fed chairman Jerome Powell has begged for more fiscal assistance to monetary policy.

It is possible that the vaccine is not a game changer. However, if COVID-19 was a game changer, being able to deal with it over a period of time will also be one. The emphasis is on the period of time.

We do not think the Fed will change much, although we are having a debate around its plans for asset purchases – specifically whether it extends their duration. It is possible that the fiscal side will be less important in 2021 if we start to see a vaccine distributed and the service side of the economy performing better.

We could see the emphasis of conversation change from a focus on the need for fiscal stimulus to the game changer of actually getting past the virus.

We agree the split government means we are likely to see a smaller and more targeted stimulus package, for two reasons. First, by 31 December some of the programmes in place now will expire and some of the people on them will be hurting upon expiration. Second, both parties have Georgia on their mind so might want to agree to a smaller package, possibly somewhere closer to US\$1 trillion than the US\$3 trillion Democratic package we have heard about.

We are somewhat optimistic about the move from the need for fiscal stimulus to actually being able to get past this period with a vaccine. [National Institute of Allergy and Infectious Diseases director] Anthony Fauci estimates April is when a majority of people may be able to get a vaccine. We will see – but we are optimistic.

■ **LAKE** Tom Porcelli's comment around the psychology of a potential vaccine is particularly significant. We are seeing a micro-example in New York, where by August the number of vacant apartments reached the highest level since data began. This is because of university students not coming back and employers telling people they will not be coming into the office until at least mid-2021.

People have changed their habits. Anything that makes people think it is safer to do the things they did before will be very important.

Another important factor in the US is how differently the pandemic and its impact plays out around the country. The unemployment rate varies greatly between states, from some that have been barely affected to those with unemployment in the double digits. What people do for work and the industries affected will be very important.

Another big point is that this has been a fantastic time for some of the biggest businesses in the US, such as Amazon, Google and Facebook. They have made a lot in advertising and everyone is shopping like mad online. These are not just US businesses: they earn significant revenue around the world.

This is great for those businesses but not for those who voted for Trump, a cohort that is significantly skewed toward those whose jobs are most at risk as automation continues to run its way through the workforce.

We won't see these effects play out in the national numbers but there will be dramatically different experiences between the folk working in tech on the west coast, in finance on the east coast and those in the midwest. The latter group is watching manufacturing die and a host of other jobs, in areas like retail and truck driving, go as processes are inevitably automated.

RATES OUTLOOK

Franulovich There has been a fierce risk-on sentiment since the election. US fixed-income yield slumped as the widely tipped blue tide fizzled into a trickle but they have since returned to 90+ basis points on the Pfizer vaccine breakthrough news. How much more upside is there and what happens to inflation if a vaccine is distributed in 2021?

■ **LINDBLOOM** This is a topic of hot debate, in our team and the market in general. We have been very calm about the idea that inflation globally will rise substantially. We have been hearing this for several years based on economic growth improving and it just has not eventuated – in the US or elsewhere.

From a fundamental point of view, we are not losing a lot of sleep in the near term about the possibility of inflation running substantially higher. Markets are predicting an inflation rate in the high-1s for break-evens at the long-end of the curve and we are in line with this in the near term.

In the longer term, we want to keep an open mind regarding fiscal and monetary policy, government policy,

THE BIG PICTURE ON JOBS AND TECH

Donald Trump did not bring manufacturing jobs back to the US, and Joe Biden's presidency is no more likely to arrest the impact of automation on the local employment market.

FRANULOVICH The tech, oil and gas, and banking sectors look like they might be able to avoid the worst of a more intrusive US regulatory landscape. How might the regulatory picture unfold under a divided-government scenario?

■ **LAKE** Two big issues are relevant for any country and must be on the minds of an administration in the US. This links to the relationship with China and other countries

where many of the businesses that are growing are not actually creating many jobs.

The automation of manufacturing means you can make things closer to where they are needed so there is a shift in employment patterns and opportunities, which is consistent with a more protectionist world view. You can speak to people that are quite far on the left of politics who think this is a logical way to go.

We may see activities that are designed to support and encourage the creation of jobs. This is one of the great challenges of our time, as automation of decision-making eats up white-collar jobs in the way it has taken out a lot of blue-collar manufacturing jobs.

The other thing that is a big challenge and is not going away is data access, use of data and personal information, what is done with these using AI, and the lack of transparency around

who is using what data for what purpose. We all sit here and have no knowledge of it.

The EU is beginning to act on this and I think it is another area where there must be pressure on governments to act. The US is home to some very big companies that make a lot of money out of this, which may make it difficult to change anything.

But we are in a world where there are issues around people's opinions being manipulated by what they see on the internet. This is very challenging and it is deeply entwined with what is happening in US politics at the moment.

redistribution, global trade, productivity and others. There is a lot happening that we need to be conscious and aware of. Overall, we have maintained long duration in our portfolio based on our inflation outlook.

The second reason for this, though, is that as positive and euphoric as investors have been since the election and vaccine news, it is entirely possible this turns around over the coming months – particularly if the vaccine timeline is extended.

We want to ensure we have a risk mitigator as part of our portfolios and we feel that long sovereign debt in select countries fits this bill, until we start to see proof that economies are advancing strongly and inflation is going up.

We do not think short-term interest rates will go anywhere. This is not controversial given monetary policy around the world. The impact would be if we start to see much better growth, which we hope is the case, and higher prices leading to higher long-end interest rates.

■ **PORCELLI** We have been down this road before – it is funny how short memories can be. The same conversation happened around inflation after the 2008 financial crisis and our response now is the same as it was then: if there is an impediment in the way, we will not generate meaningful inflation. I thought the

monetarist playbook on this was debunked, but clearly this is not the case.

The reality today is that there is an impediment in the form of everything related to the virus. This means the US economy is not fully open and in this environment it will be incredibly difficult to generate inflation.

I can make the argument for inflation – it comes down to whether a vaccine comes online sooner than expected and alters consumers' psyche, thereby reducing the savings rate at the same time as another stimulus package comes through. That could happen and, if it did, it would cause inflation over the coming year.

I had no vaccine and no stimulus built into my growth forecast but even then core inflation in 2021 would have been around 2.5 per cent. This is mostly base effect. But there could be higher inflation if we throw in a vaccine, consumers drawing down savings and another stimulus package. This would all have to work out perfectly, though.

The Fed will not respond to base effect. It has been clear that it will not respond even if inflation drifts higher. I think the curve will steepen in 2021 if this plays out, but I think the Fed will be late to the party. •



"The market's capacity to see the glass as half full is remarkable. We considered a Biden presidency with a divided Congress to be the least favourable outcome of the election for risk assets, but the reaction was effectively the same as if there had been a blue wave."

RICHARD FRANULOVICH WESTPAC INSTITUTIONAL BANK



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