SUSTAINABLE DEBT: CORPORATE GROWTH AND INNOVATION

COVID-19 RESPONSE: ECONOMISTS, TRADERS AND INVESTORS SPEAK

MUTUAL BANKS: FUNDING AND CAPITAL IN THE SPOTLIGHT

KangaNews

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AUSTRALASIAN FIXED INCOME: GLOBAL REACH, LOCAL EXPERTISE

FIXED-INCOME INVESTOR SENTIMENT SURVEY

UNLIMITED *LIQUIDITY*

THE FISCAL AND MONETARY RESPONSE TO COVID-19 PROVIDES CRITICAL SUPPORT TO THE AUSTRALIAN AND NEW ZEALAND ECONOMIES. MARKET PARTICIPANTS ARE WORKING THEIR WAY THROUGH THE CONSEQUENCES FOR THE FIXED-INCOME SECTOR.

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COVID complexity: impact on RMBS a tough call
Primary deals are possible in the Australian securitisation market, supported by government investment. Attention is turning to what effect the pandemic might have on new and existing RMBS pools. It is a formula with many variables.

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There is no doubt we are in a uniquely stressful period, professionally and personally. In a rapidly changing but always frightening environment, talking to people in the market about the challenges we face has been heartening.

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The RBA took unprecedented action on 19 March to provide a "bridge" to an expected economic recovery after the COVID-19 crisis. The reserve bank expects the support package to be required for the foreseeable future.

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COVID RESPONSE
RBNZ joins the QE choir
The RBNZ added its voice to the global chorus of central banks implementing unconventional monetary policy measures with the launch of its asset-purchase programme on 23 March. It is designed to reverse tighter funding conditions caused by the COVID-19 crisis.

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Buy side on hold
The RBA jumped into the fog of dislocated debt capital markets in March with an unlimited government and semi-government asset purchase programme. Local investors are contemplating a cascade of market consequences.

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Fitch Ratings and KangaNews have been conducting the **Fixed-Income Investor Survey** since the first half of 2014. The 2020 iteration combines a deeply negative outlook with vast areas of uncertainty to produce the survey's most worrying set of data ever.

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Illiquidity bites New Zealand credit market
The New Zealand dollar corporate market appears to have battened down the hatches in the face of the COVID-19 storm. The specifics of local demand have shielded New Zealand from worldwide volatility on occasion but market participants say the low-rate environment now leaves it more vulnerable to global moves.

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Greg Hammond has become a key player in the mutual space, including as the author of a report into the sector that has sparked much discussion on issues including capital for mutual entities. He spoke to *KangaNews* shortly after the KangaNews Mutual Sector Wholesale Funding Seminar.

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COPUBLISHED ROUNDTABLE
TWO DEGREES OF CONTAGION
A panel of market participants from New Zealand, convened via teleconference, agree the country is in a better public-health position than almost anywhere but acknowledge the outsized influence of global markets on the local economy. The discussion is an expanded version of a panel session that would have featured at the postponed **KangaNews New Zealand Capital Markets Forum**.

EVENT REPORT

Mutual ADIs position for the future
Mutual banks' funding evolution

The second annual **KangaNews Mutual Sector Wholesale Funding Seminar** took place in Sydney on 25 February. Discussions covered the sector's performance and competitive position, access to wholesale funding markets, the potential for additional-capital issuance and how mutuals can incorporate technology to add efficiency in the treasury function.

68+72

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FEATURE

Anatomy of a taxonomy

In March, Europe's technical expert group on sustainable finance delivered the final report on the EU's taxonomy for climate change mitigation and adaptation. The taxonomy – and the green bond standard that is expected to follow it – will have global ramifications for sustainable finance including for Australasian market participants.

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Q+A

INVESTA REAPS THE BENEFITS OF BEING A GREEN FRONTRUNNER

Investa Property Group's general manager, corporate sustainability, **Nina James**, and head of corporate planning and treasury, **Lisa Story**, discuss the merits of a green-focused debt strategy and the company's funding plans..

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NEWS FEATURE

Australian corporates push the boundaries of sustainable funding

An extended issuance hiatus could slow progress, but Australian corporate borrowers continue to show willingness to engage with new sustainability-linked products. Sydney Airport and Wesfarmers have completed new sustainability-linked funding – the former as the first such issuer in any global bond market.

COVID-19 CRISIS

TO SEE ALL *KANGANEWS* COVERAGE, GO TO
bit.ly/KNCOVIDhub
(case sensitive)

TRANSACTION ANALYSIS

AOFM sets the tone with record syndication

The Australian Office of Financial Management (AOFM)'s first syndicated deal since the beginning of the COVID-19 crisis and the consequent deluge of fiscal stimulus is a key moment in the Australian market recovery. Deal sources are confident jumbo volume and broad-based demand signal successful transactions will be possible.

The A$13 billion (US$8.2 billion) syndication eclipses AOFM's A$11 billion deal printed in February 2017 as the largest ever transaction completed in the Australian dollar primary market. The sovereign issuer holds all the top five spots (see table).

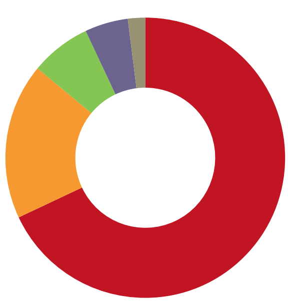
LARGEST-EVER SYNDICATED DEALS IN AUSTRALIAN DOLLARS

ISSUER	PRICING DATE	VOLUME (A$BN)	MATURITY DATE	ISSUE YIELD (PER CENT)
Australian Office of Financial Management	15 Apr 20	13	21 Nov 24	0.25
Australian Office of Financial Management	22 Feb 17	11	21 Nov 28	2.75
Australian Office of Financial Management	17 Jan 18	9.6	21 Nov 29	2.75
Australian Office of Financial Management	18 Jan 17	9.3	21 Dec 21	2.00
Australian Office of Financial Management	12 Oct 16	7.6	21 Mar 47	3.27

SOURCE: KANGANEWS 16 APRIL 2020

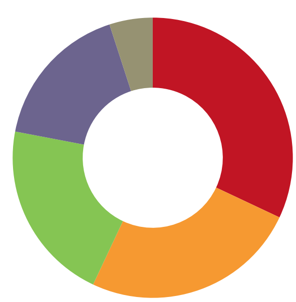
Issuer name: **Australian Office of Financial Management**
Issuer rating: **AAA/Aaa/AAA**
Pricing date: **15 April 2020**
Maturity date: **21 November 2024**
Volume: **A$13 billion**
Final book volume: **A$25.8 billion**
Margin: **19bp/3yr futures**
Margin at launch: **16-19bp/3yr futures**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, Deutsche Bank, UBS, Westpac Institutional Bank**

CHART 1. AOFM DEAL GEOGRAPHIC DISTRIBUTION



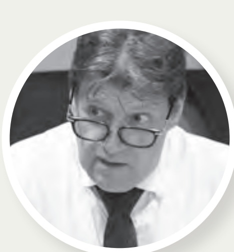
SOURCE: AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT 16 APRIL 2020

CHART 2. AOFM DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT 16 APRIL 2020

TRANSACTION INSIGHTS



ROB NICHOLL
CHIEF EXECUTIVE
AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT

"Right now, we are looking at every option available to us that will increase our access to markets and broaden our investor participation. Everything we do for the foreseeable future will reflect this."

"The size was around what we expected for a syndicated 2024 bond but it was always going to depend on the scale and composition of the book. There were enough real-money bids at the wide end of guidance for us to leave pricing there, rather than tighten it and leave those bids behind."

TRANSACTION ANALYSIS

Australian states move to bolster funding positions

The Australian semi-government sector undertook a flurry of issuance in syndicated (see table) and privately placed format in late March and early April, as borrowers seek to stay ahead of growing funding tasks. Deal sources say the market is functional but challenging, as issuers try to overcome substantial sovereign supply and an evolving central-bank buying programme.

Syndicated semi-government issuance amounted to more than A$7 billion (US$4.3 billion) in just 11 days to 9 April. There has also been substantial volume – at least several billion dollars in aggregate – of privately placed issuance from semi-government borrowers.

Nonetheless, liquidity and pricing remained challenging across most of the Australian debt space. Market sources say the Reserve Bank of Australia (RBA) had early success in its goal of driving down yield in the three-year part of the Australian Commonwealth government bond (ACGB) curve. But elsewhere liquidity remains choppy and pricing elevated, including across the semi-government sector.

By the close on 7 April, the three-year ACGB was yielding 0.265 per cent, Yieldbroker ratesheets show – near the RBA's 0.25 per cent target. By contrast, 10-year sovereign bonds were yielding 0.92 per cent while TCorp's three- and 10-year bonds were yielding 1.12 per cent and 1.78 per cent.

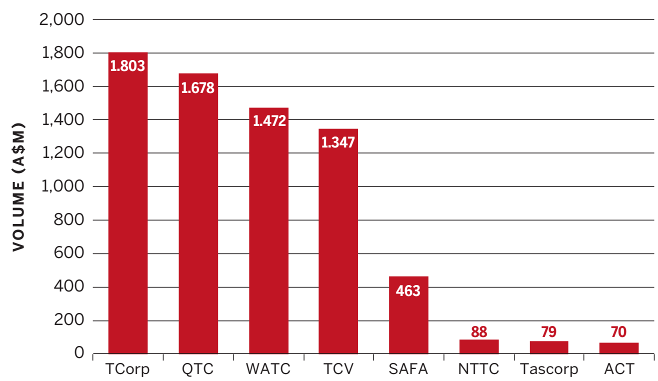
KangaNews understands semi-government issuers have been looking to place as much volume as they can in anticipation of a massive increase in Australian Office of Financial Management issuance in the coming months, to take advantage of demand that may not be there going forward – particularly from bank balance sheets.

There has been speculation that the RBA will perform more significant intervention in the semi-government market. The primary goal of its QE programme is controlling three-year ACGB yield, but the reserve bank has been empowered to buy, and has bought, elsewhere on the sovereign curve and in the semi-government sector with the narrower goal of supporting market function.

The RBA re-entered the semi-government secondary market on 8 April, purchasing A$2 billion from a selection of state issuers across a tenor range of 1-4 years. The reserve bank had previously targeted 6-10 year maturities.

This marked the third consecutive Wednesday on which the central bank had entered the semi-government space. Those

CHART 1. RBA SEMI-GOVERNMENT PURCHASES TO 8 APRIL



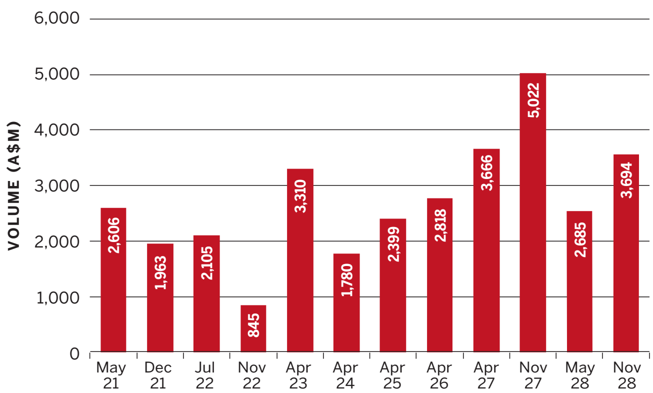
SOURCE: KANGANEWS, RESERVE BANK OF AUSTRALIA 13 APRIL 2020

AUSTRALIAN SEMI-GOVERNMENT SYNDICATED TRANSACTIONS, 30 MARCH – 9 APRIL 2020

PRICING DATE	ISSUER	RATING	MATURITY DATE(S)	TOTAL VOLUME (A$M)	MARGIN	LEAD MANAGER(S)
30 Mar 20	South Australian Government Financing Authority	AA+/Aa1	2 Apr 21	250	55bp/AONIA	ANZ
2 Apr 20	New South Wales Treasury Corporation	AAA/Aaa	9 Oct 23 8 Feb 24	3,200	39bp/3m BBSW 58bp/EFP	Citi, CommBank, UBS, Westpac
7 Apr 20	South Australian Government Financing Authority	AA+/Aa1	22 Sep 22 15 Aug 24 20 Jul 26 24 May 28 24 May 30 24 May 32	1,500	45bp/EFP 66.5bp/EFP 95bp/EFP 65bp/EFP 88bp/EFP 107bp/EFP	Citi, CommBank, NAB, UBS
7 Apr 20	Queensland Treasury Corporation	AA+/Aa1/AA	16 Apr 40	300	137.5bp/EFP	Citi
8 Apr 20	Australian Capital Territory	AAA (S&P)	17 Apr 23 22 May 29	1,325	60bp/EFP 84bp/EFP	ANZ, Deutsche, UBS, Westpac
9 Apr 20	Treasury Corporation of Victoria	AAA/Aaa	20 Nov 41	500	142bp/EFP	Citi

SOURCE: KANGANEWS 13 APRIL 2020

CHART 2. RBA ACGB PURCHASES TO 7 APRIL



SOURCE: KANGANEWS, RESERVE BANK OF AUSTRALIA 13 APRIL 2020

three interventions combined were relatively small, totalling A$7 billion (see chart 1), compared with nearly A$32 billion of sovereign bonds (see chart 2).

By mid-April, further intervention – in the form of much greater volume of semi-government purchases or additional yield targets – does not appear to be on the table. A source familiar with RBA thinking tells *KangaNews* the reserve bank is yet to be persuaded that more action is necessary in the secondary space for semi-government paper.

The RBA is not seeking to impose pricing beyond its existing mandate, except insofar as a steep yield curve or wide semi-government spreads impede market functionality. The reserve bank may take the April surge of primary semi-government issuance as a further signal that the market is functional even without a wider mandate to intervene. •

TRANSACTION INSIGHTS

ANDREW KENNEDY
DIRECTOR, TREASURY SERVICES
SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY

"Semi-governments are not necessarily trading in great volume and they are not as liquid as they were in February. But, with the RBA undertaking QE and other central banks around the globe doing the same, there is ongoing appetite for fixed-income product."

"The next couple of weeks will be more important than right now for defining how stable the market will be over the next 3-6 months, given the potential supply challenges ahead."

FIONA TRIGONA
HEAD OF FUNDING AND BALANCE SHEET
NEW SOUTH WALES TREASURY CORPORATION

"The fact we issued A$1.125 billion the previous week gave us confidence that bank balance sheets were very interested in the FRN format. We then had our intermediary banks engage the broader investor community to determine what interest there was in a new 2023 FRN or an increase to our 2024 fixed-rate line."

"We received comprehensive feedback from investors and were confident to issue both the fixed-rate and the floating-rate bond. The market had been more or less dormant for five weeks, so we knew we had to approach it differently. This meant increased engagement with investors before launching the transaction."

DANIEL CHANDLER
DIRECTOR, DEBT CAPITAL MARKETS AND SYNDICATE
WESTPAC INSTITUTIONAL BANK

"The market passed another crucial test with the delivery of [TCorp's] large benchmark-sized transaction. We can confidently say investors are willing participants at the right price point as markets unwind some of the volatility of the past five weeks."

JAMES HAMMERMASTER
DIRECTOR, DEBT CAPITAL MARKETS
COMMONWEALTH BANK OF AUSTRALIA

"The primary market has reopened and the semis have undertaken considerable reverse-enquiry issuance over recent weeks. These are solid building blocks. But more consolidation needs to take place, particularly in the semi sector, before we start to see a return to more normal market patterns."

TRANSACTION ANALYSIS

SSA issuers pick off Kangaroo issuance opportunities

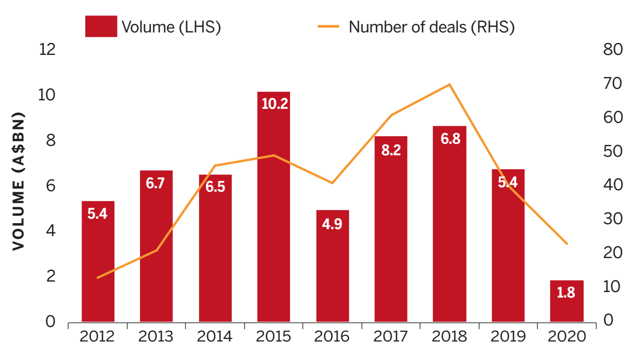
The Australian dollar market went quiet at the start of March as the COVID-19 crisis intensified. Supranational, sovereign and agency (SSA) issuers were the first to return, for a series of small, mid-curve deals (see table).

SSA KANGAROO DEALS, 9-20 MARCH 2020

PRICING DATE	ISSUER	RATING	MATURITY DATE	VOLUME (A$M)	MARGIN (BP/ ACGB)	LEAD MANAGER
9 Mar 20	KfW Bankengruppe	AAA/Aaa	9 Feb 22	100	38/Dec 21	JPM
9 Mar 20	International Finance Corporation	AAA/Aaa	3 Apr 25	75	51.25/Apr 25	TD
10 Mar 20	Asian Development Bank	AAA/Aaa/AAA	9 Mar 22	100	41.75/Jul 22	TD
10 Mar 20	International Finance Corporation	AAA/Aaa	15 Aug 22	100	39.3/Jul 22	ANZ
10 Mar 20	KfW Bankengruppe	AAA/Aaa	27 Feb 25	100	49.25/Apr 25	TD
10 Mar 20	KfW Bankengruppe	AAA/Aaa	6 Jun 22	100	40/Jul 22	JPM
20 Mar 20	KfW Bankengruppe	AAA/Aaa	7 Mar 23	100	60/Apr 23	TD
20 Mar 20	International Finance Corporation	AAA/Aaa	21 Aug 23	150	55.5/Apr 23	TD

The Kangaroo market has experienced lower SSA issuance than usual this calendar year, initially because basis-swap dynamics were creating unfavourable pricing points in Australian dollars and subsequently because of across-the-board market dislocation. Core currency markets have soaked up the majority of SSA supply. KangaNews data show year-to-date SSA issuance in the Australian market of A$1.6 billion (US$983.5 million), much less than the same period in previous years (see chart).

SSA KANGAROO VOLUME, 1 JAN – 20 MAR 2020



SOURCE: KANGANEWS 13 APRIL 2020

TRANSACTION INSIGHTS

YURIY POPOVYCH
DIRECTOR, SYNDICATE
TD SECURITIES

"There was a big pop in the basis swap for the front end of the Australian dollar curve, which made pricing come back in line with global curves. We started the year at 5-7 basis points wide of US dollars but pricing is starting to make sense for SSA borrowers after recent moves."

"When we receive a reverse enquiry in this volatile environment, we go straight to pricing rather than open the books. That is why there have been no bookbuilds: we want to minimise execution uncertainty."

RYAN CHAMBERLAIN
AUSTRALIAN SYNDICATE
J.P. MORGAN

"Given the rally, outright yields are at historic lows, which makes the pick-up SSA paper offers more attractive. A margin of 40 basis points over ACGB looks significantly more attractive when ACGBs are yielding less than 50 basis points than it did when they were yielding 1-2 per cent."

TRANSACTION ANALYSIS

IFC is first Kangaroo mover as COVID-19 raises social bonds' relevance

International Finance Corporation (IFC)'s latest Kangaroo social bond leverages increased recognition of the product's utility in the COVID-19 crisis, the issuer says. It is the first new green, social and sustainability (GSS) bond line established in the Australian dollar market this year.

Social bonds have been slower to pick up momentum in global capital markets than green or sustainability bonds. This is primarily due to social targets being less easily measured than those relating to green assets. However, the COVID-19 pandemic may provide the impetus for more investors to look at social bonds given the product's ability to fund initiatives that can help emerging economies in particular meet health-related economic challenges.

IFC's deal is also the first new public Australian dollar line a supranational, sovereign and agency sector borrower has established in 2020. Prior to volatility from COVID-19, basis swap conditions had made Australian dollar economics unfavourable for offshore borrowers and issuance had been restricted to taps.

Volatility has also paused the momentum the Australian dollar GSS bond market built during 2019. Prior to IFC's deal, the only GSS deals this year had been taps from Asian Development Bank and European Investment Bank.

On 31 March, the International Capital Market Association disclosed that existing guidance under the Social Bond Principles and Sustainability Bond Guidelines is immediately applicable to efforts addressing the COVID-19 crisis. This means issuers do not need to amend documentation to bring a social or sustainability bond to market if its focus is on projects related to the pandemic.

Issuer name: **International Finance Corporation**
Issuer rating: **AAA/Aaa**
Pricing date: **6 April 2020**
Maturity date: **15 April 2035**
Volume: **A$200 million (US$122.9 million)**
Margin: **54bp/s-q swap**
Lead manager: **Daiwa Capital Markets**

TRANSACTION INSIGHTS

MARCIN BILL
SENIOR FINANCIAL OFFICER
INTERNATIONAL FINANCE CORPORATION

"The margin was relatively close to what is achievable in global markets and more favourable than US dollar pricing. We are in a period of pricing recalibration. The tenor and thematic nature of this deal added complexity and we were happy to price at this level."

JAMES HOLIAN
HEAD OF ASIAN SYNDICATE AND MTNs
DAIWA CAPITAL MARKETS

"We have been in discussions with investors about ESG projects for some time and were delighted to find an available window for IFC's new social bond, given the current backdrop."

INTERNATIONAL CAPITAL MARKET ASSOCIATION

"Social bonds finance projects that directly aim to address or mitigate a specific social issue and/or seek to achieve positive social outcomes directed towards a specified target population…The global COVID-19 outbreak is a social issue that threatens the wellbeing of the world's population, especially the elderly and those with underlying health problems."

INTERNATIONAL FINANCE CORPORATION

"As the pandemic is causing far-reaching economic disruption in emerging markets and developing countries, the social-bond market is one avenue through which the public and private sectors could access the critical capital required to meet healthcare needs, restore economic stability and preserve jobs."

TRANSACTION ANALYSIS

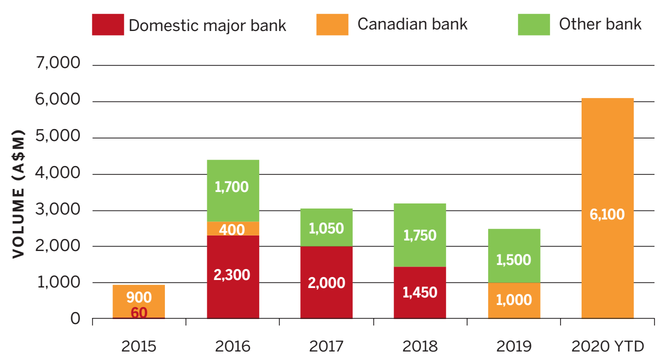
Canadian banks show Australian market is open for low-risk, familiar credit

Four Canadian banks reopened the Australian dollar credit market with covered-bond priced between the end of March and mid-April. Each deal showed signs of market development, although demand remains driven primarily by bank balance sheets even as liquidity gradually improves with central-bank support.

The latter two deals broke the record for the largest Australian dollar covered bond since a dual-tranche Westpac Banking Corporation transaction in 2017. The aggregate volume from the four Canadian syndications brings total Australian dollar covered-bond volume to a record annual total, despite the absence of domestic issuers (see chart 1).

The Australian dollar credit market had been effectively shut since late February, with COVID-19 related volatility making market access impossible. Major banks are typically the issuers to reopen the Australian dollar market. But with the reserve bank stepping in to support local banks' wholesale funding needs through its term funding facility (see p34), this task fell to other issuers.

CHART 1. AUSTRALIAN DOLLAR COVERED BOND VOLUME



SOURCE: KANGANEWS 9 APRIL 2020

Issuer name: **Canadian Imperial Bank of Commerce**
Issuer rating: **A+/Aa2/AA-**
Issue rating: **NR/Aaa/AAA**
Pricing date: **2 April 2020**
Maturity date: **14 April 2023**
Volume: **A$600 million (US$368.8 million)**
Margin: **125bp/3m BBSW**
Margin at launch: **125bp/3m BBSW**
Geographic distribution: **see chart 2**
Distribution by investor type: **see chart 3**
Lead managers: **CIBC Capital Markets, HSBC, National Australia Bank (NAB), Westpac Institutional Bank**

★

Issuer name: **TD Bank**
Issuer rating: **AA-/Aa1**
Issue rating: **Aaa**
Pricing date: **3 April 2020**
Maturity date: **14 April 2023**
Volume: **A$1.25 billion**
Margin: **125bp/3m BBSW**
Margin at launch: **125bp/3m BBSW**
Geographic distribution: **see chart 2**
Distribution by investor type: **See chart 3**
Lead managers: **ANZ, CommBank, NAB, TD Securities, Westpac**

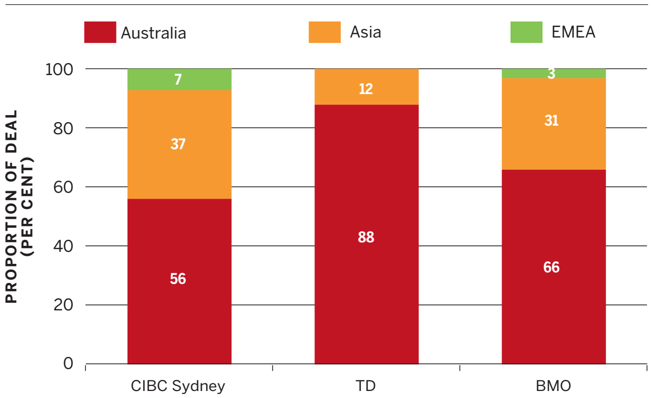
★

Issuer name: **Bank of Montreal**
Issuer rating: **A+/Aa2/AA-**
Issue rating: **NR/Aaa/AAA**
Pricing date: **8 April 2020**
Maturity date: **17 April 2023**
Volume: **A$2 billion**
Margin: **120bp/3m BBSW**
Margin at launch: **125bp/3m BBSW**
Geographic distribution: **see chart 2**
Distribution by investor type: **see chart 3**
Lead managers: **BMO Capital Markets, CommBank, NAB, UBS, Westpac**

★

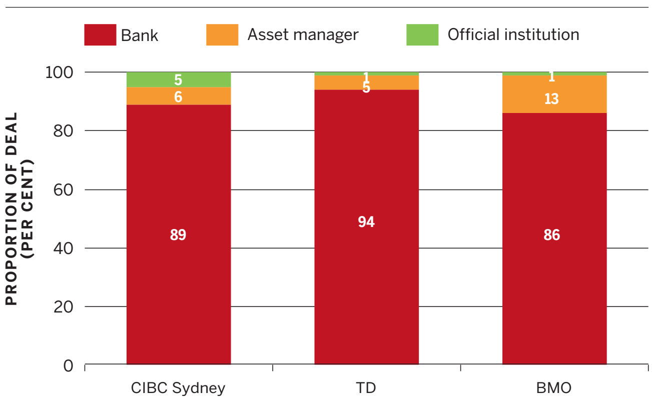
Issuer name: **Royal Bank of Canada Sydney Branch**
Issuer rating: **AA-/Aa2/AA+**
Issue rating: **NR/Aaa/AAA**
Pricing date: **15 April 2020**
Maturity date: **24 April 2023**
Volume: **A$2.25 billion**
Margin: **100bp/3m BBSW**
Margin at launch: **100bp/3m BBSW**
Lead managers: **ANZ, CommBank, NAB, RBC Capital Markets, Westpac**

CHART 2. CANADIAN BANK COVERED BOND DEALS GEOGRAPHIC DISTRIBUTION



SOURCE: NATIONAL AUSTRALIA BANK 9 APRIL 2020

CHART 3. CANADIAN BANK COVERED BONDS DISTRIBUTION BY INVESTOR TYPE



SOURCE: NATIONAL AUSTRALIA BANK 9 APRIL 2020

TRANSACTION INSIGHTS

WOJTEK NIEBRZYDOWSKI
VICE PRESIDENT, TREASURY
CANADIAN IMPERIAL BANK OF COMMERCE

"Being a known, highly rated issuer from a strong jurisdiction, combined with indications of interest, made this transaction feasible."

"We were able to use global guidance to initiate Australian dollar price discovery. Price indications are typically arrived at in Australian dollar equivalent from secondary levels in other currencies."

BROOKE HALES
ASSOCIATE VICE PRESIDENT
TD BANK

"While we traditionally focus on domestic pricing to determine an appropriate level for an Australian dollar transaction, the lack of primary issuance meant investors were focused on global comparable deals. Specifically, TD Bank's US$1.25 billion three-year covered bond executed on 27 March."

RICHARD COYNE
DIRECTOR, DEBT SYNDICATE
NATIONAL AUSTRALIA BANK

"The Canadian bank complex is strong, well capitalised and familiar to the Australian dollar market. The execution of a low-risk product – covered bonds – from these issuers was an appropriate way for the Australian dollar credit market to reopen."

"In the near term, Australian dollar issuance is likely constrained to low-risk transactions from familiar names. Issuers that can offer covered bonds will likely be in vogue."

TRANSACTION ANALYSIS

AOFM's presence alongside supportive investors boosts Firstmac RMBS

The swift entry of the Australian Office of Financial Management (AOFM) into the local securitisation market added confidence to Firstmac's return to new issuance and facilitated an upsized transaction. The issuer says it also retained third-party investor engagement from before the COVID-19 related shutdown of new issuance in Australia.

Firstmac printed A$1 billion (US$614.7 million) in a new prime residential mortgage-backed securities (RMBS) transaction on 27 March (see table). Firstmac Mortgage Funding Trust No. 4 Series 1-2020 had J.P. Morgan as arranger and ANZ, National Australia Bank and Westpac Institutional Bank as additional lead managers.

The AOFM bought A$189.14 million across the transaction structure, including the entire A$70 million A2 note. It was a price taker in the other five tranches it supported and states it "has not crowded out other investors".

James Austin, chief financial officer at Firstmac in Brisbane, says without the AOFM's supporting bid the transaction would have been smaller and securing government investment added to confidence around the new issue.

The AOFM's presence as an RMBS buyer evolved quickly. The Australian federal government announced the AOFM programme on 19 March and new legislation governing it came into effect on 24 March (see p34).

"The AOFM indicated that its first order of business would be to assist deals that were already under way but struggling," Austin explains. "Ours had been in the market for six weeks and we had been in discussion with a number of cornerstone investors for some time. We have strong relationships with our investors and this allowed us to resume the deal process – assisted by the confidence the AOFM brought."

Third-party investors bought more than four-fifths of total deal volume and Austin reveals there was participation from accounts in Australia, the UK and Asia. He adds that the Australian component of the book exclusively comprised real-money investors.

KangaNews understands the AOFM approached the Firstmac transaction as one that already had significant interest and, therefore, needed gaps plugged rather than cornerstone support.

Based on this, subsequent AOFM investments in securitisation may account for greater proportions of total deal structures. The purpose of the investment programme is to have a multiplier effect on the private-sector bid but the AOFM appears to be working under the principle that it may have to do more of the heavy lifting.

FIRSTMAC MORTGAGE FUNDING TRUST NO. 4 SERIES 1-2020 DEAL STRUCTURE

TRANCHE	RATING (S&P/ FITCH)	WAL (YEARS)	CREDIT ENHANCEMENT (PER CENT)	VOLUME (A$M)	LAUNCH VOLUME (A$M)	MARGIN (BP/1M BBSW)	AOFM SUPPORT
A-1	AAA/AAA	3.2	15.00	850	748	120	Y
A-2	AAA/AAA	4.4	8.00	70	61.6	75	Full tranche
AB	AAA (S&P)	5.6	4.50	35	30.8	275	Y
B	AA	5.6	3.00	15	13.2	325	Y
C	A	5.6	1.75	12.5	11	400	Y
D	BBB	5.6	1.00	7.5	6.6	500	Y
E	BB	5.6	0.59	4.09	3.6	700	N
F	NR	5.6	N/A	5.91	5.2	ND	N

SOURCE: AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT, J.P. MORGAN 27 MARCH 2020

HARDSHIP CONSEQUENCES

By tightening the margin on the A2 notes, the AOFM facilitated extra margin elsewhere in the trade, thus supporting Firstmac and providing other investors with a buffer against weaker loan quality.

Execution came despite uncertainty about the impact of the COVID-19 economic fallout on structured-finance trusts (see p30). Market participants are scrambling to calculate the impact of financial stress – and, potentially, mortgage holidays – on special-purpose vehicle (SPV) cash flows.

Austin says a team of eight within the Firstmac treasury department has been working on the book data and modelling SPV liquidity outcomes, and the firm hoped to have a clearer picture of its book by early April. The consequences have been manageable to date.

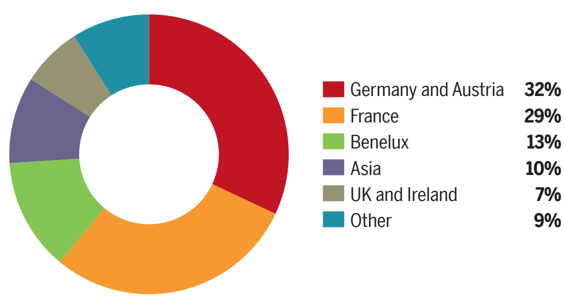
"The impact has been quick but not huge so far: we had A$65 million of loans in hardship – all the result of COVID-19 – by 25 March, which is not, of itself, concerning in a book of A$13 billion," Austin reveals. "We are aware the scale of the problem will grow. Our job is to keep modelling and analysing the data, and making the correct management decisions on a timely basis."

Austin also highlights the fact that a loan in hardship may still have payments being made on it. More than half Firstmac's hardship book is still making 50 per cent mortgage payments. •

Transurban shows familiar Australian corporates can achieve euro success

Transurban's euro transaction on 1 April marked the first time an Australian corporate has waded into public debt capital markets since the onset of the COVID-19 crisis. Deal sources say offshore liquidity has been strong but it took an issuer familiar to the market to take advantage.

TRANSURBAN DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: BNP PARIBAS 6 APRIL 2020

Issuer name: **Transurban Finance**
Issuer rating: **BBB+/Baa1/A-**
Pricing date: **1 April 2020**
Maturity date: **8 April 2030**
Volume: **€600 million (US$665 million)**
Book peak volume: **€1.3 billion**
Margin: **310bp/mid-swap**
Indicative margin: **325bp/mid-swap**
Number of investors: **>60**
Geographic distribution: **see chart**
Distribution by investor type: **63% asset manager, 35% insurance/pension fund, 2% official institution**
Lead managers: **BNP Paribas, BofA Securities, Citi, MUFG Securities**

TRANSACTION INSIGHTS

KATE STEWART
MANAGING DIRECTOR AND HEAD OF DEBT CAPITAL MARKETS
BNP PARIBAS

"In Europe, new-issue concessions have become more differentiated between corporate-sector purchase programme-eligible deals and ineligible names, sectors and credit ratings."

MATTHEW CARR
HEAD OF DEBT CAPITAL MARKETS, AUSTRALIA AND NEW ZEALAND
MUFG SECURITIES

"Bookbuilds have been extended to accommodate the logistical challenges of everyone working remotely. But the volumes being printed suggest investors are comfortable."

OLLIE WILLIAMS
DIRECTOR, DEBT CAPITAL MARKETS ORIGINATION
CITI

"Transurban's familiarity and well-established euro investor franchise eliminated the need for a roadshow. Thus it could minimise exposure to market volatility by executing the deal intraday."

CHAD KARPES
MANAGING DIRECTOR AND HEAD OF AUSTRALIAN DEBT CAPITAL MARKETS AND SYNDICATE
BofA SECURITIES

"While markets are generally still volatile, European and US investment-grade credit markets have continued to demonstrate depth and liquidity in abundance. There was close to €40 billion of corporate and financial institution supply in Europe [the week ahead of the Transurban deal], so access and liquidity are available."

ISSUER INSIGHTS

NZDM talks strategy following return to primary market

New Zealand Debt Management (NZDM) faces a mountain of issuance in the coming months despite a NZ$3.5 billion (US$2.1 billion) May 2031 syndicated transaction printed on 7 April. The sovereign debt-management agency speaks to *KangaNews* about its strategy in the wake of the new transaction.

On 1 April, New Zealand Debt Management (NZDM) increased the New Zealand government bond (NZGB) programme to NZ$25 billion for the 2019/20 financial year. This is an increase of NZ$12 billion from the update given on 17 March and is NZ$15 billion more than forecast following the New Zealand government's half-year economic and fiscal update on 11 December 2019.

The 17 March update came shortly before the New Zealand federal government's NZ$12.1 billion COVID-19 stimulus package announcement. The immediate impact is that NZDM will have to raise an unprecedented NZ$17 billion in the June quarter.

The latest NZDM deal launched with indicative price guidance at 32-37 basis points area over the April 2029 NZGB. It ultimately priced at the tight end of guidance, though 5 basis points wide of pre-launch secondary levels. As has been the case with deals brought to Australasian markets recently, the leads undertook a significant amount of investor engagement to establish fair value.

Dean Spicer, head of capital markets at ANZ in Wellington, explains: "We needed a wider price guidance than what we would normally see for a sovereign debt transaction. It allowed the book to build strongly which in turn allowed the deal ultimately to price at the tight end of guidance."

Issuer name: **New Zealand Debt Management**
Issuer rating: **AA+/Aaa/AA+**
Pricing date: **7 April 2020**
Maturity date: **15 May 2031**
Volume: **NZ$3.5 billion (US$2.1 billion)**
Orderbook: **~NZ$5 billion**
Number of investors: **50**
Coupon rate: **1.5%**
Margin to NZGB: **32bp/April 2029**
Margin at launch: **32-37bp/April 2029**
Geographic distribution: **Australasia 56%, rest of world 44%**
Lead managers: **ANZ, BNZ, Commonwealth Bank of Australia, UBS**

MATTHEW COLLIN
HEAD OF PORTFOLIO MANAGEMENT
NEW ZEALAND DEBT MANAGEMENT

How important has the Reserve Bank of New Zealand (RBNZ)'s intervention in the secondary market been in providing the confidence to execute a public, syndicated deal? How closely is NZDM working with the RBNZ?

The RBNZ has provided a couple of meaningful interventions in the NZGB market recently. The first was to provide liquidity support for the interbank market by transacting in market parcels to generate more price discovery and transparency in the secondary market. The second was undertaking large-scale asset purchases (LSAP) of NZGBs to meet monetary-policy objectives by conducting repurchase tenders several times a week.

This has created a lot more stability in the market and reduced our issuance premia relative to what we saw a few weeks ago. All markets globally started showing signs of stress and dysfunction as investors grappled with the potential sovereign supply resulting from the economic impacts of, as well as the anticipated fiscal response to, the COVID-19 pandemic.

There is no doubt the improved market function that resulted from the RBNZ activity gave us the confidence to launch a large syndicated transaction.

We have a very good working relationship with the RBNZ and we are both committed to ensuring the NZGB market functions as efficiently as possible. At the same time, we need to recognise and respect boundaries related to independence. The Treasury has a significant borrowing requirement to meet, while the RBNZ needs to think about monetary policy and resolving any issues around market function that may have second derivate impacts on this primary objective.

It is also worth recognising that the impacts of, and responses to, COVID-19, are rapidly evolving. These are extraordinary times and decisions need to be made and implemented under significant time pressure. I think NZDM and the RBNZ are both doing our best to support market function by providing as much clarity and transparency as possible in pursuit of our objectives.

Final pricing on the new deal was 5 basis points wider than secondary. How did you go about establishing a fair new-issue premium?
We obviously did a lot of work internally and had many discussions with the syndicate regarding fair value for this transaction and what premium we thought might be appropriate given the global backdrop.

Again, these are extraordinary times, and recent new issues have been attracting significant premia. It would have been naïve for us to ignore this in the current environment.

We were also happy to print a bigger ticket this time than for previous transactions, which naturally comes at a greater cost. We were also mindful that we have a large funding task to complete: issuance is now, more than ever, a repeat game for us. We wanted to ensure we arrived at price guidance that struck the right balance between attracting as much interest and participation in our market as possible while optimising long-term borrowing costs for the Crown and New Zealand taxpayers.

We were comfortable with where we landed and essentially let the market tell us what concession was needed. It was pleasing that we ended up at the lower end of this range, which according to our analysis is consistent with the 5 basis points you mention. We think this is appropriate given the global backdrop, the uncertainty investors are facing and the volume we were able to get away.

"Pleasingly, we saw significant interest in this transaction from global real-money investors, both longstanding, good-quality names in our market and some new participants."
MATTHEW COLLIN NEW ZEALAND DEBT MANAGEMENT

The deal was upsized to NZ$3.5 billion. Was the final size the maximum amount you were looking for?
To be honest we didn't have a firm view on maximum size. This is why we stated we expected to issue "at least" NZ$2 billion at transaction launch.

This was a tough one for us. We conduct issuance activities using our core principles of transparency, even-handedness and consistency – so we felt it important to provide the market as much transparency and certainty of total supply for this transaction as possible while giving ourselves flexibility to capture upside demand if it was there.

We are comfortable we ended up with the right outcome by keeping the market informed of how the book was evolving throughout the transaction and by capping the size prior to closing the book.

Why was the 2031 maturity targeted?
We felt coming to market with a syndicated tap was the best approach. Issuing into an existing bond, with a sufficient amount already outstanding and a transparent secondary market price point, simplified the transaction for us and investors alike. The 2031 was chosen as we had a lot of capacity to issue into this bond and it is effectively our current on-the-run 10-year bond.

How much engagement did you have with investors in particular around NZDM's much larger issuance task?
Unfortunately, due to time constraints and the need to come to market in a short space of time, we were not able to engage with investors as completely as we might have liked to. We did however consult with our trusted set of intermediaries, who conveyed thoughts and views around market function, investor demand and preferences, and execution options.

These considerations were all taken into account when formulating our issuance strategy, including the syndicated tap of the 2031s. We have tried to be open and transparent with the market around our funding requirement while acknowledging the uncertain environment we are all in and accepting there are some unknowns out there.

I think investors recognise and understand the position we are in. But at the same time they appreciate being provided with as much certainty as possible – again, I think this approach played a significant role in the success of this transaction.

Were you surprised by the level of offshore interest in the deal? Also, did NZDM find a buyer base beyond the bank sector?
The only statistic we release publicly is Australasia – at 56 per cent – versus the rest of the word, which was very similar to the original issue of the 2031s. I won't go into specifics of account types and geographies beyond saying the breakdown was quite interesting.

Our prior assumption was that we might see more bank trading and hedge-fund interest in this transaction and less demand from real-money accounts. This was on the basis that a lot of bonds was being repurchased by the RBNZ as part of its LSAP programme and we had the sense that New Zealand wasn't top of mind for global investors currently, given global market volatility and the impact it is having on other parts of their portfolios.

Pleasingly, though, we saw significant interest in this transaction from global real-money investors, both longstanding, good-quality names in our market and some new participants.

This was in part a function of NZGBs offering good value relative to other sovereign markets. But in our view it was also driven by an appreciation of our strong balance-sheet position and low level of debt. We believe the strength and breadth of interest in the transaction represents a clear endorsement of the New Zealand government's fiscal and funding approach, as well as our ongoing commitment to market transparency. •

TRANSACTION ANALYSIS

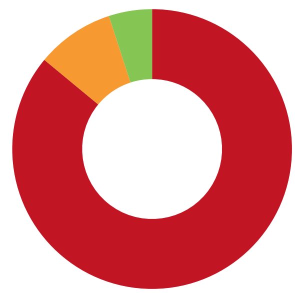
LGFA says its latest deal demonstrates improving demand in New Zealand

New Zealand Local Government Funding Agency (LGFA) is confident domestic market conditions are improving, supported by an expanded central-bank asset-purchase programme. The issuer says its latest transaction is an encouraging sign the market will have capacity for increased supply from New Zealand's semi-government borrowers.

LGFA has historically priced at a relatively consistent spread to NZGBs, of about 50 basis points for the 2025 and 2027 maturities. The spread widened in early March and, while it has crept back in since the RBNZ announced unconventional monetary policy measures, it was not back at pre-crisis levels by mid-April.

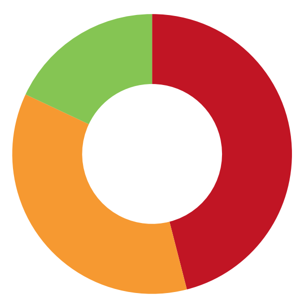
Issuer name: **New Zealand Local Government Funding Agency**
Issuer rating: **AA+/AA+**
Pricing date: **9 April 2020**
Maturity date: **15 April 2026**
Volume: **NZ$1.1 billion (US$663.7 million)**
Launch volume: **NZ$300 million**
Final book volume: **NZ$1.3 billion**
Margin: **78bp/mid-swap**
Margin at launch: **78-83bp/mid-swap**
Geographic distribution: **see chart 1**
Distribution by investor type: s**ee chart 2**
Lead managers: **ANZ, BNZ, Commonwealth Bank, Westpac Banking Corporation New Zealand Branch**

CHART 1. LGFA DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY 15 APRIL 2020

CHART 2. LGFA DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY 15 APRIL 2020

TRANSACTION INSIGHTS

MARK BUTCHER
CHIEF EXECUTIVE
NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY

"New Zealand dollar bonds have become cheap relative to other markets – particularly the US and Australia – but there are also a lot of other relatively cheap markets now. We also received feedback that the tenor was not long enough for many offshore investors. This was the same for our 2024 syndication from 2019."

"Asset purchases have made New Zealand's capital markets more functional by increasing liquidity and creating downward pressure on spreads and yields, resulting in lower borrowing costs. The extension of the programme to the LGFA is positive not just for the issuer but also for the wider market."

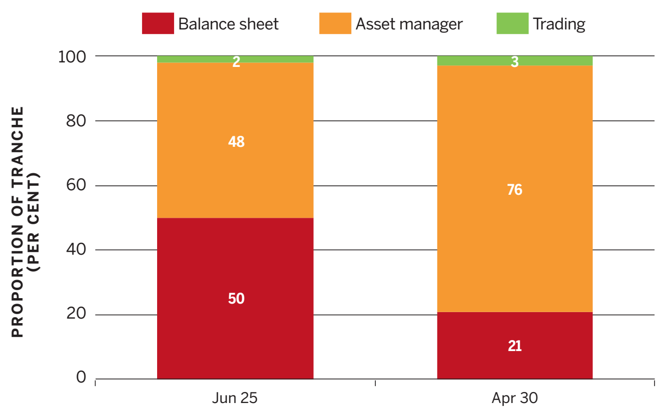
Kāinga Ora rides market support to blockbuster deal

Kāinga Ora – Homes and Communities has become the first New Zealand issuer without direct secondary support from the central bank to print a primary deal in New Zealand since the COVID-19 crisis began. The issuer says demand for the 17 April transaction outstripped expectations, particularly at 10-year tenor.

Issuer name: **Kāinga Ora – Homes and Communities**
Issuer rating: **AA+/Aaa**
Pricing date: **17 April 2020**
Maturity date: **12 June 2025 & 24 April 2030**
Volume: **NZ$500 million (US$301.7 million) & NZ$500 million**
Launch volume: **NZ$100 million & NZ$100 million**
Final book volume: **More than NZ$1 billion & more than NZ$900 million**
Margin: **75bp/mid-swap & 125bp/mid-swap**
Margin at launch: **75-80bp/mid-swap & 125-130bp/mid-swap**
Deal distribution by investor type: **see chart 1**
Lead managers: **ANZ, BNZ, Commonwealth Bank, UBS, Westpac Banking Corporation New Zealand Branch**

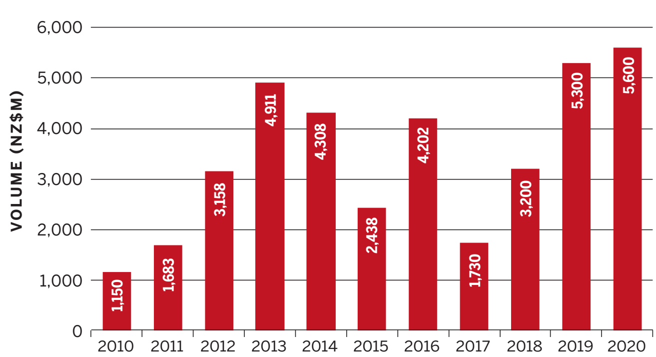
Combining the NZDM, LGFA and Kāinga Ora deals priced 7-17 April, 2020 is already the largest-ever year for New Zealand dollar government sector supply by syndication (see chart 2).

CHART 1. KĀINGA ORA DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: KĀINGA ORA – HOMES AND COMMUNITIES 20 APRIL 2020

CHART 2. NEW ZEALAND DOLLAR GOVERNMENT-SECTOR SYNDICATED ISSUANCE



SOURCE: KANGANEWS 20 APRIL 2020

TRANSACTION INSIGHTS

SAM DIREEN
TREASURER
KĀINGA ORA – HOMES AND COMMUNITIES

"This deal is a game changer for us. We could not afford to have a deal at this time that was not outstanding so we have been working hard to keep our finger on the pulse and the information flowing between ourselves, intermediaries and investors."

"We had 15 new investors in the transaction, many of whom we have met with over the past six months."

"We would welcome inclusion in the LSAP, or even small-scale purchases, but respect that the RBNZ is going through a process. We know it is doing what it deems is best to help the market function and we are engaging with it at multiple levels in the organisation."

COVID-19 timeline

COVID-19 and its economic and market impacts evolved at a dizzying pace through the first quarter of 2020. *KangaNews* plots the key developments with a focus on those most relevant to Australian and New Zealand debt capital markets.

BY CHRIS RICH

Pandemic and political developments / Economic and market developments

15 April 2020

Global cases hit **2 million**.

AOFM prints **A$13 billion** November 2024 syndicated treasury bond.

14 April 2020

US President, **Donald Trump**, announces a halt on funding to the WHO while a review is conducted into its handling of the outbreak.

IMF states the global economy as a result of "the great lockdown" is projected to contract sharply, by 3 per cent, in 2020, much worse than during the 2008-9 financial crisis.

"In a baseline scenario, which assumes that the pandemic fades in the second half of 2020 and containment efforts can be gradually unwound, the global economy is projected to grow by 5.8 per cent in 2021 as economic activity normalises, helped by policy support."

12 April 2020

UK death toll passes **10,000**.

UK prime minister, **Boris Johnson**, released from hospital after spending three days in intensive care.

11 April 2020

Global cases pass **1.75 million**, US death toll passes **20,000**.

10 April 2020

Global death toll passes **100,000**, cases in US pass **500,000**.

LGFA prints **NZ$1.1 billion** April 2026 syndicated transaction.

AOFM's SFSF investment adds secondary support and considers forbearance fund.

9 April 2020

Global death toll passes **90,000**.

Fed announces it will provide up to **US$2.3 trillion** in loans to support the economy, including purchases of subinvestment-grade bonds.

8 April 2020

Global cases pass **1.5 million**, Australian cases pass **6,000**.

Death toll in Australia passes **50**.

China lifts lockdown on **Wuhan**.

Asian Development Bank estimates global economic impact of COVID-19 at US$2-4 trillion.

NZDM adds **NZ$3.5 billion** to its May 2031 line via syndication.

Fitch downgrades Australia's big-four banks, to A+.

APRA issues guidance to ADIs and insurers on capital management, seeking to limit discretionary capital distributions in the months ahead, including deferrals or prudent reductions in dividends.

7 April 2020

Global death toll passes **80,000**, cases in US pass **400,000**.

S&P lowers outlook on **Australia**'s **AAA** rating to negative.

"We were happy to print a bigger ticket this time than for previous transactions, which naturally comes at a greater cost. We were also mindful that we have a large funding task to complete: issuance is now, more than ever, a repeat game for us."

MATTHEW COLLIN
NEW ZEALAND DEBT MANAGEMENT

6 April 2020

Global death toll passes **70,000**, US death toll passes **10,000**.

RBNZ announces its intent to purchase LGFA bonds to complement its LSAP programme.

5 April 2020

Global cases pass **1.25 million**, New Zealand passes **1,000**.

UK prime minister, **Boris Johnson**, admitted to hospital for COVID-19 treatment.

RBNZ adds term lending facility for banks to its suite of COVID-19 relief measures. Banks also restricted from redeeming non-CET1 capital instruments.

4 April 2020

Global death toll passes **60,000**, Australia passes **30**.

US cases pass **300,000**.

Moody's revises outlook on Australian banking system to negative.

"On the other side of the crisis, the banks will have weaker loan portfolios [while] at some stage needing to rebuild capital positions that have been allowed to slip for the time being."

FRANK MIRENZI MOODY'S INVESTORS SERVICE

CIBC Sydney Branch prices **A$600 million** three-year covered bond, reopening the Australian dollar credit market.

3 April 2020

New cases hit **100,000** in a day for the first time.

2 April 2020

Global cases pass **1 million**.

Global death toll passes **50,000**.

Australian federal government announces **free childcare for six months**.

TCorp prints **A$3.2 billion** syndicated, dual-tranche deal. It is the first benchmark deal in the Australian public market since the COVID-19 pandemic escalated. The last deal was the same issuer's **A$1 billion** transaction on 27 February.

1 April 2020

Global cases pass **900,000**. Cases in Australia pass **5,000**, cases in US pass **200,000**.

US death toll passes **5,000**.

NZDM increases issuance programme by NZ$12 billion, to **NZ$25 billion**, due to the additional fiscal impact of COVID-19.

Transurban prices **€600 million** transaction, becoming the first Australian corporate to enter public debt capital markets since the onset of the COVID-19 crisis.

31 March 2020

Global cases pass **800,000**.

Global death toll passes **40,000**. Australian death toll passes **20**, US death toll passes **4,000**.

Projections suggest the best-case scenario for deaths in US is **100,000-240,000**.

"A lot of people have said – a lot of people have thought about it. 'Ride it out. Don't do anything, just ride it out and think of it as the flu.' But it's not the flu. It's vicious."

DONALD TRUMP US PRESIDENT

RBNZ introduces corporate facility, providing additional liquidity to the corporate sector.

"Our objective is to encourage banks to continue to fund their corporate clients by purchasing their debt securities, given the confidence that these securities can be funded by exchanging them with us for cash."

CHRISTIAN HAWKESBY
RESERVE BANK OF NEW ZEALAND

30 March 2020

Cases in Australia pass **4,000**.

Australian federal government announces **A$130 billion** wage subsidy programme. Prime minister **Scott Morrison** says: businesses "may go into hibernation and close down for six months".

APRA announces deferral of Basel III reforms in Australia by one year, to January 2023 from January 2022.

29 March 2020

Australian federal government limits social gatherings to two people, places a moratorium on evictions over the next six months for commercial and residential tenancies and announces **A$1.1 billion** healthcare package.

Global cases hit **700,000**, Australia hits **4,000** cases.

28 March 2020

Global death toll passes **30,000**, US death toll passes **2,000**.

Global cases hit **600,000**, New Zealand cases pass **500**.

New Zealand records its **first COVID-19 death**.

27 March 2020

Cases in the US pass **100,000.** It now leads the world in confirmed COVID-19 cases.

Global deaths per day pass **3,000**.

Australian federal government announces all international arrivals must undertake mandatory quarantine for 14 days at designated facilities.

"While the medical advice remains that it is safe for children to go to school, to assist with the transition under way in our schools to the new mode of operation we ask that only children of workers for whom no suitable care arrangements are available at home to support their learning physically attend school."

SCOTT MORRISON AUSTRALIAN PRIME MINISTER

UK prime minister, **Boris Johnson**, diagnosed with COVID-19.

US president, **Donald Trump**, approves **US$2.2 trillion** stimulus package.

AOFM participates in **Firstmac RMBS** transaction to kick off its investment programme.

"Our deal had been in the market for six weeks and we had been in discussions with a number of cornerstone investors for some time. We have strong relationships with our investors and this allowed us to resume the deal process – assisted by the confidence the AOFM brought."

JAMES AUSTIN FIRSTMAC

S&P/ASX 200 gains 7 per cent for the week.

26 March 2020

Cases in Australia pass **3,000**.

Global cases per day pass **60,000**.

Global cases hit **500,000**.

US Senate agrees on **US$2.2 trillion** fiscal stimulus package.

After a full week of QE, the **RBA**'s total asset purchases amount to **A$18 billion**.

"I have been avoiding calling it a crisis but I think we certainly can label it as that now. It is a human health crisis overlayed by an economic crisis and it is threatening to turn into something ugly in financial markets as well."

SHARON ZOLLNER ANZ

"We are now seeing some stabilisation with the Fed throwing the kitchen sink at the US market, and some liquidity is coming back. As an investor, you might not like the price and bid-offer spreads are still large – but a price does exist."

DIANA GORDON
KIWI INVESTMENT MANAGEMENT

25 March 2020

Death toll in Australia hits **10**, US death toll hits **1,000**.

Spain overtakes China with the second-highest tally of coronavirus deaths.

Global death toll passes **20,000**.

New Zealand enters **level four lockdown**.

24 March 2020

Cases in Australia pass **2,000**, cases in US pass **50,000**.

Global deaths per day pass **2,000**.

Global cases hit **400,000**.

23 March 2020

Australian federal government announces further restrictions on social gatherings. "The point and the principle are very clear – large gatherings brought together by organised events are things that we are seeking to avoid."

SCOTT MORRISON AUSTRALIAN PRIME MINISTER

US Senate fails for a second time to pass a **US$1.8 trillion** coronavirus rescue package.

"Our plan is simple. We can stop the spread by staying at home and reducing contact. Now is the time to act. Effective immediately, we will move to alert level three nationwide. After 48 hours...we will move to level four."

JACINDA ARDERN NEW ZEALAND PRIME MINISTER

Global cases per day pass **40,000**, US deaths hit **500**.

New Zealand moves to **level three lockdown** and flags level four lockdown will come into effect in 48 hours.

Australian federal government passes the *Structured Finance Support (Coronavirus Economic Response Package) Act 2020*, establishing the Structured Finance Support (Coronavirus Economic Response) Fund.

RBNZ announces **NZ$30 billion** NZGB buying programme.

Fed announces **US QE programme**.

"We are not sure how much the RBA will do going forward, or how often, but it has established some credibility with this strong start. It is clearly committed to the 0.25 per cent target at three years and is prepared to step in further out on the curve when markets are volatile and dysfunctional."

BILL EVANS WESTPAC BANKING CORPORATION

22 March 2020

Australian federal government introduces more widespread restrictions on social gatherings.

Australian federal government announces second stimulus package of **A$66.1 billion**, bringing the total injected into the economy by all arms of government to **A$189 billion**.

Cases in New Zealand pass **100**.

21 March 2020

Global cases hit **300,000**.

Cases in Australia pass **1,000**.

20 March 2020

Italy's death toll passes China's, with **3,405** dead.

Australian federal government postpones annual May budget to 6 October 2020.

IFC issues **US$1 billion social bond** to support countries affected by COVID-19, the first such issuance in global markets.

RBNZ introduces term funding measures to support short-term liquidity.

S&P/ASX 200 gains 0.5 per cent for the week.

19 March 2020

Australian federal government closes its borders to all noncitizens and nonresidents.

Global death toll passes **10,000**.

Global deaths per day pass **1,000**.

Cases in US pass **10,000**.

Qantas, **Jetstar** and **Virgin Australia** announce suspension of all international flights.

Australian federal government announces **A$15 billion** programme to support SME lending.

RBA cuts the cash rate to 0.25 per cent, announces ACGB buying programme and a **A$90 billion** term funding facility for the financial system.

"The reserve bank board did not take these decisions lightly. But in the context of extraordinary times and consistent with our broad mandate to promote the economic welfare of the people of Australia, we are seeking to play our full role in building that bridge to the time when the recovery takes place."

PHILIP LOWE RESERVE BANK OF AUSTRALIA

APRA provides temporary relief to banks by relaxing expectations on bank capital ratios.

Fed announces the establishment of temporary US dollar liquidity arrangements with other central banks, including RBA and RBNZ.

18 March 2020

Australian federal government no longer permits nonessential indoor gatherings of more than **100 people**.

New global cases per day pass **20,000**.

RBNZ defers standard terms for residential mortgage obligations and other regulatory initiatives.

"In such uncertain times, it is important that firms have as much capacity as possible to deal with critical problems as they arise. So it makes sense for regulators to free up financial institutions to focus on matters such as helping customers through financial or other stress, or increasing their degree of monitoring and managing their own most urgent risks."

GEOFF BASCAND
RESERVE BANK OF NEW ZEALAND

Fed broadens programme of support for the flow of credit to households and businesses by establishing a Money Market Mutual Fund Liquidity Facility.

17 March 2020

New Zealand government announces NZ$12.1 billion fiscal stimulus package – equivalent to 4 per cent of its GDP. **Grant Robertson**, finance minister, says the package "is one of the largest in the world on a per capita basis".

Cases from outside China surpass those in China.

Italy reports **475 COVID-19 deaths**, the highest single-day death toll for any country since the outbreak began.

Fed announces a commercial paper funding facility and a primary dealer credit facility to support the flow of credit to households and businesses.

16 March 2020

Infections and deaths outside China exceed Chinese total for the first time.

International arrivals to Australia required to **self-isolate for 14 days**.

"If you're talking about the virus, no, that's not under control for any place in the world."

DONALD TRUMP US PRESIDENT

RBNZ cuts OCR by 75 basis points to **0.25 per cent** and delays implementation of new capital standards for banks by 12 months.

"We will watch to see how the government's fiscal package works, as well as how the COVID-19 crisis unfolds… If there is a significant increase in domestic cases, this will change the situation."

ADRIAN ORR RESERVE BANK OF NEW ZEALAND

Statement by the **Council of Financial Regulators** assuring the market that Australian policymakers and regulators are working together closely.

RBA says it may buy government bonds in the secondary market.

"The reserve bank stands ready to purchase Australian government bonds in the secondary market to support the smooth functioning of that market, which is a key pricing benchmark for the Australian financial system."

PHILIP LOWE RESERVE BANK OF AUSTRALIA

S&P/ASX 200 falls 9.7 per cent in a day.

S&P 500 falls 12 per cent, its largest daily drop since the Great Depression.

15 March 2020

Death toll in Australia hits **five**.

New Zealand government announces that its borders will close to all noncitizens and nonresidents on 19 March.

"This is a very contagious virus. It's incredible. But it's something that we have tremendous control over."

DONALD TRUMP US PRESIDENT

Fed funds rate cut to **0-25 basis points band** and **Fed** announces at least **US$700 billion** of bond purchases across US Treasuries and mortgage-backed securities, as well as actions to support the flow of credit to households and businesses.

14 March 2020

Spain enters full lockdown.

13 March 2020

Australian federal government advises against nonessential, organised public gatherings of more than **500 people**, starting 15 March.

"Well, I do still plan to go to the football on Saturday as I said, because this is an arrangement we're putting in place for next week as a precaution. This is an early-stage action that we're undertaking to make sure we get ahead of this. And I would be going along on Saturday because I had previously planned to."

SCOTT MORRISON AUSTRALIAN PRIME MINISTER

US president, **Donald Trump**, declares a national emergency.

Australian minister for home affairs, **Peter Dutton**, diagnosed with COVID-19.

S&P/ASX 200 falls 13.1 per cent for the week.

S&P 500 rises 9.3 per cent for the day.

"Fitch expects hardship applications to increase in Australian RMBS, especially from self-employed or contractor borrowers, those who work for SMEs and those in sectors the COVID-19 outbreak more directly affects, such as travel, tourism and hospitality."

NATASHA VOJVODIC FITCH RATINGS

12 March 2020

Australian federal government announces stimulus package of **A$17.6 billion**.

"This plan is about keeping Australians in jobs. This plan is about keeping a business in business, particularly small and medium-sized businesses, and this plan is about ensuring the Australian economy bounces back stronger on the other side of it, and with that, the budget bounces back with it."

SCOTT MORRISON AUSTRALIAN PRIME MINISTER

S&P 500 falls 9.5 per cent on the day.

"If assets are less volatile because they simply stop trading, this can help keep things from getting out of hand. Less volatility reduces the risk of panic, which should reduce redemptions from funds, allowing managers to maintain positions without having to liquidate."

DAVID MCLEISH FISHER FUNDS MANAGEMENT

11 March 2020

WHO classifies COVID-19 as a pandemic.

"We have never before seen a pandemic sparked by a coronavirus. This is the first pandemic caused by a coronavirus. And we have never before seen a pandemic that can be controlled."

TEDROS ADHANOM GHEBREYESUS WHO

"Lower interest rates will provide more disposable income to the household sector and those businesses with debt. They may not spend it straight away, but it brings forward the day when they will be comfortable with their balance sheets and resume a normal pattern of spending."

GUY DEBELLE RESERVE BANK OF AUSTRALIA

10 March 2020

Australian federal government announces **A$2.4 billion** health plan to fight COVID-19.

Cases in US pass **1,000**.

RBNZ launches its principles on using unconventional monetary policy.

"We need to be considered and realistic as to how effective any potential change in the level of the OCR will be in buffering the New Zealand economy from shocks such as a lack of rainfall and the onset of a virus."

ADRIAN ORR RESERVE BANK OF NEW ZEALAND

9 March 2020

"So last year, 37,000 Americans died from the common flu. It averages between 27,000 and 70,000 per year. Nothing is shut down, life and the economy go on. At this moment, there are 546 confirmed cases of coronavirus, with 22 deaths. Think about that!"

DONALD TRUMP US PRESIDENT

S&P/ASX 200 falls 7.4 per cent on the day.

S&P 500 falls 7.6 per cent on the day.

8 March 2020

Italy places all citizens under **lockdown**.

Saudi Arabia begins oil price war after the collapse of a deal with **Russia**.

6 March 2020

Australian federal government commits to 50-50 shared health funding deal with the states and territories to deal with the COVID-19 outbreak.

New global cases per day pass **20,000**.

S&P/ASX 200 falls 10.9 per cent for the week.

5 March 2020

Foreign nationals entering from South Korea will not be allowed to enter Australia.

3 March 2020

RBA cuts cash rate to **0.50 per cent** from 0.75 per cent.

"The global outbreak of the coronavirus is expected to delay progress in Australia towards full employment and the inflation target. The [RBA] board therefore judged that it was appropriate to ease monetary policy further to provide additional support to employment and economic activity."

PHILIP LOWE RESERVE BANK OF AUSTRALIA

2 March 2020

New Zealand records its **first COVID-19** case.

1 March 2020

Foreign nationals entering from Iran banned from entering Australia. A Perth man rescued from the *Diamond Princess* cruise ship becomes Australia's first fatality.

29 Feb 2020

US records its **first COVID-19** death.

28 Feb 2020

"This is their new hoax."

DONALD TRUMP US PRESIDENT

Columbus Capital prints **A$1 billion RMBS** transaction.

"Despite our concerns about increased market volatility and where spreads might be heading, we decided to continue with the transaction. The decision was correct because, during that week, pricing moved out on one tranche."

DAVID CARROLL COLUMBUS CAPITAL

27 Feb 2020

"It's going to disappear. One day – it's like a miracle – it will disappear."

DONALD TRUMP US PRESIDENT

26 Feb 2020

"It's a little like the regular flu that we have flu shots for. And we'll essentially have a flu shot for this in a fairly quick manner."

DONALD TRUMP US PRESIDENT

21 Feb 2020

WHO expresses concern about COVID-19 spread in **Iran**, which reports 18 new cases and four deaths in two days.

20 Feb 2020

WHO renames novel coronavirus disease **COVID-19**.

"Having a name matters to prevent the use of other names that can be inaccurate or stigmatising. It also gives us a standard format to use for any future coronavirus outbreaks."

TEDROS ADHANOM GHEBREYESUS
WORLD HEALTH ORGANIZATION

ASX 200 reaches its highest mark ever, at 7,162 points.

19 Feb 2020

S&P 500 reaches all-time record high.

11 Feb 2020

Global death toll passes **1,000**.

9 Feb 2020

Death toll in China surpasses that of the 2002-3 SARS outbreak, with 811 fatalities recorded.

7 Feb 2020

Chinese whistleblower **Li Wenliang** dies.

6 Feb 2020

Date of **possible first COVID-19 death in the US** (confirmed in April), suggesting community transmission began as early as mid-January.

4 Feb 2020

RBA keeps the cash rate on hold at 0.75 per cent.

"Global growth is expected to be a little stronger this year and next than it was last year and inflation remains low almost everywhere. One continuing source of uncertainty, despite recent progress, is the trade and technology dispute between the US and China, which has affected international trade flows and investment. Another source of uncertainty is the coronavirus, which is having a significant effect on the Chinese economy at present. It is too early to determine how long-lasting the impact will be."

PHILIP LOWE RESERVE BANK OF AUSTRALIA

3 Feb 2020

More than **200 Australians** evacuated on Qantas flight from Wuhan to be quarantined on Christmas Island for 14 days.

2 Feb 2020

First COVID-19 death outside of China is recorded, in the Philippines.

1 Feb 2020

Australia announces a 14-day quarantine period for non-Australian citizens arriving from China.

30 Jan 2020

WHO declares outbreak a "public health emergency of international concern".

"The main reason for this declaration is not because of what is happening in China, but because of what is happening in other countries. Our greatest concern is the potential for the virus to spread to countries with weaker health systems, which are ill-prepared to deal with it."

TEDROS ADHANOM GHEBREYESUS WHO

25 Jan 2020

Australia records its first case of novel coronavirus.

Australia's Department of Foreign Affairs and Trade raises Wuhan alert level to "do not travel".

23 Jan 2020

Singapore announces first imported case.

Wuhan is placed under quarantine.

"The emergency committee was divided over whether the outbreak of novel coronavirus represents a PHEIC [public health emergency of international concern] or not. Make no mistake. This is an emergency in China, but it has not yet become a global health emergency. It may yet become one."

TEDROS ADHANOM GHEBREYESUS
WORLD HEALTH ORGANIZATION

13 Jan 2020

First case of novel coronavirus outside China recorded, in Thailand.

11 Jan 2020

China records its **first death.**

10 Jan 2020

WHO issues its first guidance on the novel coronavirus.

8 Jan 2020

World Bank expects global growth to rise 2.5 per cent in 2020, a small uptick from 2.4 per cent in 2019.

"Following its weakest performance since the global financial crisis, the world economy is poised for a modest rebound this year – if everything goes just right."

5 Jan 2020

WHO reports on **pneumonia** of unknown cause in China.

4 Jan 2020

WHO responds to a cluster of pneumonia cases in **Wuhan.**

31 Dec 2019

Pneumonia of unknown cause in Wuhan, Hubei, reported to **World Health Organization China Office**.

COVID-19 CRISIS

TO SEE ALL *KANGANEWS* COVERAGE, GO TO
bit.ly/KNCOVIDhub
(case sensitive)

Rating the banks' readiness

The Australian banking system should be better set up to deal with the economic consequences of COVID-19 than it was for the 2008-9 financial crisis. Government support and an accommodative regulator will also help. But rating agency commentary and actions underscore that there is no easy way out of an all-encompassing downturn.

BY LAURENCE DAVISON AND MATT ZAUNMAYR

In mid-March – just as the response to the COVID-19 outbreak ramped up – Australia's banks appeared to be well set for funding, after being active in the first six weeks of 2020 particularly in offshore markets. The big four had taken advantage of conducive conditions to raise an aggregate of nearly US$17 billion equivalent across currencies and asset classes. S&P Global Ratings noted that the banks "have significantly completed their wholesale term funding for the financial year".

Furthermore, the major banks' latest pillar-three reporting prior to the crisis suggests their liquidity coverage ratios (LCRs) and net stable-funding ratios (NSFRs) are well above the regulatory minima (see table 1).

Commonwealth Bank of Australia (CommBank)'s Sydney-based head of term funding, Fergus Blackstock, confirms that the bank went into the period of volatility with a strong balance sheet. "There were very good deposit flows into CommBank through last year, which have continued this year. Credit growth was also relatively good, particularly in mortgages, but deposit growth far outpaced credit growth. This limits our need for wholesale term funding."

RELEASING PRESSURE VALVES

COVID-19 creates some obvious areas of potential stress for Australia's banks. Social-distancing policies are hammering households and businesses, and banks' lending books will inevitably suffer from consumers' decreased ability to pay back loans.

Various measures have been enacted to mitigate the fallout in the financial sector. First in place was the Reserve Bank of Australia (RBA)'s 25-basis-point cash rate cut on 3 March. An emergency cut down to the RBA's effective lower bound of 0.25 per cent followed on 19 March.

A Fitch Ratings report published on 17 March states these cuts will put bank earnings and profitability under pressure – prefiguring later ratings action – but will also help prop up the economy and support bank asset quality. Federal and state governments are delivering fiscal support, which should also provide relief by helping businesses and households remain solvent.

S&P's expectation in mid-March was for bank credit losses to double to about 30 basis points in 2020, albeit from a historically low level in 2019, with losses on business loans expected to be the most substantial. The rating agency's report states: "Nevertheless, we expect the impact on the Australian banking system to be relatively small in the short term, on the back of sound long-term economic prospects and our forecast rebound in economic growth as this event passes."

S&P also identified short-term offshore borrowing as a potential immediate risk for banks. This type of funding is more susceptible to negative market sentiment and an increase in spreads during refinancing.

"There have been very good deposit flows into CommBank through last year, which have continued this year. Credit growth was also relatively good, particularly in mortgages, but the rate of deposit growth far out-paced credit growth. This limits our need for wholesale term funding."

FERGUS BLACKSTOCK COMMONWEALTH BANK OF AUSTRALIA

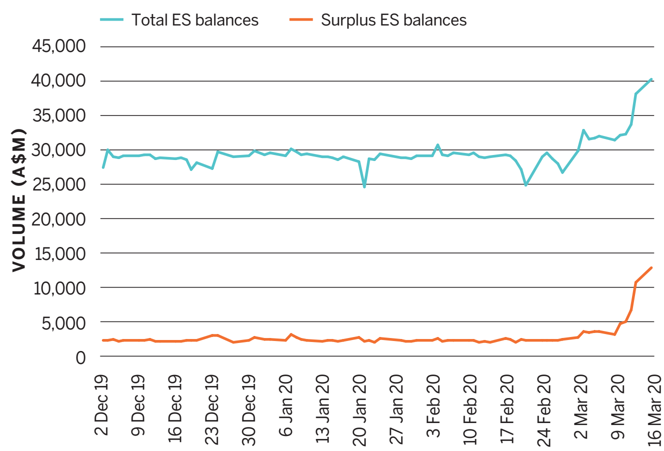
TABLE 1. AUSTRALIAN MAJOR BANKS' LIQUIDITY COVERAGE RATIOS AND NET STABLE FUNDING RATIOS (%)

	REGULATORY MINIMUM	ANZ	COMMBANK	NAB	WESTPAC
LCR	100	141	134	129	130
NSFR	100	116	113	112	112

*Data as at 31 December 2019, except ANZ NSFR (30 September 2019).

SOURCE: AUSTRALIAN SECURITIES EXCHANGE 16 MARCH 2020

RBA EXCHANGE SETTLEMENT BALANCES



SOURCE: RESERVE BANK OF AUSTRALIA 17 MARCH 2020

There were signs of heightened volatility in short-term markets in mid-March, which the RBA immediately greeted with increased repo operations. On 16 March, as part of an announcement from the Council of Financial Regulators (CFR), the central bank revealed it would increase its provision of one-, three- and six-month repo for as long as was necessary to support commercial bank liquidity.

The RBA's exchange settlement balances, which measure daily demand from commercial banks to settle balances with the RBA and with one another, indicate banks immediately took advantage of the extra repo funding (see chart).

An ANZ research note published on 17 March stated: "This injection of liquidity, and the knowledge that the RBA will be proactive in managing funding market stress, should lead to some reduction in Australian dollar funding stress. This has already played out to some extent…We think these funding market stresses will continue to unwind. But it is not a straightforward path and is predicated on what additional actions the RBA takes and a reduction in US dollar funding stress."

Martin Whetton, CommBank's Sydney-based head of bond and rates strategy, added in a daily research report on 17 March that the RBA's liquidity injection caused one-, three- and six-month bank bill spreads to overnight index swap to narrow from wide levels.

More positive news for the banks came on 19 March, as the Australian Prudential Regulation Authority (APRA) elected to relax some capital requirements to give lenders capacity to provide credit through the crisis.

SYSTEM SUPPORT

Fitch's 17 March report says the regulatory response from the CFR has been in line with rating agency expectations for system support. "The action by the RBA, ASIC [Australian Securities and Investments Commission], APRA and government has been aimed broadly at shielding the economy from the impacts of COVID-19 and promoting stability and liquidity within the financial system."

The next stage of support was the RBA's Term Funding Facility (TFF), announced as part of a raft of QE measures on 19 March (see p34). The facility, and the expectation that it will be expanded if required, appears to secure banks' wholesale funding needs. Global market activity since the acceleration of the COVID-19 crisis suggests liquidity may be available to Australian banks but pricing may not be supportive of ongoing lending. The Australian government clearly regards this as critical to the success of social distancing.

Bank issuance in global markets resumed quickly after a hiatus. For instance, on 17 March, Royal Bank of Canada priced a €1 billion (US$1.1 billion) covered bond while Bank of America and Goldman Sachs issued a combined US$5.5 billion. The US dollar market had more than a half-dozen new corporate deals priced on the same day.

Since then, the euro and US dollar markets have seen a panoply of issuance from banks and corporates. Two Australian corporate borrowers – Transurban Finance and Toyota Finance Australia – issued in the euro market in early April. However, local banks have been absent from domestic and global markets, buoyed by their pre-funding positions and the security of the TFF.

Deposit growth could also help keep the banks out of funding markets, as consumers switch out of riskier assets and into deposits for relative safety. All things considered, most market participants expect little or no wholesale issuance from the Australian major banks in the near term.

UNQUESTIONABLY STRONG – FOR NOW

The banks have made many changes since the financial crisis to ensure they are unquestionably strong, as regulators require. As a result, their creditworthiness does not seem in immediate danger from the current crisis. However, the COVID-19 outbreak and its effect on the economy still have the government and regulators pondering how they can get banks to maintain the flow of credit to the real economy.

S&P predicts a manageable impact on Australian banks if the virus outbreak subsides after the second quarter of 2020. However, the rating agency states that major problems could emerge if the crisis is longer and more severe. First, dislocated funding markets would weaken banks' ability to provide credit. Second, a fall in economic activity could lead to a sharp rise in unemployment and a drop in property prices, leaving the banks exposed to property lending problems.

Meanwhile, Fitch downgraded the long-term issuer default ratings of the Australian major banks and their New Zealand

TABLE 2. KEY DRIVERS OF MOODY'S AUSTRALIAN BANKING SYSTEM OUTLOOK

FACTOR	OUTLOOK (2 APRIL UPDATE)	PREVIOUS OUTLOOK
Operating environment	Deteriorating	Deteriorating
Asset risk	Deteriorating	Stable
Capital	Deteriorating	Stable
Profitability and efficiency	Deteriorating	Deteriorating
Funding and liquidity	Stable	Stable
Government support	Stable	Stable
OVERALL	**Negative**	**Stable**

SOURCE: MOODY'S INVESTORS SERVICE 2 APRIL 2020

subsidiaries on 7 April, to A+ from AA-, and kept all four on negative outlook. The decision reflects the expected effect on the banks' core markets and operations of measures governments are implementing to limit the spread of COVID-19.

Fitch has also revised its outlook for Australia's operating environment factor to negative. Downside risks are considerable, it adds. "The agency's base case is for a sharp downturn in economic growth in H1 2020, with only partial stabilisation in Q3 2020 and a gradual recovery beginning in Q4 2020."

Bank asset quality will deteriorate and be offset only partially by government and bank support, Fitch predicts. This will develop over the next 6-12 months, but a fall in profitability is likely to eventuate more promptly due to low interest rates and declining business activity, the rating agency explains.

Fitch also expects bank capital ratios to come under pressure, but buffers built since the financial crisis have put each of the banks in a "reasonable position to withstand a downturn that modestly exceeds our base case". The liquidity and funding positions of the banks can withstand short-term pressures, given the RBA support, Fitch states.

Moody's Investor's Service did not go as far, but on 2 April it revised its outlook on the Australian banking system to negative. This is despite its belief that the banks are in a solid position to manage the requirements placed on them to support the economy during the crisis.

In fact, Frank Mirenzi, Sydney-based vice-president and senior credit officer at Moody's, says all government actions to date reinforce the importance of the banking system within the Australian economy and the likelihood of government support.

The Moody's analysis focuses on what comes next and how Australian banks are positioned to manage it. For this reason, the rating agency's view does not rest on specific modelling of the duration of the crisis.

"It is going to take a long time for the economy to recover after it returns to 'normal', irrespective of whether that takes six months or even longer," Mirenzi says. "Some sectors will be slow to recover and others may not recover at all. This will affect borrowers' credit quality and thus that of the banks."

He adds: "On the other side of the crisis, the banks will have weaker loan portfolios [while] at some stage needing to rebuild capital positions that have been allowed to slip for the time being."

Moody's assesses six factors in building its overall outlook on a banking sector. Its announcement on 2 April drops Australia in two of these – asset risk and capital – to "deteriorating" from "stable" (see table 2).

On asset risk, Moody's notes that problem loans are set to rise "from a very low base" because of the ongoing disruption. The effect is likely to be particularly acute in the residential mortgage book, which comprises two-thirds of Australian bank assets.

While Mirenzi emphasises that Australian banks came into the crisis with strong capital positions, he also points out that asset quality and profitability were already weakening. Lower interest rates – which bottomed out at the start of the COVID-19 crisis – were putting downwards pressure on revenue even from performing loans. This and other factors have hampered banks' ability to self-generate capital – a situation that will only worsen as more loans fall into hardship.

Bank credit quality is constantly suffering while the crisis is ongoing. "Profitability starts to burn as soon as banks have a critical mass of customers receiving loan holidays," Mirenzi explains. "The banks have fixed costs, and while they may be able to make cuts it is hard to see how they can do so in a way that keeps pace with the revenue decline."

Moody's base case is for a slow rebound. Mirenzi says the agency is factoring in a lengthy adjustment period after COVID-19 risk recedes; for instance, with a long lag while people who have been rendered unemployed return to work at the same level they left.

The rating agency is looking beyond the near term on the issue of Australian banks' calls on capital markets as well. The big four rely heavily on international markets for wholesale funding and Mirenzi says this leaves them vulnerable to global investor sentiment when they return to new debt issuance. •

"Profitability starts to burn as soon as banks have a critical mass of customers receiving loan holidays. The banks have fixed costs and while they may be able to make cuts, it is hard to see how they can do so in a way that keeps pace with the revenue decline."

FRANK MIRENZI MOODY'S INVESTORS SERVICE

COVID complexity: impact on RMBS a tough call

Primary deals are possible in the Australian securitisation market, supported by government investment. Attention is turning to what effect the pandemic might have on new and existing residential mortgage-backed securities (RMBS) pools. It is a formula with many variables.

BY MATT ZAUNMAYR

One easy conclusion to draw about the COVID-19 pandemic is that the measures put in place to fight it will cause unemployment to rise precipitously. Anticipating this, lenders have already begun offering loan payment holidays and other types of forbearance.

Loans to borrowers on payment holidays would naturally fall into arrears. If a lender has many loans fall into this category at once it could lead to cash-flow problems in RMBS structures.

New government policy has been filtering through to counter this. Welfare and support measures for employers and employees have been ramped up to try to build a bridge to the other side of the economic crisis.

The fiscal package the government announced on 30 March aims to enable businesses to keep staff on payroll by subsidising wages by up to A$1,500 (US$922) a fortnight. This could put a ceiling on the unemployment rate. However, many people are still not going to be able to maintain mortgage repayments, which could affect standalone RMBS trusts.

Banks may receive a regulatory respite. The Australian Prudential Regulation Authority (APRA) announced on 23 March that for borrowers using payment holidays as a result of COVID-19, "the bank need not treat the period of the repayment holiday as a period of arrears".

Martin Jacques, Sydney-based head of securitisation and covered bond strategy at Westpac Institutional Bank, wrote on 24 March that "there is less chance that transactions will fail stepdown conditions" if banks follow this guidance.

While nonbanks are not mentioned in APRA's announcement, a Moody's Investors Service report published on 31 March suggests some nonbank lenders could also choose to follow the guidance. It adds that the emergence of an industry standard will be key to the credit impact on noteholders.

Direct government support for RMBS is also falling into place. Fiscal measures support borrowers while, at the primary transaction level, there is the Australian Office of Financial Management (AOFM)'s A$15 billion Structured Finance Support Fund (SFSF), which mainly targets nonbanks and small banks.

Firstmac was the first beneficiary. The AOFM purchased A$189.1 million of the nonbank issuer's A$1 billion RMBS on 27 March (see p10). AOFM involvement should provide investors with some confidence in primary transactions. But it does not resolve any secondary-market liquidity issues, which mortgage hardship will probably exacerbate in the coming months.

By mid-April, the AOFM was working with the Australian Securitisation Forum on a "forbearance model", under which the government debt agency could extend its support to existing RMBS and warehouse structures with a focus on those which are extending repayment relief to borrowers.

MEASURES ALREADY IN PLACE

Just how effective existing provisions in securitisation structures designed to mitigate cashflow risk will be is another question. Prepayment rates in Australian RMBS have been high historically, meaning most securitisation trusts have principal they can draw on to maintain interest cash flows.

"If a borrower cannot be kept employed they are now entitled to twice as much welfare as they would have been in the past. At the same time, borrower balance sheets and cashflow positions are dramatically different from previous economic downturns."

ROB CAMILLERI REALM INVESTMENT HOUSE

They also have liquidity facilities or reserves available to pay interest if principal is exhausted. Drawing on these has a cost but gives a further buffer for cash-flow issues.

David Carroll, treasurer at Columbus Capital in Sydney, says these mechanisms to protect noteholders should provide some headroom during the expected decline in prepayment rates in coming months.

An S&P Global Ratings research note published on 25 March estimates buffers are typically sufficient in prime RMBS structures to cover around nine months of senior expenses and note coupons at current interest rates, "even if cash inflow to the transaction falls to zero – a scenario which remains unlikely". For nonconforming structures, S&P estimates about 11 months of coverage to be typical.

These buffer facilities were designed and implemented with stress events such as recessions and rising unemployment in mind. In a typical recession, however, unemployment would rise gradually and the effect on RMBS pools would play out over years. With COVID-19, the rise will be much sharper as hundreds of thousands or even millions who were able to pay their mortgage a month ago will become unable to do so now.

NOT THE TYPICAL JOBLESS COHORT

The unusual data on who exactly becomes unemployed in this crisis makes assessing the effect on securitisation structures even more complex.

Typically, a securitisation of prime mortgages could be assumed to have lower borrower risk in a recession than one of nonconforming mortgages. However, COVID-19 related shutdowns and layoffs do not discriminate between prime and nonconforming borrowers.

In fact, Campbell Smyth, chief executive at Bluestone Group in Sydney, states, trusts with greater excess spread – typically those for nonconforming mortgages – may have better ability to withstand a fall in cash flow.

A trust with an average interest rate for borrowers of 5 per cent and funding or trust cost of 2.5 per cent could theoretically withstand half of its borrowers ceasing payments before cash flow became insufficient for noteholders, Smyth explains. A trust with a lower average rate for mortgagees may have less headroom to withstand borrowers ceasing payments.

"Bluestone has a book of prime and nonconforming borrowers and is monitoring payment trends closely to see how the various categories perform," Smyth comments.

There is also the ever-changing fiscal support landscape to consider. As recently as mid-March, investors may have been running models based on the amount of people expected to be applying for welfare through Centrelink. As of 30 March, that number has changed. The government's new fiscal package is applicable to anyone out of a job from the beginning of the month and now potentially provides greater support for ongoing mortgage payments.

Rob Camilleri, investment manager at Realm Investment House in Melbourne, says the unprecedented welfare measures need to be considered – but so does the change in people's expenditure.

"If a borrower cannot be kept employed they are now entitled to twice as much welfare as they would have been in the past," Camilleri notes. "At the same time, expenditure is substantially down due to the containment measures. Borrower balance sheets and cashflow positions are changing and are dramatically different from previous economic downturns."

DATA DELAY

Lenders, investors and rating agencies all rely on granular data to assess securitisation pools. However, the sharp and sudden impact of the COVID-19 crisis means reliable data on changes to cash flow will not be available for months.

Columbus's Carroll tells *KangaNews* it will be mid-May, when data for April is available, before arrears reporting begins to reflect reality. He adds: "We are waiting to see if the rating agencies require any additional overlays in their processes and what impact this may have on existing deals. This will depend on where a deal is in its life cycle. If it is a mature deal that has built up a lot of credit enhancement, [the crisis] may have relatively little impact compared with a newer deal."

How the rating agencies assess the effects of mortgage relief and welfare measures on RMBS pools in the coming months will be important for the ongoing functioning of the market, Camilleri says. If some of the direr speculation on unemployment figures proves to be correct, he adds, there could be severe downgrades of triple-A notes, potentially to triple-B level.

"We know the government and lenders are trying to ensure borrowers are in a position where they can start paying their mortgage again in three or six months," Camilleri comments. "A lot of the arrears from this period will cure over time so rating agencies need to be aware of what is happening in securitisation pools and with borrowers." •

"We are waiting to see if the rating agencies require any additional overlays in their processes and what impact this may have on existing deals. This will depend on where a deal is in its life cycle."

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Down time

There is no doubt we are in a uniquely stressful period, professionally and personally. Our best hope is community spirit. In a rapidly changing but always frightening environment, talking to people in the market about the challenges we face has been heartening.

Thinking back over the time since mid-February, I'm struck by how many things that seemed like outliers came to pass seemingly within hours – and then got left in the wake of further spiralling events.

To give just one example, at the end of February, KangaNews still had some hope of running conferences in Sydney in late March, with perhaps 700 delegates coming through the doors on the busiest day. By 29 March – the same week the conferences had been set to run – Prime Minister Scott Morrison was appearing live to tell Australians not to gather in groups of more than two.

By that stage, participants in the Australian and New Zealand debt capital markets were largely watching developments from home offices in spare bedrooms, studies and kitchens. Some had been in place for a while.

I count myself among the lucky ones, as I have spent most of my time working from home for more than half a decade. I have already completed both the physical office set up and, I hope, the mental adjustment, while others had to cordon themselves off in a hurry. I understand obtaining a desk in Sydney in March was almost as difficult as finding a roll of toilet paper.

So here we are: adapting to economic and living circumstances that have not been seen in the developed world since the Second World War. The physical threat may be less – though it is very real – but the intrusion of the state into the economy and our personal lives must be similar to that of a nation in wartime.

OUR ROLE

Early in what I'll call the acceleration period – the time of rapid escalation of measures to contain the virus – we started talking about how KangaNews could adapt to this unique and challenging environment.

In part, this meant business adaptation. It is fairly clear, for instance, that we won't be able to get those 700 people into a room together for some time. We have postponed various events and are looking forward to rolling out new options for connecting the market virtually during the period when we cannot do so in person. We aim to be what we have always aspired to be – a town hall for our industry – even while physical meeting is impossible.

> "WE ARE LOOKING FORWARD TO ROLLING OUT NEW OPTIONS FOR CONNECTING THE MARKET VIRTUALLY, WITH THE AIM OF CONTINUING TO BE WHAT WE HAVE ALWAYS ASPIRED TO BE – A TOWN HALL FOR OUR INDUSTRY – EVEN WHILE PHYSICAL MEETING IS IMPOSSIBLE."

We have also tried to respond with our editorial coverage. *KangaNews* has traditionally aimed for accuracy and depth over pace. We are happy to take a couple of days to publish transaction coverage, for instance, if it is necessary to bring in the right range of perspectives and collate all the relevant information.

COVID-19 changed this. A small editorial team reinvented itself as a provider of rolling news, more or less overnight. I think our business's adaptivity was best summed up on 23-24 March. In the absence of our Debt Capital Markets Summit, we set up a live dial-in for the chief economists panel that would have been part of the conference and reached capacity on the line almost immediately. Then we hosted the discussion, transcribed and edited it, secured sign off from all the participants and had it published online within 24 hours.

UNIVERSAL CHALLENGES

At the same time, we discussed what we could do to broaden our role as a town hall during the lockdown. The first thing we settled on was *The COVID Diaries* – a new avenue for *KangaNews* coverage. The idea is to allow market participants to speak anonymously about their working and personal lives under lockdown.

We were conscious that our coverage in more normal times focuses exclusively on market activity. We had never considered it part of our job to share perspectives on the pressures and worries that colleagues, clients and peers must share. It just didn't seem to be what people come to *KangaNews* for.

We are in a different world now. The idea of *The COVID Diaries* is to let market participants know their struggles are not unique, and to share – outside our paywall – insights into how others are coping and what is keeping them awake at night.

Some of my favourite comments from the diaries so far are about the day-to-day challenges of transitioning to home working. The story about not being able to find a desk, for instance, or the pervasive tales of trying to juggle a full-time job with full-time childcare and home schooling.

The consequences of having children constantly adjacent to the work environment is perhaps the most common theme of the diaries. It also gives a heartening reminder of the value of community spirit and the understanding that we are facing universal challenges. For every story of a banker trying to keep small children off videoconference calls there is another of how willing colleagues have been to accommodate the unpredictable presence of offspring.

It strikes me that necessity is going to change attitudes towards flexible working in the long term. A few months ago, 'working from home' was still greeted with at least an undertone of suspicion, the idea being that as soon as a colleague or employee was out of sight they would prioritise the school run or a nice afternoon nap.

Now we are all in the same boat, perspectives seem to have changed overnight. Suddenly, there is a common understanding that everyone is doing their best in difficult circumstances and if that means a stray child popping up on a video call every so often, well, it's nice to see signs of humanity.

I have to say it is also notable, as a journalist, to find how willing people generally are to talk on the phone now. It is not that they don't have plenty to do – though I suspect we will be in for periods of eerie calm alongside those of panic-stricken frenzy – but there seems to be a sense that it is important to make time to talk, about work but also about the world in which we are living.

"THERE IS A COMMON UNDERSTANDING THAT EVERYONE IS DOING THEIR BEST IN DIFFICULT CIRCUMSTANCES AND IF THAT MEANS A STRAY CHILD POPPING UP ON A VIDEO CALL EVERY SO OFTEN, WELL, IT'S NICE TO SEE SIGNS OF HUMANITY."

EXIT STRATEGY

Now we are past the immediate adaptation phase, it is natural for minds to turn to what the world might look like 'when this is all over'. I'm not going to speculate much about the economic impact. I'm not qualified to do so, and the variables are so wide-ranging that guessing about the shape of a future recovery is largely meaningless.

I am finding it increasingly hard to put much faith in the idea of a VE Day equivalent, where the war is suddenly over and we can all resume our lives as they were before (after, presumably, one hell of a party). The best hope is probably for a gradual return to something like normality while we wait for a COVID-19 vaccine. International travel and large gatherings might not become routine again until one is readily available.

Some of the more worrying coverage suggests that any wide-scale lifting of social restrictions before a vaccine is available will almost inevitably mean a second wave of infection and the return of social distancing. I'm not sure I buy into the idea that prolonged distancing measures will result in social unrest, but I can certainly imagine it becoming harder and harder to enforce restrictions the longer they are in place. Which comes to much the same thing, I suppose.

The macro story of the crisis really boils down to how governments and societies weigh off the respective impact of massive self-imposed limits on freedom – and the consequent economic damage – against the terrifying prospect of health systems being overwhelmed by a virus against which we have no ready defence.

So far, most people seem more or less willing to sacrifice their near-term freedom and financial status to mitigate the public-health catastrophe. My concern is that this is unsustainable, especially as the positive benefits of social distancing potentially breed complacency about the virus in the population at large.

Clear and honest public messaging is going to be critical to ensuring people continue to buy in to painful demands being made of them. In this context, the approach taken by Donald Trump – an immediate prioritisation of business over public health, and a predictable focus on electoral outcomes and personal enrichment – is particularly frightening. Increasingly, I wonder if, in the long term, the US system carries the tools it needs to rejuvenate and repair its societal structure.

We are already seeing speculation about how society might change. We are all going to be more understanding, some say. Populism and nationalism will rise unchecked, others argue. All I feel I can usefully contribute is that I doubt the character of humans will fundamentally change for long. We are social people, and months of being denied that contact is not going to stop us craving it.

I also doubt many people will become fundamentally better or worse. Even in the early days of social distancing, there is a clear split between those who are trying to help their communities by making personal sacrifices and those who think the rules should not have to apply to them. Some leaders put people ahead of their own ambitions, others see everything through the lens of electoral prospects or how deeply they can get their own snouts in the trough.

In our corner of the world, it would be nice to think at least some of the sense of community that has emerged could be retained. Where we are now shows what we are capable of: we are all thankful to have jobs and have presumably written off much hope of near-term financial or hierarchical improvement, yet in the main we have all managed to focus on our numerous advantages and spare thoughts for the many who are less fortunate. If this feeling can linger, maybe the new world will be a happier one. •

Go to **bit.ly/KNCOVIDhub** (case sensitive) for all *KangaNews*'s ongoing coverage of the COVID-19 crisis, including *The COVID Diaries*.

Unlimited ACGB purchases and direct bank funding to support RBA's bridge

The Reserve Bank of Australia (RBA) took unprecedented action on 19 March to provide a "bridge" to an expected economic recovery after the COVID-19 crisis. RBA governor Philip Lowe expects the support package to be required for the foreseeable future but says he can see better times on the horizon.

BY LAURENCE DAVISON AND MATT ZAUNMAYR

In a sweeping set of policies enacted, the RBA cut the cash rate to 0.25 per cent, announced it would purchase government and semi-government bonds, established a A$90 billion (US$55.3 billion) Term Funding Facility (TFF) for banks and modified the remuneration rate for its exchange-settlement account.

The reserve bank has placed no limit on the scale of bond purchases beyond saying they will continue for as long as necessary to keep the three-year sovereign bond yield at about 0.25 per cent until economic recovery begins. The TFF offers three-year lending to banks at a fixed rate of 0.25 per cent, with "at least A$90 billion" initially available.

The facility's goals are to "reinforce the benefits to the economy of a lower cash rate, by reducing the funding costs of ADIs [authorised deposit-taking institutions] and in turn helping to reduce interest rates for borrowers" and to "encourage ADIs to support businesses during a difficult period".

The second goal will be achieved, the RBA hopes, by increasing the volume of funding available to ADIs if they increase lending to business – especially SMEs. "Eligibility and continued access to the TFF will…be dependent upon ADIs acting, in the opinion of the reserve bank, in good faith and in a manner consistent with the objectives of the TFF," a notice accompanying the announcement states.

The RBA has also announced that exchange-settlement balances at the reserve bank will be remunerated at 10 basis points rather than zero, as would have been the case under the previous arrangements. "This will mitigate the cost to the banking system associated with the large increase in banks' settlement balances at the reserve bank that will occur following these policy actions," the announcement reads.

At the same time as the RBA announcements, the Australian federal government stated it planned support for nonbank and smaller ADI lenders in the securitisation market in the form of an investment capacity of A$15 billion, to be provided to the Australian Office of Financial Management (AOFM) (see box on facing page). This is almost as much as the AOFM's securitisation investment programme rolled out during the financial crisis, not all of which was allocated.

The Australian Prudential Regulation Authority also got involved, announcing soon after the news of the other measures a temporary relaxation of requirements for common equity tier-one (CET1) capital (see box on p36). The goal is to allow the banks to facilitate lending to the wider economy, including small businesses

"The timing and strength of [the] recovery will depend in part upon how successful we are, as a nation, in building that bridge to the other side."

PHILIP LOWE RESERVE BANK OF AUSTRALIA

SECURITISATION SUPPORT

The A$15 billion (US$9.2 billion) made available to the Australian Office of Financial Management (AOFM) to support bank and nonbank lenders via purchases of asset-backed securities (ABS) could be enough to account for the bulk of the public securitisation market for the balance of 2020.

In a statement, federal treasurer Josh Frydenberg said the AOFM programme will allow the agency "to support a substantial volume of expected issuance by these lenders over a 12-month period".

Assets to be acquired are not limited to residential mortgage-backed securities (RMBS), as was the case in the asset-purchase programme during the financial crisis. Frydenberg says: "The AOFM will also be able to invest in a range of other ABS and warehouse facilities. The government will provide the AOFM with investment guidelines that will outline the basis on which the AOFM is to undertake these investments."

The AOFM says it will provide support primarily "but not exclusively" within the nonbank market. The idea is for the investment facility to complement the RBA's term-funding facility for banks.

The first investment came on 27 March, when the AOFM bought A$189.1 million of an upsized A$1 billion RMBS transaction issued by Firstmac that had been in the market since before the crisis escalated but was struggling to complete (see p12).

KangaNews understands the AOFM is prepared for its allocation to represent a larger proportion of deals than it did in Firstmac's market return, and A$15 billion would almost certainly account for a significant proportion of securitisation issuance in 2020. In 2019, total Australian dollar securitisation volume outside the big four banks amounted to A$35 billion.

Total issuance will almost inevitably fall in the months ahead, as new mortgage lending is set for a massive downturn while swathes of the economy go on hiatus.

Past programme

The AOFM invested more than A$15 billion of a A$20 billion fund in 2008-12, the bulk of it during 2009 and 2010. These investments were limited to triple-A rated, prime RMBS from lenders other than the big four and Macquarie Bank.

Research by Martin Jacques, head of ABS strategy at Westpac Institutional Bank in Sydney, highlights the fact that the AOFM's previous investment programme never accounted for half of total market issuance. Even in 2009, the AOFM's allocation of about A$6 billion to RMBS transactions was part of a total market of about A$14 billion.

The AOFM did provide crucial structural support that allowed shorter-dated notes to be marketed to external investors. Third-party distribution of AOFM-supported securitisation deals was worth about A$3 billion in 2009 and comfortably more than A$10 billion in 2010, Jacques writes.

The new investment programme will probably be deployed more quickly than the previous iteration. The line from government and regulators remains that Australia is set for a harsh period of economic disruption but one with a finite horizon: until COVID-19 is contained.

For instance, in a 19 March speech, Reserve Bank of Australia governor, Philip Lowe, said: "As our country manages this difficult situation, it is important that we do not lose sight of the fact that we will come through this. At some point, the virus will be contained and our economy and our financial markets will recover."

In a Q&A following the same speech, Lowe expressed hope that workers who lose their jobs during the period will be back in work by the end of the year.

This points to a rapid deployment of funds by the AOFM in the securitisation market. However, Jacques points out that last time a similar approach was used, the AOFM "was focused on fostering a sustainable and innovative RMBS market, not reliant on government support".

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and households, which are expected to come under stress in coming weeks and months.

PACKAGE RATIONALE

In a speech following the RBA's announcement, Lowe explained: "This is a comprehensive package to lower funding costs in Australia and support the supply of credit…The term-funding scheme and the three-year yield target are both significant policy developments that would not have been under consideration in normal times."

Lowe's tone made clear the gravity of the task the reserve bank is undertaking. He emphasised that the TFF and government bond purchasing both carry financial and other risks for the reserve bank and both represent significant interventions by the bank in Australia's financial markets.

He was also at pains to stress that the reserve bank board did not take these decisions lightly. "In the context of extraordinary times and consistent with our broad mandate to promote the economic welfare of the people of Australia, we are seeking to play our full role in building that bridge to the time when the recovery takes place," Lowe explained.

Market participants had been certain that QE was coming in the lead-up to the RBA board's extraordinary meeting and the announcement of the purchasing programme. Most analysts predicted this would come in the form of yield curve control (YCC), which would anchor government bond yields and, hence, reduce risk-free rates across the curve.

Lowe said the 0.25 per cent target yield on three-year Australian Commonwealth government bonds was consistent with the board's expectation that the cash rate would remain at the same level for some time but not forever. In a Q&A, he suggested he would be surprised if the cash rate were still at this level in 10 years – but not if it remained there for three.

On the subject of purchase volume, Lowe added: "Rather than quantities or the size of our balance sheet, our focus is very much on the price of money and credit. Our objective here

APRA PROVIDES TEMPORARY CAPITAL RELIEF

The Australian Prudential Regulation Authority (APRA) is temporarily relaxing expectations on capital ratios to ensure banks can continue to provide credit while dealing with funding problems caused by COVID-19, the regulator revealed on 19 March.

The announcement followed shortly after the Reserve Bank of Australia (RBA)'s monetary policy decision and the unveiling of further economic stimulus from the federal government.

APRA states that banks were typically maintaining common equity tier-one (CET1) capital well above minimum regulatory requirements at the end of 2019. It adds: "Given prevailing circumstances, [banks] may need to use some of their current large buffers to facilitate ongoing lending to the economy. This is especially the case for banks wishing to take advantage of new facilities announced today by the RBA."

During the disruption from COVID-19, the regulator will waive the requirement on banks to meet enhanced CET1 capital levels announced in 2016. The goal is to allow the banks to facilitate lending to the wider economy, including small businesses and households.

APRA chair, Wayne Byres, said in the announcement: "APRA's objective in building up this capital strength has been to ensure it is available to be drawn upon if needed in times such as this. Today's announcement reflects the underlying strength of the system. Even if the banking system utilises some of its current large buffers, it will still be operating comfortably above minimum regulatory requirements."

"Even if the banking system utilises some of its current large buffers, it will still be operating comfortably above minimum regulatory requirements."

WAYNE BYRES AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

is to provide support for low funding costs across the entire economy…We are prepared to transact in whatever quantities are necessary to achieve this objective."

The RBA began multiprice auctions for bonds on 20 March, making announcements at 11.15am on each day of purchase. It states: "The size and composition of purchases [are] determined subject to market conditions and vary across auctions."

The immediate market reaction to the deployment of QE in Australia was a rally in three-year bond yields but a steepening of the curve. Damien McColough, head of rates strategy at Westpac Institutional Bank (Westpac) in Sydney, reports that three-year yields fell by 15 basis points but remained 15 basis points above the 0.25 per cent target.

The 10-year government bond sold off heavily after the announcement before recovering to sit 50 basis points wide on the day, says Gareth Aird, senior economist at Commonwealth Bank of Australia (CommBank) in Sydney, in a research note. He adds that this was indicative of market disappointment that YCC did not target the 10-year bond.

Lowe says YCC is being directed at the three-year rate because it "influences funding rates across much of the Australian economy" and is consistent with the term of the bank TFF. The RBA will be buying government and semi-government bonds across the curve, though.

Lowe would not comment on the specific conditions required for lifting the target yield on the three-year bond but said the economy would need to be in recovery and heading towards an unemployment rate of 4.5 per cent – the nonaccelerating inflation rate of unemployment.

BANK SUPPORT

The TFF, meanwhile, attempts to mitigate a lengthy credit-market closure. It encourages banks to lend by initially capping funding for individual banks at 3 per cent of outstanding credit and making access to further funding conditional on banks increasing their lending to businesses, particularly SMEs.

For every extra dollar a bank lends to a large business, it will be eligible for an extra dollar from the TFF. For every extra dollar of lending to SMEs, banks will be eligible for an extra five dollars. Lowe says additional lending to the already heavily indebted household sector will not make banks eligible for additional funding through the TFF.

Banks accessing the initial funding based on current outstanding credit have until the end of September to draw funds, while those seeking additional funds based on increased business lending have until the end of March 2021 to draw on the TFF. Lowe says institutions accessing the scheme will need to provide the usual collateral to the reserve bank, with haircuts applying.

The scale of the TFF could lead to Australian banks making minimal draw on capital markets. Brendon Cooper, director, credit strategy at Westpac, notes the facility will probably cause a "sharp fall in the requirement for traditional credit market supply in the short term".

ONGOING OMOs

The RBA had already begun implementing support to short-term money markets via an increase in repo operations. It reiterated in its 19 March announcement the commitment to conducting one- and three-month repo operations daily and six-month operations weekly for as long as necessary.

Analysts applauded the earlier measures for helping to provide immediate relief to front-end funding conditions. Martin Whetton, CommBank's Sydney-based head of bond and interest rate strategy, said in a 17 March research note: "The injection of repo funds has hit a record level, and the RBA's one-, three- and six-month tenors, accompanied by solid volume, have narrowed the spread of repo to overnight indexed swap."

Making sure repo operations are functional and cost effective for increased usage by banks is also the motivating force behind the RBA's decision to lower the rate at which exchange-settlement balances are remunerated.

Exchange-settlement balances rose sharply as the RBA began its increased repo operations and these increases are likely to continue. Lowe said balances had risen to A$20 billion by the time of the announcement from A$2.5 billion a month previously.

The combination of the increased need for the system and a desire to make banks as willing as possible to use the facilities being made available made the RBA decided to reduce the rate, Lowe explained. He added that the RBA would continue to monitor the cash market and was prepared to make further adjustments if necessary.

BUILDING A BRIDGE

Lowe was keen to stress the sound fundamentals with which the Australian economy and financial system entered the latest crisis. "Before the coronavirus hit, we were expecting to make progress towards full employment and the inflation target, although that progress was expected to be only very gradual," he commented.

The reserve bank is confident this state of stability and prosperity will return once the spread of COVID-19 is brought under control. However, Lowe also acknowledged the undeniable pain that people and the economy will experience in the near term.

"We are expecting a major hit to economic activity and incomes in Australia that will last for a number of months," he said. "We are also expecting significant job losses. The scale of these losses will depend on the ability of businesses to keep workers on during this difficult period."

With this in mind, Lowe said the RBA, the government, regulators and financial-market participants all have a role to play in building a bridge back to prosperity and stability. "The timing and strength of that recovery will depend in part upon how successful we are, as a nation, in building that bridge to the other side," he commented.

A GOOD START

The RBA wasted no time getting stuck into activity in the market following the announcement of unconventional policy measures on 19 March. Early signs for the asset purchasing were positive, analysts say, as three-year government bond yield headed towards its target in the early days of implementation.

The reserve bank made A$5 billion of government bond purchases on 20 March and A$4 billion of purchases each on 23 and 24 March. It also began buying further out along the curve and in the semi-government sector in short order, including acquiring A$2 billion debt issued by various semi-government issuers on 25 March.

The central bank opted for a target on the three-year government curve to provide an anchor point for yield across the curve without being obliged to buy a particular quantity of bonds. It also determined that the three-year point was most relevant to credit in the real economy.

Extreme volatility in bond markets spurred the decision. Government bonds across the curve first rallied as investors sought safe havens, then blew out as it became clear the government would need to inject substantial fiscal stimulus to keep the economy afloat.

The rally in yields in response to RBA purchasing probably brought some relief to market participants. In a daily research note published on 23 March, CommBank's Melbourne-based senior fixed-income strategist, Philip Brown, said the RBA's purchases on the same day were executed in a much tighter range than those on 20 March. All lines on offer had a lowest accepted yield about 1.25 basis points lower than the weighted average, compared with up to 8 basis points in the previous auction.

Brown added that this range narrowed again in the 24 March auction, with all three lines bought having a lowest accepted yield within 1 basis point of the average accepted yield. The RBA does not publish the highest accepted yield.

Brown tells *KangaNews* the policy of YCC gives the RBA a degree of nuance and an ability to make judgement calls. The same, he argues, cannot be said of volume-based purchasing that other central banks deployed in earlier QE packages.

David Plank, Sydney-based head of Australian economics at ANZ, points out: "The way the programme has been designed means the RBA is virtually guaranteed of success. There is no specified timeframe for achieving the target, no quantity of bonds specified for purchase and no specified metric for the curve flattening."

Plank adds, however, that the curve became steeper in the long end coming into the RBA announcement and the central bank would probably like this to flatten.

The issue, as Westpac Banking Corporation's Sydney-based chief economist, Bill Evans, discussed during the KangaNews economists roundtable on 23 March (see p37), is that the 10-year soverign bond is more susceptible to global moves than shorter-dated bonds and, therefore, more out of the RBA's control. •

RBNZ joins the QE choir

The Reserve Bank of New Zealand (RBNZ) added its voice to the global chorus of central banks implementing unconventional monetary policy measures with the launch of a large-scale asset purchase (LSAP) programme on 23 March. This is designed to reverse tighter funding conditions caused by the COVID-19 crisis.

BY CHRIS RICH AND MATT ZAUNMAYR

The RBNZ will purchase up to NZ$30 billion (US$18.3 billion) of government bonds across the curve in the secondary market over 12 months. "The programme aims to provide further support to the economy, build confidence and keep interest rates on government bonds low," the RBNZ said.

The move follows a widening in New Zealand government bond (NZGB) yields following the announcement of the New Zealand government's fiscal stimulus measures on 17 March, which greatly increased its funding requirement.

The RBNZ announced its first set of measures to combat this widening on 20 March, introducing a funding facility for banks out to a 12-month duration and the establishment of a temporary US dollar swap line with the US Federal Reserve. Analysts in New Zealand remained adamant, however, that QE would be the only avenue to ease funding concerns.

Indeed, the reserve bank eventually introduced the LSAP programme for government bonds and a term-lending facility (TLF) to provide funding of up to three-year tenor to banks.

EARLY MOVES

The 20 March measures came four days after the RBNZ cut the official cash rate (OCR) by 75 basis points to 25 basis points and delayed the implementation of new capital standards for banks.

The measures, including the provision of term funding through a term auction facility (TAF), were implemented immediately. This gave banks access to funding for up to 12 months in exchange for NZGBs, residential mortgage-backed securities (RMBS) or other bonds in collateral.

In a separate statement, the RBNZ said the TAF would operate in a manner similar to its open market operation (OMO). Specifically, the central bank would offer it daily in lieu of the day's OMO, with terms of about three, six and 12 months on offer.

In addition, the RBNZ revealed it would provide liquidity in the foreign-exchange swap market to ensure this form of funding could be accessed at rates near the OCR. Along with many other central banks, the RBNZ re-established a temporary US dollar swap line with the Fed, in an amount up to US$30 billion.

The RBNZ also stated it had already commenced "providing liquidity to the NZGB market", though it did not disclose the extent of its involvement.

Even with these measures in place, the interest rate on NZGBs significantly increased as liquidity dried up. In a research note, Dominick Stephens, Auckland-based chief economist at Westpac New Zealand, revealed that New Zealand soveign yield reached 2.6 per cent for 17 years on 19 March, a doubling of the interest rate in just a week.

QE DEMAND GROWS

Stephens feared the set of RBNZ measures in the 20 March announcement would do little to reduce long-term interest rates. He noted that long-term NZGB yields fell by just 10 basis points in the wake of the announcement.

"We suspect the RBNZ is going to have to begin a QE programme very soon, similar to the Reserve Bank of Australia's move," Stephens wrote. "This would involve buying large quantities of government bonds."

Other analysts had doubts as well. ANZ and BNZ published research notes on 19 March detailing a blowout in NZGB spreads (see chart 1) and what BNZ's analysts called an "extremely strained" credit market. Volatility in New Zealand remained acute, even after the government announced a massive fiscal stimulus package.

The NZ$12.1 billion stimulus is designed to ease the financial burden on households and businesses set to take an economic hit. But analysts said investors appeared to be baulking at the inevitable huge influx of government bonds.

New Zealand Debt Management (NZDM) will need to issue NZ$5.1 billion of bonds in the second quarter of 2020 based on the stimulus volume. BNZ's research note says: "Such an increase in supply would be testing for the market under normal conditions, but these are not normal times."

Compounding the sheer volume of NZGB issuance to come in the months and years ahead is the fact that New Zealand's government-sector borrowers are likely to be "off the radar of, or well down the priority list for, global investors at present", BNZ analysts wrote.

"In recent days, governments across the world have been outlining major fiscal stimulus plans," the BNZ note continued. "This raises the spectre of much higher government bond supply across multiple countries simultaneously. Against this backdrop, it is likely to be more challenging for New Zealand to access global capital."

On top of all this, offshore investor holdings of government bonds had already been on a downward trend at the beginning of 2020 (see chart 2).

RBNZ RESPONDS

The RBNZ bowed to the pressure within days. Its 23 March statement accompanying the announcement of the purchasing programme notes that higher yields, particularly on long-end NZGBs, counteract the 75-basis-point reduction in the OCR implemented on 16 March. The central bank had stated at the time of that decision that its next measure would probably be QE if further monetary policy stimulus was necessary.

Also on 23 March, NZDM stated that the RBNZ's decision did not alter its current funding task – which it updated on 17 March. NZDM says it will work closely with the central bank to ensure the efficient functioning of the NZGB market.

New Zealand's central bank may increase the size of its QE programme and has also left the door open for the use of other instruments, likely in line with the guiding principles for unconventional monetary policy it published on 11 March.

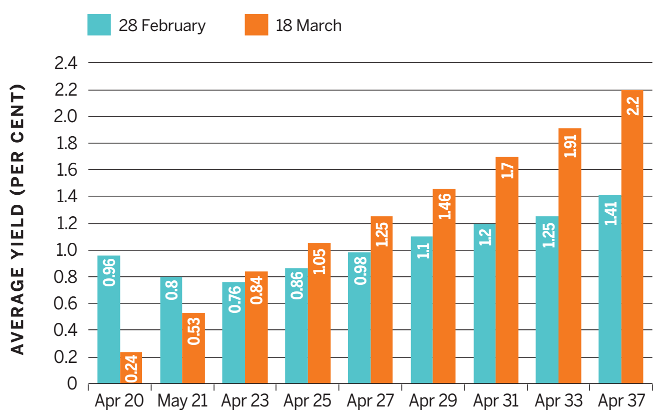
The RBNZ also entered the market for New Zealand Local Government Funding Agency bonds in early April. Initially it did so with little fanfare and outside the purview of its main asset-purchasing programme purely to support market functionality. This repidly escalated to a full programme of bond buying (see box on p40).

Analysts in New Zealand expect the large-scale asset purchases to deliver relief for the NZGB market. Nick Smyth, Wellington-based interest rate strategist at BNZ, argues that the programme will provide investors with confidence that the RBNZ is prepared to support the market amid much higher NZGB issuance volume. This, he adds, should help offset upward pressure on yields.

An ANZ research note was also optimistic about the impact of QE on government bond yields. "RBNZ purchasing should exceed NZDM primary issuance to ensure that yields move sharply lower… If anyone doubts the potency of this policy, consider this: there is about NZ$80 billion of NZGBs on issue, and if the RBNZ ended up buying it all, it would still have a smaller balance sheet than some of the major trading banks. In other words, the RBNZ's capacity to buy bonds is [in effect] absolute."

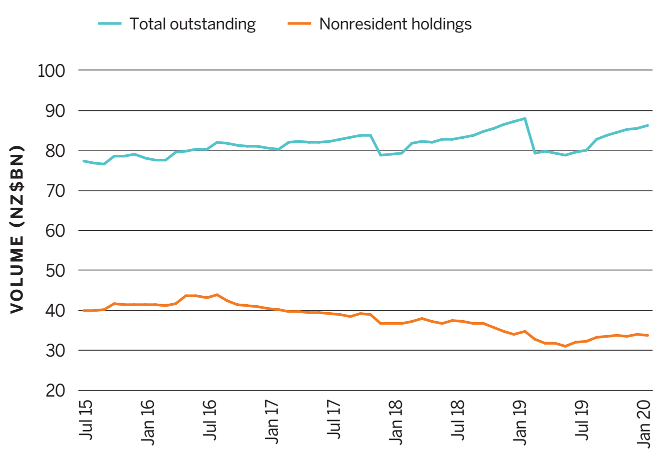
ANZ's analysts expect yield curves to tighten and flatten in response to the RBNZ's QE announcement and that NZGB yields will converge with those of Australian Commonwealth government bonds (ACGBs).

CHART 1. NEW ZEALAND GOVERNMENT BOND YIELDS



SOURCE: YIELDBROKER 19 MARCH 2020

CHART 2. NONRESIDENT HOLDINGS OF NZGBs



SOURCE: RESERVE BANK OF NEW ZEALAND 19 MARCH 2020

The Reserve Bank of Australia began the implementation of its own unconventional monetary policy programme, in which it is targeting a three-year ACGB yield of 0.25 per cent, on 20 March (see p34). On that day, the three-year ACGB yield reached 0.3 per cent whereas the three-year NZGB was at 0.66 per cent, ANZ states.

By the morning of 23 March, BNZ's Smyth wrote, NZGB yields had fallen by 26-48 basis points. He argued that this will eventually go some way towards reducing volatility in credit markets as well as taking pressure off the risk-free curve. "However, there will likely need to be some stability in global credit and risk-asset markets before there is a meaningful repricing of credit spreads in New Zealand," he added.

The RBNZ had deployed NZ$1.85 billion of its QE allocation by the end of 3 April via purchases every other day. It was initially active in NZGBs with maturities from 2021 to 2037.

NZDM successfully returned to the primary issuance market in the wake of the QE programme announcement. On 7 April,

RBNZ'S QUICK TURNAROUND ON LGFA BONDS

The Reserve Bank of New Zealand (RBNZ) will expand its large-scale asset purchase (LSAP) programme to include NZ$3 billion (US$1.8 billion) of New Zealand Local Government Funding Agency (LGFA) debt.

The 7 March announcement came just a day after the reserve bank said it would make "small scale" purchases of LGFA bonds to support liquidity and market function alongside, rather than as part of, the LSAP.

The RBNZ says the updated decision of its Monetary Policy Committee (MPC) reflects the important role LGFA bonds play in determining interest rates in the wider economy. A larger purchase programme for LGFA bonds "will provide stability and retain confidence in New Zealand's capital market".

Prior to this, the RBNZ's asset purchases were restricted to NZ$30 billion of New Zealand government bonds (NZGBs). The new intervention will represent up to about 30 per cent of LGFA debt on issue.

The RBNZ states that "purchases of NZGBs to date have successfully reduced longer-term interest rates. However, the negative economic effects of the COVID-19 outbreak continue to evolve."

The addition of LGFA bonds to the RBNZ's LSAP programme will not come as a surprise to market participants.

BNZ's Auckland-based interest rate strategist, Nick Smyth, wrote in early April that LGFA bonds represent a "quick and easy first step into the nongovernment market", given the issuer provides about 90 per cent of New Zealand's local government funding.

Analysts also note that the RBNZ's announcement leaves the door open for further additions to the size and scope of the LSAP to be delivered following the reserve bank's next MPC meeting on 13 May.

Smyth says he expects the committee formally to increase the size of LSAP, including discussing the inclusion of other semi-government borrowers, at its May meeting. The RBNZ will probably buy securities across the LGFA curve, he adds.

the government debt-management agency successfully priced NZ$3.5 billion of 2031 NZGBs in a syndicated transaction. The issuer tells *KangaNews* the deal attracted solid support from offshore investors – which accounted for 44 per cent of the book – and from real-money accounts (see p14).

NZDM also plans to introduce another syndicated transaction before the end of June. It had not disclosed targets for the deal's volume or maturity by the middle of April, though it will seek feedback from across the market and expects to provide a funding update alongside the national budget to be delivered on 14 May.

CREDIT SUPPORT EXTENDED

The RBNZ also brought in further support, in particular for the banking sector. On 2 April, it added the TLF for banks to its suite of COVID-19 relief measures. It also restricted banks from redeeming capital instruments that are not common-equity tier-one (CET1).

The TLF gives banks access to funding at a low interest rate for up to three years. The RBNZ says it has been designed "in support of the government's business finance guarantee scheme to help promote lending to businesses". The TLF will require eligible collateral and haircuts like those for the term auction facility announced on 20 March.

Also in the 2 April announcement, the RBNZ restricted New Zealand's banks from paying dividends on ordinary shares and redeeming capital instruments.

RBNZ deputy governor, Geoff Bascand, said: "To further support the stability of the financial system during this period of economic uncertainty, we have agreed with the banks that during this period there will be no payment of dividends on ordinary shares, and that they should not redeem non-CET1 capital instruments." The reserve bank had already delayed the implementation of higher bank capital requirements for at least one year.

Three days before the announcement of the TLF, the RBNZ added a corporate and asset-backed securities (ABS) funding facility to support domestic credit liquidity. The central bank will accept corporate bonds rated triple-A to triple-B minus, with haircuts increasing for longer tenor and lower credit ratings. It will also accept corporate commercial paper and only triple-A rated ABS and RMBS.

The RBNZ assumes RMBS on a single-name basis are not traded in the secondary market and, therefore, that no market price is available. For ABS, it will not accept securities from an institution obliged to provide more than half the liquidity provision for that security.

The nature of the New Zealand credit market can make illiquidity particularly pervasive in times of volatility. For instance, in a roundtable KangaNews and ANZ hosted on 26 March, investors suggested portfolios were, in effect, locked in place (see p58).

The RBNZ is aiming to unblock some of this congestion in the corporate market. Assistant governor Christian Hawkesby said: "Our objective is to encourage banks to continue to fund their corporate clients by purchasing their debt securities, given the confidence that these securities can be funded by exchanging them with us for cash. In this way, by banking the banks, we are ensuring large businesses can better manage their cash flows and lower their funding costs." •

A BRIDGE TO WHERE?

On 23 March, *KangaNews* hosted a live dial-in featuring some of the leading market economists covering Australia. It was the same illustrious panel that was to be a highlight of the KangaNews Debt Capital Markets Summit – which had been scheduled for the same day. In a rapidly changing world, the economists provided a snapshot of contemporary thinking about a unique and vast, but practically unquantifiable, risk.

KangaNews would like to thank ANZ, RBC Capital Markets, TD Securities and Westpac Institutional Bank for supporting the live session and the following coverage, and Deal Roadshow by Finsight for facilitating.

PARTICIPANTS

■ **Bill Evans** Chief Economist, Managing Director and Global Head of Economics and Research WESTPAC BANKING CORPORATION ■ **Prashant Newnaha** Senior Asia-Pacific Rates Strategist TD SECURITIES ■ **Su-Lin Ong** Chief Economist and Head of Australian Research RBC CAPITAL MARKETS ■ **Richard Yetsenga** Chief Economist ANZ

MODERATOR

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

CRISIS CONTAGION

Davison The emerging COVID-19 situation seems eerily similar to 2008-9 in that events keep overtaking the response – and at a seemingly accelerating pace. Has what was originally a public health crisis with economic consequences officially turned into a market contagion with major ongoing concerns for liquidity and credit?

■ **EVANS** It is fundamentally a health crisis. But the economy and markets are being affected by the actions that need to be taken to deal with the health crisis. In Australia, the government is surprising us every day with further shutdowns that will affect the economy.

We don't know when the crisis will peak. Wuhan's lockdown started on 23 January and it appears to have come out the other side. That is two months – but it is under best practice. We certainly do not think Europe, the US and Australia are exercising best practice.

While the crisis is playing out, government policies will constrain growth and that feeds straight into markets.

What worries me most about markets is that the US seems to be the country that is least on top of this. Even if Australia gets on top of its own issues, we will still have massive volatility in the markets until confidence returns to the US.

■ **ONG** The impact of the virus on the broader economy is creating uncertainty that is feeding into the volatility in markets. Uncertainty is causing the greatest issue. By this I mean uncertainty about the depth of the problem, its duration and the response from central banks, government and regulators. Measures are constantly being announced, and it adds to volatility even when there are delays in those measures.

The impact on the broader economy is feeding through to the credit space. This is where we are seeing the greatest stress in Australia and globally. Credit spreads have widened and we are trying to figure out how significant the impact will be on the real economy.

The volatility in markets, particularly in credit, comes back to positioning as well. In the last few years, we have been in a world of low yield with a lot of corporate issuance. Investors have been overweight credit exposure and this has exacerbated, to some degree, the movements we have seen over the last few weeks.

This is going to be in focus for the next little while as we see ongoing implementation of new measures. What we are getting from central banks is particularly encouraging but we are a long way from real stability. It comes back to the core questions with this virus around depth, duration and spread. I think we are still a long way from understanding it.

■ **YETSENGA** I am less worried about the uncertainty. Our problem is perspective. In a sense, this is kind of our Hurricane

AUSTRALIAN QE AND CAPITAL MARKETS

The Reserve Bank of Australia (RBA) is rolling out QE to support local liquidity and keep lending rates low. One likely consequence for capital markets is a private-sector issuance hiatus.

DAVISON What are the likely consequences for debt-market activity of the RBA's package announced on 19 March? It seems likely that the RBA is going to suck up quite a lot of government-sector and bank bond supply while the Australian Office of Financial Management (AOFM) is likely to be the main bid in the securitisation market. Will there inevitably be a private-sector market hiatus while these measures are in effect?

■ **NEWNAHA** I think this is a fair assessment, at least in the near term. I agree that it feels as if the news is going to get worse before it gets better. The risk is we are going to get a continued blowout in credit spreads, which would keep investors skittish.

If this is the case, it will obviously affect the amount of issuance we have coming into the market and the appetite to absorb that supply. At the moment, the focus is going to be on liquid, highly rated issues for the next couple of months.

Government bond issuance is going to ramp up significantly, but the RBA will also be buying a lot of bonds. The AOFM will be purchasing about A$15 billion (US$9.2 billion) of RMBS and ABS over the next couple of months. There is a contrast with 2008, in that the AOFM ended up purchasing A$15 billion back then, but over four years. The risk is that the AOFM comes more aggressively this time to address funding issues.

■ **ONG** It is the right decision for the RBA and AOFM to step into markets like this, which are dislocated and where there is much uncertainty and illiquidity.

The RBA's announcement on 19 March will deliver greater certainty going forward and should encourage the private sector to come in at some point, particularly when things start to settle down.

The RBA has also enhanced forward guidance, in effect anchoring the front end of the curve and providing certainty around where securities at the three-year point will trade. It also confirmed that it will be in the market across the curve in times of dislocation. These steps send the right signals to an uncertain market that is not prepared to participate now.

The measures will go a long way towards anchoring expectations around where yields will be over time. They will bring back private-sector participants. This is what you want to see with unconventional policy.

■ **EVANS** What the RBA is doing is exactly what a central bank should be doing in this sort of situation. The most important aspect was to provide funding for the banks.

The banks are the most important part of capital markets and the RBA support means they do not necessarily have to go to the markets for quite some time and will not be exposed to the blowout

> "I DON'T THINK THE SUPPLY STORY IS PARTICULARLY IMPORTANT. THERE WILL BE A FAIR BIT OF DISINTERMEDIATION AS WHATEVER CREDIT IS BEING CREATED GOES BACK INTO THE BANKING SYSTEM. IT IS ALL ABOUT DEMAND RATHER THAN THE SUPPLY OF CREDIT IN THIS ENVIRONMENT."
>
> **BILL EVANS** WESTPAC BANKING CORPORATION

Katrina moment: there was a storm approaching that was pretty easy to see and the levees were never designed to deal with a storm of that severity. Yet everyone just stood and watched.

When we look back at this period, we will note that we could model the spread of contagious viruses quite easily. Wuhan taught us that we will face an avalanche of health issues if we don't exercise draconian social measures. If our health system is not prepared, the result will be major societal disruption and existential questions none of us thought we would have to consider.

Beyond that, we don't have enough redundancy in the way we run our economies these days. We are certainly more fortunate in Australia to have low debt levels in the government sector, but the household sector is very indebted.

The US corporate sector is very indebted, and governments, households and corporates in parts of Europe are incredibly indebted.

If this is a health problem first, what we are doing now is like starting to apply chemotherapy. The problem with chemotherapy is that it weakens the body as it is trying to heal it. In this case, that means worsening the economy.

The data we already have makes tough reading. Restaurant bookings in North America are down 90 per cent year-on-year, Chinese retail sales are down 20 per cent and state-by-state jobless claims out of the US suggest we have seen the fastest ever increase in claims.

It takes only 100,000 layoffs in Australia to add 0.8 per cent to the unemployment rate. I can probably count that just in the last couple of weeks without having to think too hard about it.

We are still in the bad news phase of this crisis and, until we deal with the health issues, the economic policy response is just trying to catch up.

■ **NEWNAHA** Singapore is pretty much on the doorstep of China and at one time the greatest number of infections outside of China was in Singapore, if we exclude cruise ships.

The way the Singapore government has responded has been exceptional. It has been quick and this has helped keep conditions under control. However, it is easier to monitor the developments of this virus in smaller countries.

in spreads. The banks were already well positioned before the crisis, too.

I don't think the supply story is particularly important. There will be a fair bit of disintermediation as whatever credit is being created goes back into the banking system. But it is all about demand rather than the supply of credit in this environment.

We have the instant write-offs, for instance, but how much of this will corporates want to take advantage of considering uncertainty and low confidence?

From the economic perspective, it is the demand for credit rather than the supply that is critical at this point. The RBA can help on supply by flattening the yield curve and potentially bringing in credit spreads. But demand is what is important for the economy.

YETSENGA I agree – demand is the main issue. All policy can do is try to minimise the fall in demand. It is inconceivable that the demand for credit in aggregate would be stronger in a period like the one we are experiencing.

There are two other points to make. One of them is on Australia in particular. We know the offshore experience, which is specifically that zero per cent rates, QE and a flat yield curve – which the RBA is targeting – cause damage to the financial system.

This is especially true for the parts of the financial system that we might call the shadow banking sector, but it even affects the parts that are primarily deposit funded. I think there will be some noticeable adjustments to the financial system in Australia as these conditions go on.

Somewhat related, two-thirds of US debt has been intermediated by the market not the banks. You can't encourage the bond market in the US to exercise forbearance around rolling over loans and evergreening some credits that may be having short-term repayment problems. I think the US economy is a huge problem here.

Australia has an advantage, to some extent – the big end of town can get in a room and talk about policy to deal with circumstances.

For example, the Ministry of Health's website is so detailed you can find out whether there is a person on your street who has COVID-19. You don't know any of their personal information but you will have an idea of where they have been and where they most likely got it. Having this amount of information is incredible and has kept people well informed and calm.

We have been running on a disaster-recovery platform for the last six weeks and it feels like other parts of the world are starting to move towards this.

Even so, with the news deteriorating more and more overseas, there is a greater risk that we will get a further clampdown in Singapore. Not all stores are shut yet and most are operating as usual, which was a bit of a surprise to me. But I expect the draconian measures we have seen in Australia to start filtering into Singapore.

DEMAND COLLAPSE

Davison QE and fiscal packages have a common problem at this stage in that it is hard to stimulate an economy if people are being told to stay at home. Is this stage of the response just about having factors in place to prompt a quick economic recovery when one is possible? Is it possible to have any idea of the scale of the 'bridge' that will be needed to support an inactive economy through to the other side?

YETSENGA I don't think we know the scale of the package required. We can model the spread of the virus but very small changes to any assumptions can make enormous differences.

For example, if you model the spread using a three-stage process, with three different assumptions for R0, or the replication rate [the number of people each person infected goes on to infect], shifting between an R0 of 0.8 or 0.9 for the third stage in the US nearly halves or doubles the number of people ultimately infected.

The more miscommunication there is in the early stages of the medical and logistical response, the more it widens the span of likely outcomes. Political divisions in the US are still hurting its response.

Economic policy can respond only to the information it has at the time. What is clear is that budget deficits will become very, very large, very, very quickly.

ONG I agree, and I'd add that whatever we think is the right amount of stimulus to build this bridge, the amount ultimately needed is probably more. This is why we are seeing additional policy announcements globally every other day.

We can take comfort from the fact that Australia has more scope on the fiscal side to deliver stimulus. We are in the fortunate position of having debt levels that allow measures to be scaled up and down.

The same goes for the authorities. The package the Reserve Bank of Australia (RBA) announced in mid-March can be

> "We have been in a world of low yield with a lot of corporate issuance. Investors have been overweight credit exposure and this has exacerbated, to some degree, the movements we have seen over the last few weeks."
>
> **SU-LIN ONG** RBC CAPITAL MARKETS

LIFE AFTER *COVID-19*

An eventual economic recovery from COVID-19 may not begin in 2020. Even when it does, the world may have profoundly changed.

DAVISON We have been saying for years that central banks would in all likelihood go into the next crisis with few bullets to deal with it. Looking ahead, how can the monetary and fiscal armoury ever be restocked? Should we assume that the recovery will inevitably involve another round of hollow asset-price inflation?

■ **YETSENGA** I am not sure we can have much confidence in the answer to this. These sorts of questions are incredibly important when it comes to what politics is going to look like coming out of this. I don't think populism is the right term, but we seem to use it a lot – and if we thought populism was high going into this, it is going to be much higher coming out given the way policymakers have handled this crisis in some countries.

If we are stuck at zero rates and with QE for some period, we know this tends to encourage debt and the buyback of equity. Then the response is to protect business when there is a short, sharp shock – as we have seen offshore. We need to get through this crisis first, and it is looking worse as we go on. But the world afterwards is going to look quite different.

■ **EVANS** The only comparable equity market movement that I have experienced was the 1987 crash. The market in 2020 has moved nearly 40 per cent in a month. The 2008 fall was about 50 per cent, but that was over 15 months.

The 1987 crash was rapid. In response, central banks slashed interest rates and sowed the seeds for a massive commercial property and residential housing bubble that burst and threatened the global banking system. I suspect that won't be the case this time because central banks then had the scope to slash rates. This time, the stimulus is nowhere near as large so I don't expect to see another threatening asset bubble emerge as a result of the monetary and fiscal responses to this crisis.

■ **ONG** What we do know is that rates will stay low for a long time. We are likely to see some reallocation of capital – we have seen this story many times. But we also know we have tools in Australia and other parts of the world to deal with asset-price inflation if it emerges again. These tools will be used primarily through the prudential side.

We do not have any choice now but to run the fiscal and monetary ammunition down as much as needed – and more will be needed to get through this period, as we have all discussed.

There will be consequences, as there always are, but there are tools to deal with them further down the track. If we don't act now there will be much bigger consequences. The economy will be in a far worse state and unemployment will be far higher.

■ **NEWNAHA** I don't necessarily see asset inflation as a potential consequence, even if we run loose monetary policy. Have a look at Japan, for instance: the Nikkei has been on a downward trend for decades now.

In future, we will be talking about a pre-COVID and post-COVID era. Investor psychology, as well as that of households, is going to change abruptly.

Stimulating demand will be the problem in future. For example, we know businesses will not spend if there is no boost in demand. Have a look at 2008-9 and the current situation. People who worked over this period have been psychologically scarred.

Overall, investor psychology is going to take a hit and this will have a direct impact on the ability to stimulate demand in future and on how successful monetary policy will be over the coming years.

> "IN FUTURE, WE WILL BE TALKING ABOUT A PRE-COVID AND POST-COVID ERA. INVESTOR PSYCHOLOGY, AS WELL AS THAT OF HOUSEHOLDS, IS GOING TO CHANGE ABRUPTLY."
>
> **PRASHANT NEWNAHA** TD SECURITIES

adjusted upwards. Its term-funding facility, what gets targeted, the quantum of buying for government and semi-government bonds and the potential to extend into other securities can all be increased.

There is scope to do more, and I suspect we will see more from the government and the reserve bank if necessary.

■ **EVANS** Two weeks ago, we forecast that there would be a recession, and at the time we thought that was bold. Then we saw the first fiscal stimulus package and we maintained our forecast because it seemed clear that a lot of the so-called stimulus will be saved. People will not be going out and spending money in these circumstances, so there will be limited stimulus impact on spending.

I am not sure the key tenets of the current support package are going to have much of an impact in the face of all the policies that need to be implemented to deal with the health crisis.

■ **NEWNAHA** The government, regulators, the RBA and health officials are all working around the clock to contain what is an extraordinary, multidimensional problem. Monetary policy measures have been bold and they have been quick. But it feels like monetary policy has done what it can, for now. The focus is shifting to fiscal and containment policies.

We feel confident the scale of the bridge will need to be larger. The first fiscal stimulus was never large enough, at 1 per cent of GDP. The second round was delivered over the weekend but even taking all the stimulus together, 70 per cent is targeted at businesses. It does not feel like enough is targeted at demand. As Bill Evans said, why would a business borrow when its revenue has been wiped out?

The 100 per cent wage subsidy maxes out at A$100,000. How are companies supposed to keep everyone employed if their average wage is at this level?

The risk is that we are going into a lockdown and we will need further stimulus. As Su-Lin Ong says, there is scope to broaden monetary policy – by extending purchases to corporate bonds, for instance. But if the situation deteriorates further, as it did in the US during the financial crisis, there will be talk of the need for a bail-out fund as well.

This should be kept at the back of the mind. What we have seen in the past is that bail-out funds tend to be 3-5 per cent of GDP. It feels like the bridge will need to be lengthened and widened. We expect more developments over the coming days and weeks.

YETSENGA We should expect the public sector in Australia and other countries to take on private-sector credit risk, whether this comes through the central bank or the Treasury. Policymakers will be thinking about where this risk should go, but it will likely move into the public sector at some point.

In some ways, the response has not been all that well coordinated. In Australia, the second-largest element of the first fiscal package was more than A$4 billion to pensioners, who are precisely the people we do not necessarily want to be going out and spending money given the health issues. They also have a low marginal propensity to consume.

Think about what response is appropriate as this crisis unfolds. SARS is the nearest thing to compare, and it was short and sharp. Its outcomes suggest the response to COVID-19 should be to protect business. The problem is the COVID-19 crisis will be much longer and deeper, and we need to protect people. If there is no demand on the other side, we won't prevent the adjustment.

EVANS To Richard Yetsenga's point, the package is a bit more than A$60 billion, of which A$32 billion is payments to businesses that they get only if they keep their employees. The subsidy is the tax the employees are paying.

People at this sort of wage level are paying only A$20 out of A$100 in tax. If a business is offered A$20 to keep someone they are paying A$100 but the business isn't selling anything, it will still have to let that person go. This means much of the A$32 billion will never get paid – so it would not be part of a stimulus.

RBA RESPONSE

Davison What do economists make of the precise nature of the RBA's QE package? Su-Lin Ong wrote on 16 March that she expected to see measures "tailored to the current circumstances". How well did the RBA track to expectations?

ONG The reserve bank did its first lot of bond purchases on 20 March, the day after it announced details around its unconventional monetary policy. We thought it was a strong start. It announced in the morning that it would buy A$5 billion across four lines – the 2022, 2023, 2027 and 2028 government bonds.

From what we can see, the RBA was aggressive in price and bought the full amount. It was a strong signal following a tough week when markets had to wait for the details of the RBA's policy. There was a lot of uncertainty, dislocation and volatility.

We are not sure how much the RBA will do going forward, or how often, but it has established some credibility with this strong start. It is clearly committed to the 0.25 per cent target at three years and is prepared to step in further out on the curve when markets are volatile and dysfunctional. It is also prepared to show up in size and pay up if needed. It was a good start but we will be watching closely in the weeks ahead. It is early days.

The RBA has also signalled it is prepared to step into the semi-government market, which has had a tough couple of weeks. We know that, as the burden increasingly falls on fiscal policy, the states are delivering more and that further announcements are expected. Maintaining strong functioning of this market is important, too.

EVANS All credit to the RBA. It was a brave effort, when the three-year ACGB [Australian Commonwealth government bond] was trading around 0.6 per cent before the announcement, to come in and announce a 0.25 per cent yield target. It has achieved this, so all credit for being brave and locking in the 0.25 per cent target for three years.

But we need to ask why the bond market is malfunctioning. It is due to the accumulation of over-regulation as a knee-jerk response to the global financial crisis.

> "As this crisis passes we will again be looking at the monetary policy framework and wondering whether it is fit for purpose. Not only will we be undershooting the inflation target but the world is likely to emerge with significant excess capacity, so it is hard to see how generalised inflation picks up at all."
>
> **RICHARD YETSENGA** ANZ

> "We need to ask why the bond market is misfunctioning. It is due to the accumulation of over-regulation as a knee-jerk response to the global financial crisis. Bond markets are misfunctioning because of over-regulation."
>
> **BILL EVANS** WESTPAC BANKING CORPORATION

The RBA should not try to target the 10-year ACGB or it might be embarrassed, because at this tenor yield will be driven by the malfunctioning of the 10-year US Treasury curve. The RBA should keep targeting three-year yield and buy across the maturity curve but stay away from targeting the long end of the curve.

Davison Is yield curve control the best way of going about this?

■ **EVANS** I think what the RBA has done is fantastic. Other central banks have just set quantities [for bond buying] but they do not know where the market will go. The RBA is setting a price so at least it is testing itself and will be answerable to the market. If it gets the price down, it will help the economy much more than just purchasing bonds.

The other interesting thing, though, is the timeframe. We all remember the taper tantrum in the US, and we have to ask whether we will have the same when the RBA stops these purchases. The market wants to do something all the time and it will assume the central bank is planning to hike. The curve will be volatile when the RBA stops, but I don't expect this to happen for a couple of years.

■ **NEWNAHA** I think the RBA should be applauded for what it has achieved with its move into QE. It has given itself maximum flexibility to achieve its objective.

The RBA has had the benefit of studying the QE its peers at the European Central Bank, US Federal Reserve, Bank of Japan and others have undertaken. It has not bound itself to any size programme, which I think gives very little room to disappoint markets. This also extricated the RBA from having to justify its moves. It has enormous flexibility, which is a great outcome.

I think, as Su-Lin Ong says, the message from the central bank is that it is committed and nothing is off the table. We saw this even before the announcement with the RBA injecting liquidity into the repo market. The RBA does not historically take an active involvement in the repo market – it has been content for repo to do its own thing. But it stepped in and picked up involvement in a proactive way.

This should give market participants comfort that a blowout in repo-OIS [overnight index swap] spread is unlikely to repeat to the same degree if there is another round of funding stress. Hats off to the RBA.

■ **ONG** We said for a long time that for unconventional policy to be successful in Australia it had to be tailored for Australian circumstances. These include the nature of our mortgage market and our lending environment.

I think this is very much what we have seen from the RBA in the early stages. There is a reason three-year yield is the target and the term-funding facility is also tailored to that tenor – around where most borrowing occurs. These are encouraging signs for success.

We were never going to adopt the unconventional measures that have taken place in other parts of the world. What we have seen so far is encouraging. We may see more targeted measures if necessary.

PROJECTING OUTCOMES

Audience question If you accept that the spread of the virus will determine the economic impact, can you talk about your base cases for the number of people affected in Australia at peak and when the peak is likely to occur?

■ **EVANS** Our base case over the last couple of weeks has been that the peak will be at the end of June, which is about five months since people became aware of the virus. The only thing we have to go by is South Korea and China's success. It took two months from lockdown for the virus to be contained in Wuhan.

Clearly what we do not know is whether exponential increases in challenges occur if a country is lax in the early stages.

Richard Yetsenga has done interesting modelling on this. I worry that our end-of-June timing is too optimistic. The prime minister has talked about six months but we are unsure what he means. Is he saying that in six months there will still be some policies in place but the recovery in markets and confidence will have already happened? Markets are probably 6-12 months ahead of the economy. The end of June is still our central view but this is under review.

■ **YETSENGA** This is certainly the right question but none of us is trained in the things that would make us experts in answering it.

All the health experts tell us there won't be a vaccine for 12-18 months so the downside scenario is that this is not a 3-6 month problem but a 12-18 month problem. I suspect most people are focused on how deep the initial fall in activity is, and as days go by it is obviously getting deeper. How long will

> "We are not sure how much the RBA will do going forward, or how often, but it has established some credibility with this strong start. It is clearly committed to the 0.25 per cent target at three years and is prepared to step in further out on the curve."
>
> **SU-LIN ONG** RBC CAPITAL MARKETS

activity need to stay repressed and how long will movement restrictions need to stay in place?

■ **NEWNAHA** The best guide we have for the speed of the spread is South Korea and Italy. These present daunting prospects for what is potentially ahead in the US, UK and Australia. Developments in the next two weeks will be critical.

I hope we can carve out a coronavirus trajectory similar to that of China. Then there would be some basis for saying we have this under wraps. But we need to remember that the measures China took were draconian. People were essentially locked up and could not get out. If they could get out, it was one person at a time, once per week.

It would be a big test for Western countries to adopt a similar approach. For now, we just need to be on top of containment. HIV and malarial drugs are supposedly helping to ameliorate some issues but the window is closing rapidly.

As Bill Evans said and Richard Yetsenga's work suggests, it feels like things are likely to get worse before they get better and we will all need to revise our forecasts.

■ **ONG** The added challenge for Australia is that a 3-4 month timeframe for a peak goes into southern hemisphere winter. Whether there would be a revival in virus spread then is uncertain. This is an added risk for Australia, even if the northern hemisphere has it under control by then.

I echo Richard Yetsenga's comments around our focus being on the fall in activity during the first half of this year. But one of our concerns is that if we eventually do come out of this – whenever that is – we need to remember Australia went into 2020 with soft growth numbers. Private demand was weak and the economy was fairly lacklustre.

Many of the challenges Australia was already facing – low productivity, structurally low wage growth and high indebtedness, for instance – will still be present when we come out of this. The weakness of the labour market will exacerbate them. There are many challenges beyond the initial contraction in activity.

■ **EVANS** To Richard Yetsenga's point about the sensitivity of the unemployment rate, he quite rightly points out 100,000 jobs is nearly 1 per cent on the rate. We have about 1.3 million workers in retail and nearly 1 million in accommodation, travel and recreation. That is scary.

■ **YETSENGA** Another issue that will not go away is the question around the inflation target. So far, no country has sustainably extricated itself from QE once it has started.

Australia has now gone down this track, and we all agree this is appropriate given the circumstances. But as this crisis passes, we will again be looking at the monetary policy framework and wondering whether it is fit for purpose.

Not only will we be undershooting the inflation target but the world is likely to emerge with significant excess capacity, so it is hard to see how generalised inflation picks up at all.

There is also much closer cooperation between fiscal and monetary policy, again as an appropriate crisis response. But it further raises questions around the independence of central banks and whether we have drifted away from inflation targeting in everything but name.

Audience question Everyone on the panel seems to have great confidence that COVID-19 will be contained. But outside China, and possibly South Korea, the numbers are getting very large, very quickly. In Australia, based on patterns elsewhere, there could be three million cases by the end of April. What does the panel think are the chances that at least some developed countries will not be successful in their attempts to get on top of the public-health aspect of the crisis?

■ **EVANS** We have seen best practice executed in China and South Korea and it is only a matter of time before Western countries follow suit.

■ **NEWNAHA** Globally, health systems are not ready to cope with the onslaught of this virus. I hope for a good outcome, for a drug to be developed in the next six months. But all the measures we have on the fiscal side are just a bit too late. We need payments to come through as soon as possible.

I agree we need a containment strategy. The risk is that this gets out of control. This is why, fundamentally, I am a bit more negative in the near term.

We need to watch what is going to happen in the next two weeks. The quicker we act, the better. We do have some hope if we look to what China and South Korea have been able to achieve.

Davison Until recently, most economists seemed to be talking about positive growth resuming in the second half of this year. Is it already unlikely that this positive, V-shaped

> "We feel confident that the scale of the bridge will need to be larger. Even taking all the stimulus together, 70 per cent is targeted at businesses. It does not feel like enough is targeted at demand."
>
> **PRASHANT NEWNAHA** TD SECURITIES

recovery will happen given the escalating scale of the problem?

EVANS Our view has been that growth would be positive in H2 but this has been predicated on the peak being at the end of June with confidence returning in the second half as restrictions ease. Discussions here indicate there is an expectation that social restrictions could last well into the September quarter. It will be difficult to envisage positive growth in H2 if this is the case.

YETSENGA The use of letters is unfortunate because they imply some symmetry. Whether it is U-shaped or V-shaped, there is a sense in using this terminology that the world will go back roughly to where it was before the crisis started. I think working on this presumption would be a big mistake.

We have alluded to a few things on today's call that indicate the world will be different in immeasurable ways. We are moving closer to modern monetary theory as a way to implement policy. I have many problems with this but it is the reality. There will be a health legacy, much like there was in Asia after SARS, in which a lot of social habits will permanently change.

The idea of businesses running very long and complex supply chains across the world has been challenged by the trade wars and now by this. The great hope for Chinese economic growth in the next decade has been Chinese consumers reducing their savings rate. This seems a big ask after these events.

I don't think there will be a 'U' or a 'V'. I think we will get through the collapse and the recovery will be slow, and it will be towards a different environment.

EVANS This is a good point. The last time we had a huge, global shock, the world changed. There was a massive increase in regulation and great criticism of banks. There will be a structural change this time and Richard Yetsenga identifies many issues that will come up. I think the unemployment rate will be permanently higher, on average.

NEWNAHA Prime minister Scott Morrison has said this is a once-in-100-year event and unlike anything we have seen before. It affects everyone – retail, hospitality, travel, hairdressers, dentists and the whole economy. Small business is under the pump and it will be difficult to offset some of the pressures because we just do not know how long the situation will persist.

Who knows whether it will be a V-, U-, W- or L-shaped recovery? I would be less likely to subscribe to a V-shaped recovery right now. We need to get the virus trajectory on track and the lockdown in place. Unfortunately, the cure is stifling growth in the economy.

EVANS We will see how China responds now it feels it has dealt with the peak of the shock. It will be interesting to see if there is a spectacular rebound in spending and confidence.

ONG The labour-market outlook, and the extent to which it deteriorates, is key. The worrying part is that the starting point for underemployment is high. There is already excess capacity in the market.

Unemployment will probably rise and stay high as we head into a recession and substantial downturn. The long-term unemployment rate will also rise in the next 12 months and this will be key for the economy. It will naturally temper the pace of recovery when we come out the other side.

Commonwealth and state governments are looking at the next package of stimulus. This is about how to provide support not just for the unemployed but to keep schools going and to keep training people. This will be important if the labour market is to pick up again at some point. We need the labour force to stay skilled and connected to the broader economy.

This will be a big challenge and it feeds into everything else we have talked about around confidence and sentiment. •

> "The idea of businesses running very long and complex supply chains across the world has been challenged by the trade wars and now by this. The great hope for Chinese economic growth in the next decade has been Chinese consumers reducing their savings rate. This seems a big ask after these events."
>
> **RICHARD YETSENGA** ANZ

FEATURE

Buy side on hold

The Reserve Bank of Australia (RBA) jumped into the fog of dislocated debt capital markets in March with an unlimited government and semi-government asset purchase programme (see p34). Local investors are contemplating a cascade of market consequences.

BY MATT ZAUNMAYR

COVID-19 has brought a health crisis, an economic crisis and a funding crisis. The combination and its scale are unprecedented and all the factors are weighing on the minds of local fund managers. But with investment flows shifting rapidly in recent weeks, liquidity has been the pre-eminent concern.

In the early days of crisis acceleration, even the most reliable markets came under pressure as it became clear just how deep and broad the economic impact would be. Chris Rands, credit analyst, global fixed income at Nikko Asset Management in Sydney, says: “Liquidity in the government bond market was bad and bid-offer spreads were extremely wide. It was even difficult to execute switches where there was no addition of risk.”

He adds that the semi-government market was even worse, with price makers sitting on as much stock as they could handle with no-one to sell to. In credit, Rands says, the situation was almost impossible in bonds outside major banks. Nikko AM opted to stay out of the market entirely.

Amid the escalating COVID-19 crisis, on 19 March the RBA announced it would undertake unconventional monetary policy to restore normal market function.

The cornerstone is the unlimited asset purchase programme, with which the RBA is targeting a three-year Australian Commonwealth government bond (ACGB) yield of 0.25 per cent. It is buying bonds across the ACGB curve and in the semi-government market to achieve this. The RBA also wants to promote good functioning across the bond market.

Australian fund managers say the purchases have had the desired effect of pushing government bond yields down, at least at the target tenor, and stabilising the market. But fund managers remain extremely cautious as the crisis sails on into uncharted waters.

CARTE BLANCHE

The RBA has focused its attention primarily on the government bond market so far. By 7 April, it had purchased A$33 billion (US$20.3 billion) of ACGBs. It has been explicit that it will buy as many government bonds as is necessary to keep three-year yield at 0.25 per cent. By 1 April, the reserve bank had beaten this goal as the three-year ACGB was sitting below the target.

The RBA’s blank cheque for the federal government to print money allowed confidence among fund managers to get up off the floor, at least in the government bond market.

Stephen Cooper, Sydney-based head of Australian fixed income at First Sentier Investors, says: “The RBA has deliberately not constrained itself by balance-sheet limitations and this gives the market confidence it will do whatever it takes.”

Rands adds: “We saw liquidity come back as soon as the RBA began buying bonds. The government bond market out to 10 years is becoming liquid again. It is not where it was prior to March, but it is trading.”

The RBA is not acting alone. Central banks around the world have gone headfirst into larger monetary policy expansions than ever. The US Federal Reserve has made its purchasing programme free to do whatever it takes to keep the world’s largest economy afloat.

Beverley Morris, director, fixed income and absolute return at QIC in Brisbane, says the Fed’s move has supported liquidity and trading in sovereign bond markets globally.

> “The scale, breadth and inherent uncertainty of this crisis are very different and more challenging than in the global financial crisis.”
>
> **ANNE ANDERSON** UBS ASSET MANAGEMENT

As of 7 April, the RBA has purchased only as far out on the curve as the November 2029 ACGB. Even here, it has only transacted in minute quantity relative to the outstanding volume of bond lines around the 10-year point and to purchases in the three- and seven-year maturity buckets.

Accordingly, long-end ACGB yields have been less responsive so far to the asset purchases and the spread between the three- and 10-year ACGB remains wider than it was prior to the crisis. This has caused some consternation among fund managers, given the AOFM is expected to issue at least some of what will be a massive funding task into the longer end.

Whether market skittishness will require further intervention is a point of conjecture. If anything, the RBA is flagging tapering purchases rather than an expansion of its QE programme. The reserve bank stated following its April monetary policy meeting that if market conditions continued to improve it would probably be purchasing fewer government securities. This caused a spike in 10-year ACGB yield.

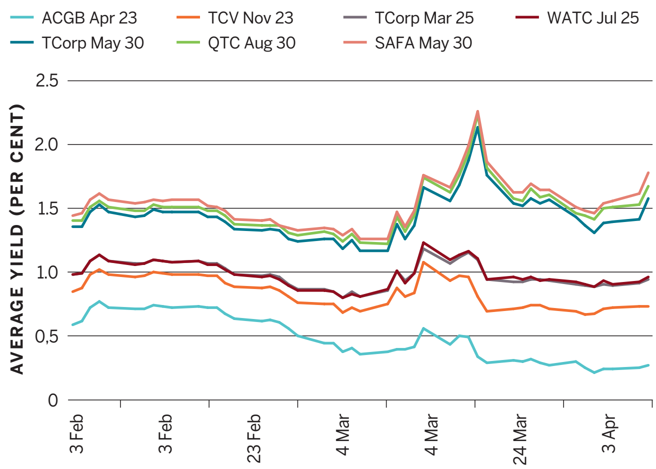
Sources familiar with the RBA's purchase programme indicate it is unconcerned with the yields of government bonds away from its three-year target per se but will intervene to ensure the market is functioning.

Tim Hext, Sydney-based portfolio manager at Pendal Group, says the reserve bank will probably remain wary of dislocation in the market but that it also likely values the considerable freedom it has generated by avoiding metrics for success in the government bond market outside the three-year yield.

Analysts point out that the longer part of the curve is particularly susceptible to moves in the 10-year US Treasury bond and that this could make RBA intervention at the long end less successful – a fact that could stay the reserve bank's hand.

Cooper says central bank policies regarding the long end of sovereign bond curves will have an impact on demand. "I suspect the RBA wants the curve to be positively shaped, but just how positive is a big question," he suggests. "Other central banks, such as the RBNZ [Reserve Bank of New Zealand], appear to be targeting a very flat curve. Policymakers will have great influence over this but it will be interesting to see how conflicting goals between central banks play out."

THREE-YEAR ACGB AND SEMI-GOVERNMENT YIELD



SOURCE: YIELDBROKER 7 APRIL 2020

WORK TO DO

The RBA has dipped its toes into the semi-government market more cautiously, with A$5 billion of purchases in the first two weeks of the programme across all states and territories. The RBA's initial focus has been on semi-government bonds maturing between 2026 and 2030.

The semi-government bond market came under more severe stress than the government bond market during early March volatility. State government budgets are expected to be hard hit by the economic fallout from COVID-19, given their reliance on property-related taxes and goods and services tax returns.

Compounding the downside risk, semi-government borrowers' issuance tasks were already on the rise to meet massive infrastructure requirements. The sector took care of the majority of its pre-existing 2019/20 issuance task in January and February but those tasks are likely to be much higher now.

Semi-government yields rallied on the announcement that the RBA would purchase bonds in the sector (see chart). However, yields generally have risen even on days when the RBA has purchased semi-government bonds. As with the ACGB market, 10-year yields spiked when the RBA indicated it was prepared to pare back purchases.

Despite the RBA intervention, QIC's Morris says the buy side remains cautious on semis due to the volume of additional issuance set to come. A flood of supply came from the sector at the end of March and start of April (see p6). Demand appears to be primarily from bank balance sheets with minimal participation from asset managers.

Morris says short-dated floating-rate note issuance and long-dated taps from some issuers illustrate that demand for the

"Given the RBA is not targeting a level of spread [for semi-governments], it may take a while for market participants to feel comfortable that the RBA's purchases can offset the weight of supply. But we think the sector is attractive over the medium term."

BEVERLEY MORRIS QIC

asset class remained patchy in early April, although most fund managers appear relatively confident that it should re-establish itself in due course.

Anne Anderson, head of fixed income and investment solutions, Australia, at UBS Asset Management in Sydney, tells *KangaNews* counterparties have become more selective in the bids they make, but over time a rhythm seems to be emerging that gives fund managers more confidence the RBA intervention is working to smooth the market.

The RBA will probably hold a significant portion of the government bond market in the coming months and years. This will have various consequences, but one will be to keep interest rates low and thus make spread product – which in this case includes semi-government bonds – relatively more attractive, Morris tells *KangaNews*.

However, she adds: "Investors will likely need to see some stability before participating in large size and I think the market has not quite got the required confidence yet. Given the RBA is not targeting a level of spread [for semi-governments], it may take a while for market participants to feel comfortable that the RBA's purchases can offset the weight of supply. But we think the sector is attractive over the medium term."

CREDIT CONUNDRUM

Australian dollar credit represents a different problem altogether. Government debt is still theoretically risk free, even though the crisis will hit revenues and fiscal programmes will put unforeseen burdens on budgets. The entire sector received a shot across the bow on 8 April, when S&P Global Ratings revised its outlook on Australia's AAA rating to negative.

Still, the indefinite economic shutdown creates much more plausible risk of declining credit quality – and even default – across various corporate sectors. Much of the fiscal stimulus seeks to allay this risk, and the central bank is chipping in to free up the flow of capital as much as possible.

Nowhere is demand narrower than in the Australian dollar corporate credit market, which remained, in effect, shut in early April. Anderson says there are still challenges around finding market clearing levels. Scheduled FX rolls exacerbated this at the end of March as the decline in the Australian dollar expanded cash calls while some parts of the fixed-income market were not functioning well.

Corporate credit was excluded from the asset-purchase programme, as the RBA preferred to incentivise commercial banks to lend to corporates supported by a term funding facility.

In a speech in November 2019, RBA governor, Philip Lowe, expressly stated the central bank's aversion to purchasing private-sector assets. The two primary reasons he gave for this were that there was "no sign of dysfunction in our capital markets that would warrant the reserve bank stepping in", and that buying private assets "would insert the reserve bank very directly into decisions about resource allocation in the economy".

Lowe added: "While there are some scenarios where such intervention might be considered, those scenarios are not on our radar screen."

Whether that scenario is now on the radar is up for debate among market participants. Morris says the risk of corporate default in Australia remains very real and market functioning is severely impaired, potentially mitigating the RBA's moral-hazard concerns about buying corporate paper.

Anderson says reduced capacity and risk appetite on bank balance sheets reduces the ability for the secondary market to find a clearing level. "The scale, breadth and inherent uncertainty of this crisis are very different and more challenging than the global financial crisis," she argues.

A corporate asset purchasing programme has been in place in Europe for several years. The Fed has now implemented its own in the US. These markets had record volume of corporate supply in March, even as the COVID-19 crisis intensified. Morris says there is clear evidence that corporate asset purchases improve market function.

First Sentier's Cooper has doubts about the efficacy of such a programme in Australia, however, given the dynamics of local corporate funding – which remains largely intermediated by banks, and the local big four in particular.

The euro and US dollar corporate markets are much larger and deeper than Australia's. Cooper points out that corporate bonds make up only about 10 per cent of the Australian composite index and, therefore, argues that providing support to the government and semi-government bond markets should naturally lead to greater corporate liquidity. But he adds that fixed-income investors have all learned to "never say never" when it comes to central bank policy.

With the Australian corporate market seemingly shut for the time being, some fund managers are likely tempted by the deal

> "We saw liquidity come back as soon as the RBA began buying bonds. The government bond market out to 10 years is becoming liquid again. It is not where it was prior to March, but it is trading."
>
> **CHRIS RANDS** NIKKO ASSET MANAGEMENT

flow, coming at newly established wider prices, in Europe and the US. Cooper says First Sentier is dipping its toes back into these markets, but market conditions are still not conducive to wide-scale portfolio rebalancing.

PARADIGM SHIFT

Specifically, liquidity across markets appeared to be too stretched as of early-to-mid April for fund managers to jump back in wholesale, even if they are starting to view the yield on many asset classes as appealing.

For confidence to truly return to the market, some fund managers are looking for a turnaround in the health and economic crises as well as the liquidity crunch. Cooper says First Sentier is looking for "peak news flow" on COVID-19 before it will be confident about meaningfully participating in primary markets again.

"Markets will gain confidence once there are signs of the infection rate slowing," Cooper comments. "At this point, I expect liquidity to return to normal and flows to normalise. This would be the appropriate time to be adding risk and we would probably be paid appropriately for that risk for the first time in quite a while."

He adds: "It is a timing game and we have, thankfully, been underweight risk over the last month or so. But we are looking for the time when we want to reverse this."

At the same time, flows out of fixed-income funds and into other asset classes are likely to leave fund managers with little room for rebalancing of portfolios, at least in the near term.

Hext says central-bank policy, rather than fund managers taking a view on pricing and rebalancing allocations, will drive market stabilisation. "We were positioned defensively so have been okay, but a lot were caught the wrong way around and are still trying to sell. Ultimately, fund managers will be driven by flows of investment and divestment."

FUTURE MARKET

How closely the market that emerges on the other side of the COVID-19 crisis resembles the one that went into it will depend to some extent on how successful central banks are in coaxing fund managers back into the assets they have been seeking to sell in March and early April.

Europe and the US have had impressive deal flow through the worst of the crisis, but those markets were already accustomed to large amounts of central-bank intervention. How the Australian fixed-income market responds remains to be seen.

Nikko AM's Rands says the impact on the local credit market may long outlast the effects of the virus. "A lot of investors were running with a lot of credit and that was a difficult position to get out of when liquidity dried up. If the index is going to be 90 per cent government bonds, we need to think about the appropriate amount of credit to hold in a portfolio. We don't want to be lumped with it when there is another stress event."

Irrespective of how much future demand there will be for Australian dollar credit, what proportion of the credit market remains in the public sphere is a separate question given the RBA's term funding facility could potentially account for all of the major banks' immediate wholesale funding needs.

However, Hext makes the point that the major banks can and will still come to market if spreads tighten sufficiently or they wish to access funding for tenor longer than three years.

There will be much greater supply of government bonds. The Australian Office of Financial Management (AOFM) is planning to issue about A$5 billion each week by tender and also to introduce two new lines by syndication before 30 June 2020. New supply dynamics will affect the Australian composite bond index, which is already weighted towards government bonds.

Cooper says: "We will engage with clients and question the appropriateness of the composite bond index for what they are trying to achieve. If it remains appropriate, we are capable of managing our funds actively against it in the same way we always have. If it isn't, we can also be flexible and adapt."

Fund managers are also now contemplating big-picture paradigm shifts. The European, Japanese and US experience of QE indicates that it is not easy to unwind. Fiscal policy dominance is likely to be a feature of the coming decade and central-bank policy now appears to be coordinated with government policy rather than independent of it.

Hext says any notions about the inability of central banks to print money are being demystified. "The expansion of the RBA's exchange settlement balances is evidence of this," he comments. He adds that central banks have inadvertently moved into what could be described as modern monetary theory.

Morris says while markets are rightly focused on the short-term recessionary outlook, this policy paradigm shift is likely to have long-run implications for all asset classes. It may take time for the full picture to become clear. •

> "Markets will gain confidence once there are signs of the infection rate slowing. At this point, I expect liquidity to return to normal and flows to normalise. This would be the appropriate time to be adding risk."
>
> **STEPHEN COOPER** FIRST SENTIER INVESTORS

Uncertainty reigns

Fitch Ratings and KangaNews have been conducting the Fixed-Income Investor Survey since the first half of 2014. The 2020 iteration combines a deeply negative outlook with vast areas of uncertainty to produce the survey's most worrying set of data ever.

BY HELEN CRAIG AND LAURENCE DAVISON

In the rapidly changing environment of the COVID-19 crisis, timing is everything. The 2020 investor survey was conducted 2-20 March, just as the virus's impact and measures to stop it were ramping up – seemingly by the hour.

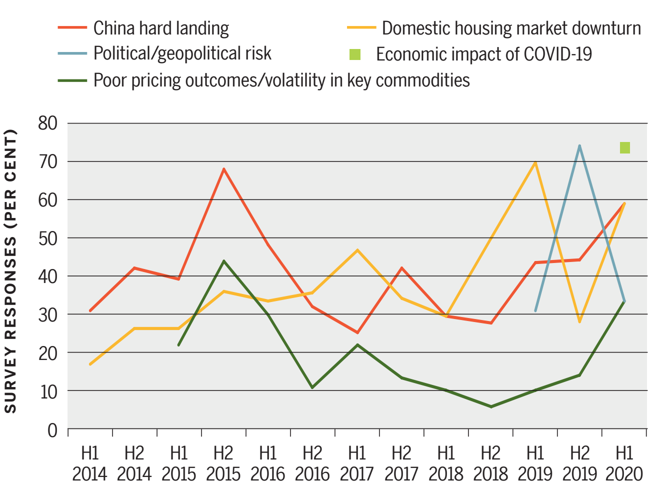
This unusually febrile period undoubtedly had an impact on the survey responses. For instance, investors who responded toward the beginning of the period might not yet have fully processed the enormity of the situation and the economic consequences of a protracted period of social distancing. Projecting outcomes would have been uniquely challenging during the whole survey period.

The survey response rate dropped somewhat on 2019 levels, no doubt due to the extreme nature of market circumstances. Having approached 50 responses in some recent iterations, the number of investors filling in the 2020 survey was closer to 30. The responses still represent the bulk of institutional fixed-income funds under management in Australia.

The results provide a fascinating and illuminating portrait of a market coming to terms with a massive negative shock but perhaps without its impact yet fully priced in. Some of the data may be inconclusive, but the clear expectation is for severely weaker conditions across the economy and markets. The silver lining is that investors have started to see signs of real value in credit spreads – arguably for the first time in years.

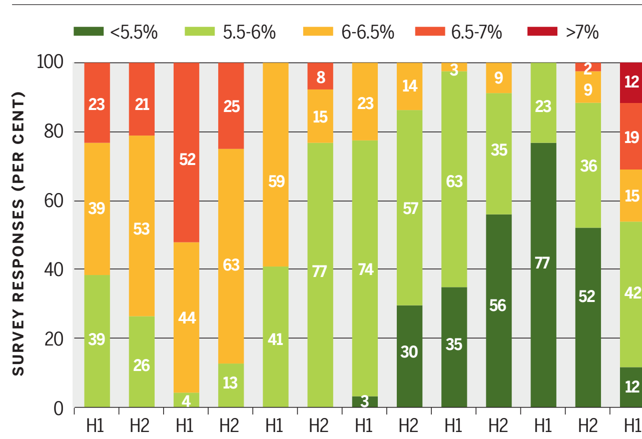
Unsurprisingly, the ramifications of COVID-19 are, by some distance, the biggest risk factor investors identified (see chart 1). There is also growing concern about the Australian housing market and the potential for a downturn in China; COVID-19 is probably a significant driver of these concerns, too.

CHART 1. RISK FACTORS RATED "HIGH"



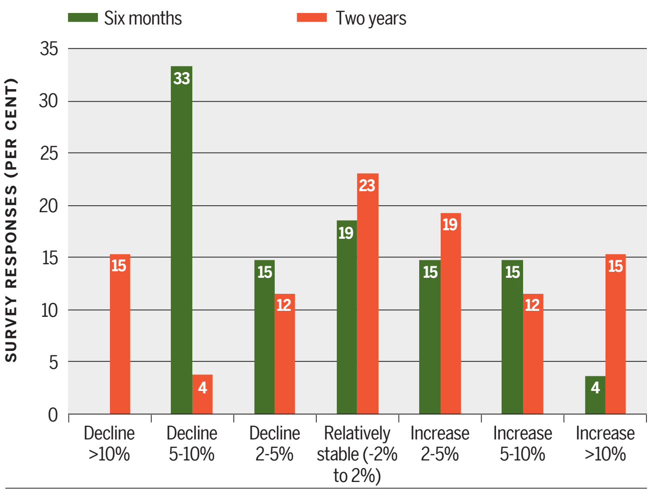
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 2. ESTIMATED AUSTRALIAN UNEMPLOYMENT RATE IN SEPTEMBER 2020



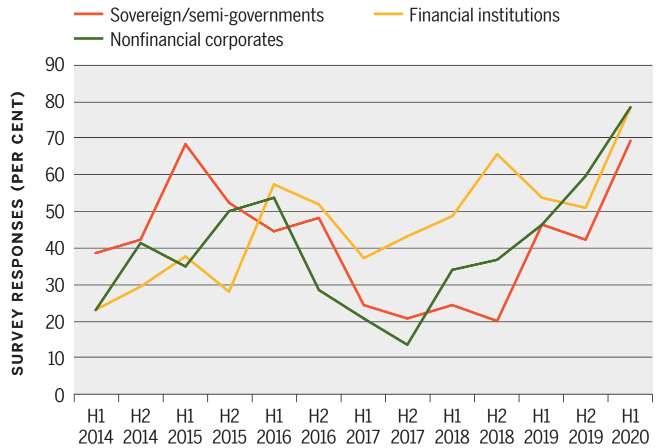
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 3. ESTIMATED AUSTRALIAN HOUSE PRICES



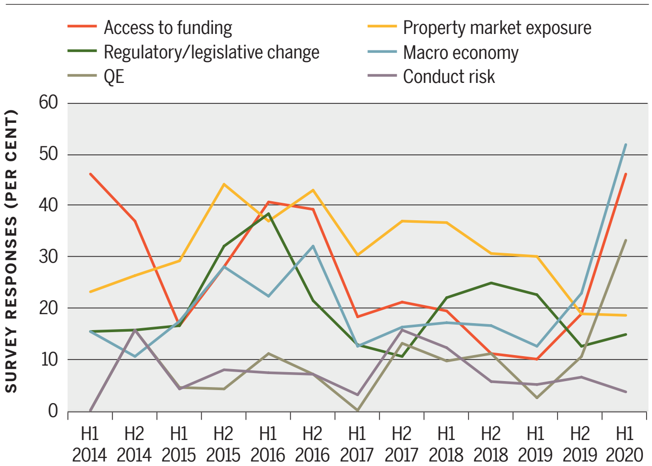
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 4. FUNDAMENTAL CREDIT CONDITIONS TO DETERIORATE "SIGNIFICANTLY" OR "SOMEWHAT" OVER THE NEXT 12 MONTHS



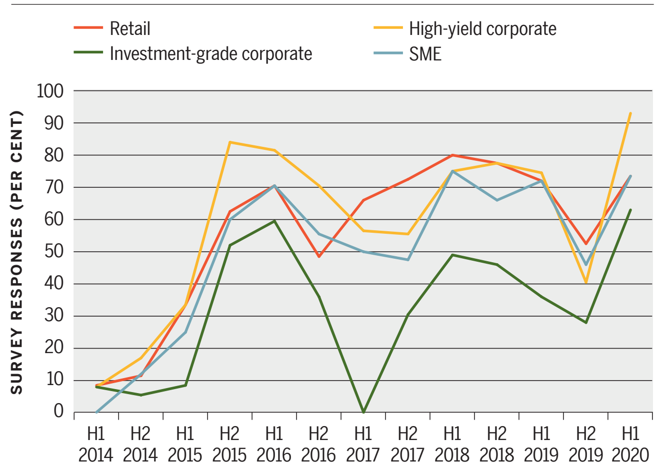
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 5. "CRITICAL" RISKS TO BANK CREDIT QUALITY OVER THE NEXT 12 MONTHS



SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 6. BANK LENDING STANDARDS TO TIGHTEN "SIGNIFICANTLY" OR "SOMEWHAT" OVER NEXT 12 MONTHS



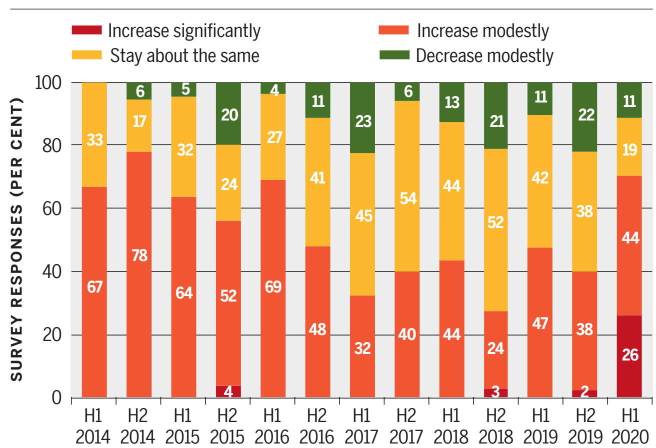
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

This concern is no surprise. By mid-April, Fitch was forecasting global growth of negative 1.9 per cent for 2020. Its analysts write: "The global health crisis sparked by the outbreak of COVID-19 is taking an extraordinarily heavy toll on the world economy. Global GDP is falling and, for all intents and purposes, we are in global recession territory."

In response to the survey results, Fitch says: "Domestically, the COVID-19 outbreak has dented consumer sentiment, which was already on a downward trend in 2019 against a backdrop of elevated debt and muted real-income growth. The spread of the virus will hit consumer spending as people self-isolate. The Australian economy is also being challenged by the pandemic fallout through its trade linkages with China and exposure to commodity exports."

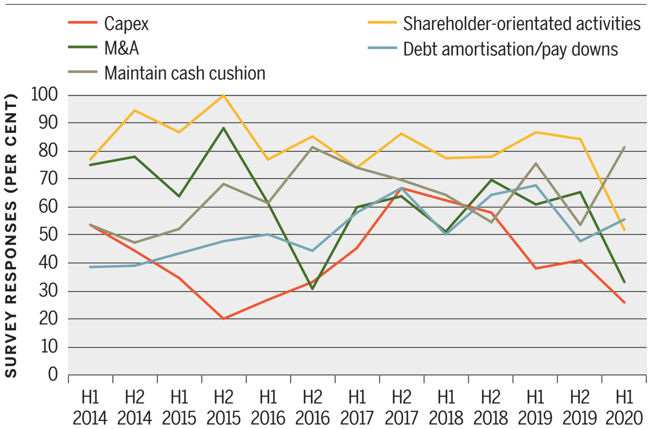
As well as gobal growth contraction in 2020, Fitch forecasts the Australian economy to contract by 2.2 per cent and Chinese growth to fall below 2 per cent.

CHART 7. EXPECTATIONS FOR CORPORATE LEVERAGE OVER THE NEXT 12 MONTHS



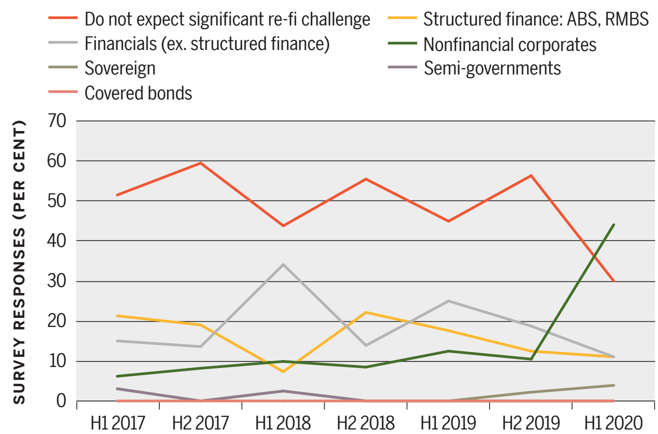
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 8. "SIGNIFICANT" OR "MODERATE" EXPECTED USE OF AUSTRALIAN CORPORATE CASH OVER NEXT 12 MONTHS



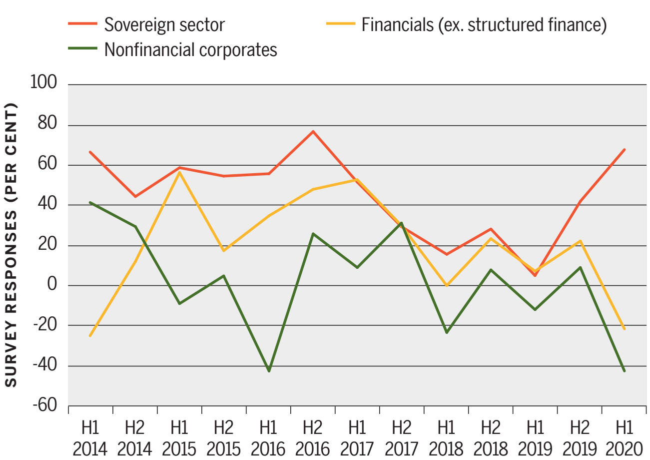
SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 9. SECTOR MOST LIKELY TO FACE REFINANCING RISK



SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 10. NET BOND ISSUANCE EXPECTATIONS OVER THE NEXT 12 MONTHS, INCREASE MINUS DECREASE



SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

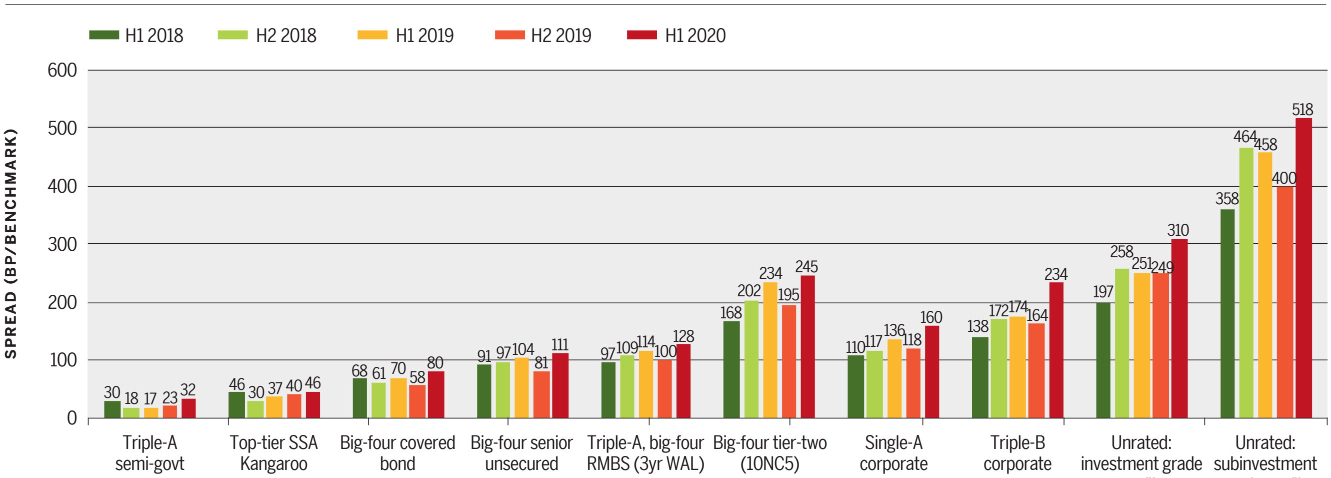
A sign that the survey was conducted during an earlier phase of the ramping up of social distancing is investors' unemployment outlook (see chart 2). The full impact of business closures may not yet have been factored into investors' thinking by mid-March.

The outlook on house prices tells a slightly different story. Here, investors are relatively sure of a sharp decline in prices over the course of 2020 (see chart 3). In contrast, there is a wide disparity of views on the longer-term outlook. As many investors – 15 per cent of respondents – expect a hard rebound as the proportion forecasting a protracted house-price decline.

There is a clear consensus that credit conditions are going to be tighter and weaker. Expectations of such deterioration are at a record high for the government sector, financial institutions (FIs) and nonfinancial corporates. About 80 per cent of investors anticipate weaker conditions for credit issuers (see chart 4).

Investors are increasingly concerned about the impact of economic conditions on banks and the potential for a funding

CHART 11. IF YOU WERE TO BUY IN THE PRIMARY MARKET TODAY, WHAT MARGIN WOULD YOU BE PREPARED TO PAY?*



* Values are an average of answers provided. Five-year tenor unless stated otherwise.

SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

squeeze. More than half the survey respondents say the economic situation is a "critical" risk to bank credit quality over the next 12 months, and more than 40 per cent highlight access to funding as a critical risk (see chart 5).

Fitch downgraded the big-four Australian banks, to A+ with negative outlook, on 7 April (see p26). Its analysts say the majors remain "adequately capitalised" with "sufficient liquidity to weather the disruption, at least in the short term".

The pandemic will pressure the operating environment for Australian banks, particularly with asset quality and earnings. Fitch's base case is for a sharp economic contraction in H1 2020, with a modest recovery beginning in H2. Unemployment is likely to remain elevated relative to pre-pandemic levels.

Significant government and bank support should assist business and household borrowers. Nevertheless, Fitch expects a portion of businesses will not resume after lockdowns end and many households will be unable to resume repayments when loan holidays finish. This will drive impairment charges higher at the same time as lower interest rates pressure net interest margins, while credit growth is likely to remain low.

The banks are generally well capitalised, which will help to offset some of these risks – although there remains a substantial downside threat to Fitch's base case.

In funding markets, the Reserve Bank of Australia announced its term funding facility (TFF) for banks on 19 March (see p34) – right at the end of the Fitch-KangaNews survey period. It is possible knowledge of this facility may have reduced investors' concern about access to funding.

The purpose of the TFF is to free up credit for businesses and households via the banking sector. Again, its existence might have mitigated investor concern about a funding squeeze in the real economy – concern that was clearly elevated during the survey period (see chart 6).

On the other hand, it seems unlikely that any support measures would have significantly changed the investor outlook on corporate Australia's weakening position. The survey shows a jump in expectations about corporate leverage (see chart 7) that is not driven by a positive view on investment – far from it. To the extent that corporates have cash to deploy in the coming year, fixed-income investors predict maintaining buffers will be the main priority, over investment and even shareholder compensation (see chart 8).

With these factors in mind, investors will probably be keeping a close eye out for any signs of stress in the corporate loan and capital markets. For the first time in the history of the Fitch-KangaNews survey, more investors foresee refinancing problems for a specific sector than predict no significant refinancing issues. The buy side thinks nonfinancial corporates will be the ones in the firing line (see chart 9).

Australian corporate issuers have been all but silent in debt capital markets since the explosion of the COVID-19 crisis, with just two deals printing – both in the euro market. Domestic banks have also been all but silent, and the TFF is likely to keep a lid on issuance by Australian FIs across the globe. The sovereign and semi-government market, meanwhile, has started ramping up to a new phase of issuance growth.

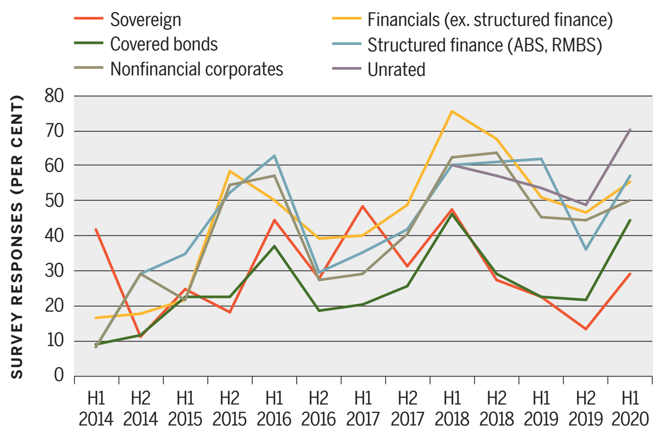
This pattern matches investor expectations. The survey shows a net 60 per cent-plus of fund managers expect growth in issuance from the government sector, while expectations around FI and corporate issuance are both in negative territory (see chart 10).

When it comes to investors' own participation in markets, the spreads fund managers say they would be willing to pay for various debt asset classes have gone up across the board – though arguably not massively (see chart 11).

Most investors forecast further spread widening in all credit asset classes. Even the proportion anticipating cheaper sovereign debt and covered bonds grew significantly from the survey conducted in the second half of 2019 (see chart 12).

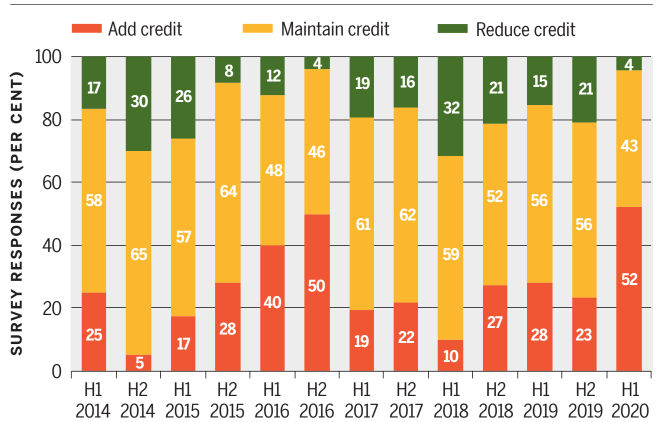
The most positive news from the survey is that investors appear to believe buying opportunities will emerge on the back of a wide-ranging repricing. At 52 per cent, the proportion of investors expecting to add credit in the coming 12 months is a record for the Fitch-KangaNews survey (see chart 13). •

CHART 12. SPREADS EXPECTED TO WIDEN "SIGNIFICANTLY" OR "SOMEWHAT" OVER THE NEXT 12 MIONTHS



SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

CHART 13. CREDIT ALLOCATION EXPECTATIONS OVER THE NEXT 12 MONTHS



SOURCE: FITCH RATINGS, KANGANEWS MARCH 2020

TWO DEGREES OF CONTAGION

As the world scrambles to battle the COVID-19 pandemic, markets are working out how measures to fight the virus will affect economies and finding their best path forward.

A panel of market participants from New Zealand, convened via teleconference, agree the country is in a better public-health position than almost anywhere but acknowledge that the outsized influence of global markets on the local economy – and the scale of economic support programmes – make for a precarious future.

The discussion took place on 26 March – three days after the New Zealand government announced an immediate transition to a level three lockdown and advised people and businesses to prepare for level four. Panel participants largely applaud this swift and drastic action.

The discussion is an expanded version of a panel session that would have featured at the postponed KangaNews New Zealand Capital Markets Forum. KangaNews would like to thank ANZ for supporting the live session and the following coverage.

PARTICIPANTS

■ **Tony Allen** Head of Wholesale FX, New Zealand and Global Head of FX Overlay ANZ ■ **Jared Barton-Hills** Head of Credit Trading, Australasia ANZ ■ **Paul Cable** Head of Interest Rate Trading, New Zealand ANZ ■ **David Croy** Senior Interest Rate Strategist ANZ ■ **Diana Gordon** Head of Fixed Income KIWI INVESTMENT MANAGEMENT ■ **Vicky Hyde-Smith** Head of New Zealand Fixed Income AMP CAPITAL ■ **Dean Spicer** Head of Capital Markets, New Zealand ANZ ■ **Sharon Zollner** Chief Economist, New Zealand ANZ

MODERATORS

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

ECONOMIC IMPACT

Davison With COVID-19, we are dealing with a public-health issue that metastasised into an economic and then a market problem. By late March, the impact is all-pervasive and it is difficult to unwind the specific impact of and relationship between the various inputs. How can we unpick everything that is going on to reach any reasonable market conclusions ?

■ **ZOLLNER** This is a multi-layered issue. I have been avoiding calling it a crisis but I think we certainly can label it as that now. It is a human health crisis overlayed by an economic crisis and it is threatening to turn into something ugly in financial markets as well.

This should be no surprise, because everyone is locked in their homes and a huge number of firms are in a lot of trouble. In this regard, there is nothing weird, irrational or strange happening. In fact, falling equities is an entirely rational response because earnings are going to be much lower.

Central banks and governments are throwing everything they possibly can at the crisis. Unfortunately, the soothing messages and packages are not having a long-lived effect. The Fed [US Federal Reserve] has brought out the bazooka now with unlimited QE. So far, so good – in that equities have had two up days.

Equities are still volatile, but pressures in the credit market may be more of a concern. Global debt has gone up to high levels in the last 10-12 years. US corporate debt is a focus – junk bonds in particular – as is the potential for fallen angels, given the deterioration in the average quality of investment-grade bonds.

Davison To what extent does the degree of disintermediation and corporate leverage in the US debt market make for an idiosyncratic challenge there? Or is everyone in the same boat?

■ **ZOLLNER** The US is a big boat. It is also massively important to the global financial system and it does seem to be acting a bit late and giving mixed messages in response to the crisis.

This is a real concern, because the US dollar is the safe haven. We all saw money rush to the US in 2008-9, even when the fire was in the house. I think the US dollar will maintain its safe-haven status for lack of alternatives if nothing else. But things get complicated quickly when it is the numeraire risk-free asset that is potentially in the thick of it.

BUY-SIDE CHALLENGES

Davison Investors are dealing with two challenges at the same time: a near-term liquidity crunch in capital markets and the medium-term deterioration of credit quality driven by the economic hiatus and downturn. How are they addressing the combination of the two factors?

■ **GORDON** My background is in the US high-yield market so I tend to keep an eye on this sector. It was down 20 per cent in a month with, in effect, zero bids for several days. This is unprecedented.

We are now seeing some stabilisation with the Fed throwing the kitchen sink at the US market, and some liquidity is coming back. As an investor, you might not like the price and bid-offer spreads are still large – but a price does exist.

High-quality US issuers have also been coming to the primary market, albeit at extraordinarily high prices. This is quite a big difference from the last two weeks.

In fact, my concern is more with the New Zealand market, where, ironically, the credit is better but liquidity has been challenging. Essentially, where you had your portfolios in mid-January is what you own now. Like it or loathe it, that is where you are.

■ **HYDE-SMITH** It is quite challenging. We went into this event with credit premia beaten down, term premia beaten down and investors chasing liquidity premia to preserve yield – in the view that financial conditions would remain easy. Liquidity deteriorated sharply as investors found themselves suddenly overexposed to risk, potentially facing downgrade risk and even default risk in some instances.

As Diana Gordon says, investors are stuck with what they owned in mid-January, because there has been very limited ability to exit ever since those doors started closing.

New Zealand is a small market and a small, open economy so we import these risks quite quickly. No issuer has been immune, although supranationals have outperformed.

We are now looking closely at what we own, and at default and downgrade risk. It is still very uncertain. The banking system goes into this in a much stronger position relative to earlier crises and, in its role as a conduit, with buffers to facilitate borrowing.

But should it persist for longer, and should policy settings not be sufficient to contain unemployment, it could morph into something more concerning for the banking sector. Rating agencies will be very focused on this as a risk.

Davison Are investors experiencing redemption pressures?

■ **HYDE-SMITH** Hedge losses can certainly lead to redemptions in this environment, as can rebalancing as multiasset managers seek to move equity exposures back to target levels. I imagine most institutional investors will be very mindful of this and will be wanting to manage cash holdings and limit headroom accordingly.

It is important to hold sufficient cash going into this environment. Even if you have positioned portfolios conservatively, you can still be the one called on for cash. We experienced this in the financial crisis. We didn't hold the exposures to credit to the extent other managers did but clients came knocking on our door to fund rebalancing trades because we had more cash.

■ **GORDON** It is much the same liquidity story for us. We are fortunate because we saw what was happening last year: with treasury yields falling and the equity market reaching new

"It is an abyss that we are tipping money into and there are limits. It is absolutely the right thing to do, but it is not sustainable forever."

SHARON ZOLLNER ANZ

SURPRISING UPSIDE: NEW ZEALAND, FX AND COMMODITIES

The New Zealand dollar declined rapidly as the COVID-19 crisis intensified. But there are reasons to think it – and many local commodity exports – may be approaching a positive trend.

DAVISON How have the past few weeks played out in the FX market?

■ **ALLEN** It has been an amazing couple of months for us. Going back to December, we had the US-China trade agreement and there was a lot of optimism in the region.

Suddenly, the virus in Wuhan starts being talked about, it increases its ferocity and the region quickly replaces the optimism with pessimism. It has created unknowns about how this will affect trade flows from China and just how big the problem is going to become.

Australasian currencies, and the New Zealand dollar in particular, started drifting down to US$0.64 from US$0.66-0.67 just before the crisis really hit. This was an orderly decline, as everyone, particularly the US stock market, was ignoring the issue.

Then, suddenly, there were huge moves south in Australasian currencies when the global equity markets were hit. It resulted in a rebalancing effect as Australasian fund managers were forced to liquidate portfolios' currency hedges.

We have seen massive outflows from our currency. At one point last week, the New Zealand dollar fell 8-9 per cent in 24 hours, down to a low of NZ$0.55. The US cut rates by 1 per cent and it had no effect on the currency because, as equities went down, the currency followed them down another 11-12 per cent. It is no longer a yield story – it is a survival story.

Funding for US dollars was much in demand. That was a problem for the euro and the yen but not so much for the New Zealand dollar because of collateral payments coming into the New Zealand banks.

The overall uncertainty revolves around how much damage has been done to portfolios and, therefore, how much currency rebalancing has to be done.

The other side is that exporters were probably over-hedged, and hedged at bad levels, and they did not know if their customers were going to be buying anymore. All these things caused a vacuum in the market.

Looking ahead, we have seen preliminary trade data, up to 18 March, suggesting New Zealand primary produce sectors are back in operation and are doing quite well. Forestry and fisheries are doing a little worse but beef and dairy are quite strong. Overall, our trade numbers are holding up well.

Once we get through this rebalancing, my view is that a lot of the pain in the currency will probably be done. QE is happening around the world but the US$2 trillion the US is printing is a massive number. After the global financial crisis, US QE helped drive the New Zealand dollar up as high as US$0.88. If we get things sorted out here, it is not obvious to me that the currency falls after this month.

■ **ZOLLNER** It is a good time to be selling food. In a global recession, selling necessities is a safe bet. I see the potential for food security being quite a pressure point this year. Governments around the world are going to prioritise it, and this will be to our advantage. Our beef industry had shifted away from China to the US as a result of the coronavirus earlier this year but it looks like it will shift right back again. It is ironic: a month ago our huge exposure to China was a vulnerability and now suddenly it is a positive again.

These things can change really quickly, but our exporters seem to have a good breadth of customers and should be able to navigate the situation pretty well. We are reasonably upbeat on our commodities.

We expect some favourable current-account outcomes with the savings rate going through the roof as people are stuck at home and have little to buy. This will cap imports.

However, I do not see much risk of the New Zealand economy being over-stimulated now. One can paint scenarios in which stagflation emerges down the track but I cannot see growth taking off. Our baseline scenario is that we go through degrees of lockdown until there is a vaccine. Economic activity will not be set free for a long time.

"ONCE WE GET THROUGH THIS REBALANCING, MY VIEW IS THAT A LOT OF THE PAIN IN THE CURRENCY WILL PROBABLY BE DONE. IF WE GET THINGS SORTED OUT HERE, IT IS NOT OBVIOUS TO ME THAT THE CURRENCY FALLS AFTER THIS MONTH."

TONY ALLEN ANZ

peaks, we figured somebody was right and somebody was wrong. Something had to give.

We continued to reduce credit in the portfolio in favour of quasi-sovereign exposure, which we had been doing for the last 12 months. But if anyone predicted what we are seeing now – the maelstrom that has occurred in markets – they deserve the Nobel Prize and have probably just made several billion dollars.

We have just been trying to keep liquidity in the portfolio for redemptions and rebalancing. When interest rates went up, it was a bit like the end of the *Titanic* – the bow rising before it

“My concern is with the New Zealand market, where, ironically, the credit is better but liquidity has been challenging. Essentially, where you had your portfolios in mid-January is what you own now. Like it or loathe it, that is where you are.”

DIANA GORDON KIWI INVESTMENT MANAGEMENT

all went down. This was shocking. We did not even see it in the global financial crisis.

The treasury market did not have this kind of pressure in the financial crisis: it was almost entirely a credit event. When we saw the types of moves that have happened in recent weeks, we realised it was not just the risk-parity funds that were unwinding – there was clearly also a massive leverage unwind happening.

Having cash and making sure you have access to liquidity has been absolutely critical for everyone’s mental health in this industry, because we are the first port of call. You might have been accumulating a beautiful portfolio, but Vicky Hyde-Smith is right – they come knocking on the door.

RATES AND CREDIT CONDITIONS

Davison Can sector specialists give a New Zealand perspective on how markets have behaved as the COVID-19 crisis has unfolded? As we have been discussing high-grade bonds let’s start with the rates market.

■ **CABLE** It has been an astonishing period. The RBNZ [Reserve Bank of New Zealand] was showing a real reluctance to ease rates as recently as February, yet now it has cut rates to what it says is the low bound – though that may change – and has begun QE. The turnaround is remarkable and I think it is possible even the reserve bank was not ready for it.

Diana Gordon and Vicky Hyde-Smith both talked about the liquidity challenges. These put a lot of pressure on the New Zealand market and I think they are what brought the RBNZ’s QE plans forward so quickly. Rates were higher after the interest-rate cut than they were before it, which is similar to what we saw during the financial crisis.

This liquidity provision the RBNZ has added was necessary and it will be big if it continues in the same vein in which it has started. Coupled with the RBA [Reserve Bank of Australia] and other central banks adding a huge amount at the same time, what we have seen is a contraction in many funding spreads. This has taken a bit of pressure off the New Zealand market.

Where it goes from here is difficult to predict. I am of the view that this will be over quicker than the market expects now. The New Zealand government’s aggressive quarantine policy, which was brought in during the early stages of the virus spread, will hold the country in good stead.

In fact, I worry that we may end up over-stimulated in a short amount of time and then the RBNZ will have to look at unwinding some of the stimulus. For now, though, the liquidity provision is necessary. It has stabilised swap spreads, put a backstop on credit and helped other funding spreads and foreign exchange.

I am not sure the problems have gone away offshore. The liquidity the RBNZ and RBA have provided has encouraged sellers, where previous QE programmes have encouraged investors to buy in the same direction as the central bank. I suspect we will see a vast reduction in offshore holdings of New Zealand government bonds and, in effect, the RBNZ bringing those bonds onshore.

■ **CROY** Something significant was needed. The size of fiscal packages globally was large and there was no way the world’s markets could absorb them. Central banks had to step up to the plate.

The good news for New Zealand is that we have gone into this with low levels of government debt, which has given the RBNZ balance sheet the flexibility to respond in significant volume.

As for the efficacy, I think the RBNZ’s LSAP [large-scale asset purchasing] programme will be successful at making the curve lower and flatter. I think it will be effective because of the large size of the programme – I thought we’d see a package of just NZ$20 billion (US$12.1 billion) and I was at the top end of market expectations – and because the RBNZ has a lot of flexibility within the NZ$30 billion to vary the pace and timing of purchases.

[RBNZ governor] Adrian Orr has hinted at widening the scope of QE. I do not think we will see other asset classes included just yet but I think this will come in time, given where credit spreads are travelling.

Davison How has the New Zealand credit market performed through the COVID-19 crisis to date?

■ **BARTON-HILLS** The backdrop coming in was years of easy policy, which crowded many investors into lower-grade credits and out on the maturity curve. The initial setup was not constructive for a negative shock, which we ended up getting.

The reaction in credit markets was the sharpest I have seen – much more severe than what we saw in 2008. The biggest casualty was liquidity.

"The fiscal and monetary stimulus being put out now is unprecedented. While governments and central banks have probably done enough to cushion this current move, how it will play out once economies recover is potentially a much bigger problem."

JARED BARTON-HILLS ANZ

We have changed shape a lot since 2008. Regulation has reduced the size of intermediary balance sheets, which has been a big factor.

Offshore, we have seen the rise of passive investing – which tends to spur much more price-insensitive trading on the buy- and sell-sides. When a price-insensitive seller comes to a market that does not have strong demand, it tends to hit whatever bid it is shown. Those bids have been moving back further and further.

We do not have the same structural setup in New Zealand in the sense that passive investing is less prominent here. But our market is of course sensitive to what is going on overseas. The link through the equity market is quite strong, too. If you cross a 100-basis-point spread to sell a bond in order to buy into an equity market that has dropped 10,000 basis points, it is still a good trade. Investors' flexibility in hitting the bid is quite high.

We definitely saw this in certain sectors, particularly retail – where we have seen amazing trades in the sense of how far spreads have moved in a short period of time.

The market was, in effect, shut for a week and a half, with only small volume going through. Those trades that did go through had wide bid-offer spreads.

There was a regional turning point for markets starting at the end of last week, when the RBA came out with its QE programme. This was backed by the widening of the Fed's programme and it has put a short-term floor under the market here.

There has been a slow but steady contraction in bid-offer spreads and a small pickup in activity. It feels like we have turned a corner, at least for the time being. A lot of medium-term risks still exist. We need to get through month-end rebalancing and then we still run the risk of rising cases [of COVID-19] in the US.

Markets did not take note of the health crisis until it hit the US, then it became the major focus. We need to watch how it progresses there. If it gets significantly worse, markets could turn again.

The other point to think about in the longer term is that the fiscal and monetary stimulus being put out now is unprecedented. While governments and central banks have probably done enough to cushion this current move, how it will play out once economies recover is potentially a much bigger problem.

Davison We have been talking for years about reduced capacity on dealer balance sheets, and this has been identified in some quarters as an exacerbating factor in the liquidity issues experienced in the early days of the COVID-19 crisis. Do conditions like those we have seen in recent weeks further affect the ability to hold bonds in trading books?

■ **BARTON-HILLS** Large swathes of the Kiwi market are still high-grade and for these sectors the issue is liquidity rather than credit. Even so, as an intermediary I cannot soak up all the selling that may come through. I need to react to changes in liquidity conditions. Looking down the credit spectrum locally, I have been a lot more cognisant of what I take on and what its long-term prognosis looks like.

Everyone has been aware of this issue on the credit side but it had fallen to the back of people's minds because high-yield came to be thought of as another relative-value trade. Everyone will probably realise in the next cycle that high-yield is not a relative-value play.

Having said this, I would like to repeat that most of the traded market here is still in the investment-grade space. There are not a lot of spots I am concerned about.

"Yield curve control is quite a clear signal and there is some value to this. It isn't volume dependent so it is equivalent to unlimited QE. We're largely indifferent, provided we think the intent is there to upsize or broaden the purchases if necessary."

VICKY HYDE-SMITH AMP CAPITAL

QE EFFICACY

Davison QE and fiscal packages seeem to have a common problem at this stage, specifically that it is hard, if not impossible, to stimulate an economy if people are being told to stay at home. Is this part of the response just about having factors in place to prompt a quick economic recovery when one is possible?

■ **ZOLLNER** The reality is that no-one knows. The government avoided calling it a stimulus package precisely because you cannot tell people to go out and spend when they are supposed to be staying at home.

The support is about getting as many jobs, businesses and mortgages through this in one piece as possible. We do not know how long this will take. The New Zealand government, like many others, announced a surprisingly large package and within a week it was scaled up again – and the situation will likely continue to require more.

It is horrendously expensive, so government debt will explode. Also, some of the package involves freeing up credit. This is great, but it means firms will be saddled with a lot of debt at the other end. They will need to stay viable through what is likely to continue to be tough times.

We just don't know how successful the support will be in getting firms through, because we do not know how long it will take. The initial package, with NZ$5.1 billion of wage subsidies for small and medium-sized businesses, will last 12 weeks and that is about three budgets' worth of spending.

It is an abyss that we are tipping money into and there are limits. It is absolutely the right thing to do, but it is not sustainable forever.

Davison Markets and analysts seem to have greeted the RBNZ announcement positively. It is interesting, though, that the RBNZ has gone for a purchase volume rather than deploying a yield curve target in the way the RBA did – also to a positive response – in Australia. Would yield curve targeting have been a superior option?

■ **CROY** Yield curve control is much more specific; no-one is under any illusion as to where the RBA would like the front end of the curve to be. There are many reasons the RBNZ went down the traditional QE route and kept it focused on government bonds. One was simple operational readiness. This is not to be critical but the obvious first step was to start vanilla – with government bonds – and evolve from there.

I think things will evolve. At some point, the [RBNZ] governor may give an idea of what the Monetary Policy Committee thinks is an appropriate level for the term structure of the government bond curve. In essence, the central bank would be using verbal guidance rather than forward guidance to give the market an idea of where it would like the long end of the curve to be – that is, what it is looking to achieve through QE.

The sovereign curve is currently 25-30 basis points above the Australian curve, despite having the same cash rate and outwardly pursuing the same objectives.

The other interesting thing is how much flexibility the RBNZ has, and I expect it to use that flexibility to bring us more into line with Australia. The responsibility for executing the NZ$30 billion QE programme sits with the RBNZ executive – the governors. It can use it quickly if it feels it must to get market conditions where it wants.

I expect some variability in the pace and timing of asset purchases to achieve the objective. The central bank can use this to send a strong signal to the market as to the level on which it wants to land. If it is not happy with where things are over the next few days, it will hit the market with more until it does achieve what it wants.

■ **HYDE-SMITH** I agree. Only time will tell what the best method is. Yield curve control is quite a clear signal and there is some value to this. It isn't volume dependent so it is equivalent to unlimited QE. We're largely indifferent, provided we think the intent is there to upsize or broaden the purchases if necessary.

As Sharon Zollner says, it is a fluid situation. What seems reasonable is not reasonable a few days later. At the moment the intent to do what is needed appears to be there. Additional assets could also be included if necessary.

■ **CABLE** Looking at the international experience, the Fed used phrases like "at least" about QE volume and then a few days later made it infinite. Central banks clearly have a yield level they want to achieve in their minds.

■ **GORDON** I think we will not return to normal any time soon. This is a global crisis, even more so than the financial crisis because then there was stimulus from the growth of China, which tempered things.

"Part of the reason the RBNZ package focused on government bonds to start with is simply because this situation was thrust upon us quickly. The initial response has been to keep it pretty vanilla, but it is evolving rapidly."

DAVID CROY ANZ

NEW DATA INPUTS

Analysts, traders and fund managers are used to financial modelling but are now, in effect, expected to develop outlooks that incorporate epidemiological outcomes.

DAVISON What are analysts using as base and outlier cases for things such as contagion peaks and timelines for relaxing social distancing measures – and thus the path back to something like normal economic activity?

■ **ZOLLNER** We are all amateur epidemiologists nowadays! The uncertainty that abounds is ridiculous. There is a lot of demand, within the bank and outside, for numbers people can work with, even though everyone knows they will be based on particularly uncertain assumptions. For what it is worth, we think New Zealand will not be able to eradicate COVID-19, simply because there are asymptomatic cases.

But we may have got on top of it earlier than other countries. Even so, our prime minister is warning us that we will have thousands of cases and that we are at least two weeks away from the peak – we have to be realistic about this.

Our base case is that we have a four-week lockdown that proves sufficient. I think this is optimistic, but if it proves correct, it should get us back down to level-three lockdown – where schools are reopened and people can go back to work but are still encouraged to work from home if they can.

From there, we get back to level two – but always with the possibility of racing back to level four.

We will manage the virus in waves until there is a vaccine. That is the circuit-breaker because herd immunity, if we are successful in flattening the curve, is years off.

■ **GORDON** I would suggest people do two things: listen to Bill Gates's TED Connect from last week and read the article *The Hammer and the Dance*. I am much more optimistic because this is an exponential function. If people go home for perhaps six weeks and we thus get to flattening the curve early enough, it is almost like eradication. We have to get absolute control of it, but that is possible.

New Zealand is in a far better position than the rest of the world. It is going to take a long time for the world to recover from this.

■ **ZOLLNER** I agree. I do not think there is any other place in the world I would rather be than New Zealand. Our borders are not porous and we got into lockdown early.

Fund managers globally will not care about the New Zealand curve; they will use the RBNZ purchases to get out of New Zealand government bonds. What worries me is who will buy the new issuance. The government will need to issue much more than NZ$30 billion and I question how much we can control this process.

We can signal, for instance by saying that things are much more stable in credit markets. But to what extent this continues to be the case is up for debate. My concern is the sheer scale of all the central banks in the world going out and doing the same thing.

I should be clear that New Zealand is in a fantastic position because it does not have a lot of debt. It is a wonderful place to be and I am grateful to live here today. On the other hand, we may be only a small proportion of every central bank's holdings but is any central bank going to buy New Zealand government paper instead of its own now? I doubt it.

Sovereign risk has become credit risk again. Bearing in mind liquidity and thinking about where I would put money right now to protect my clients, this market is now in a 'return of' rather than a 'return on' situation – and I need to be paid for that.

We also cannot have the kind of bid-offer spreads we have in the quasi-government space if we want offshore investors to come in. It would be good to see the RBNZ extend purchasing to some of the other high-quality names in the local market, for this reason.

I do not think the RBNZ needs to go down the spectrum yet. We do not know what the default situation will look like but we are in a maelstrom still, and it came on quickly. The market has not settled yet and there will be another wave of rebalancing in balanced funds at the end of the month.

I am leery of thinking NZ$30 billion will be enough. I think the RBNZ will need to buy big swathes of bonds.

■ **HYDE-SMITH** One thing we are conscious of is the long end of our curve. This comes down to the ability of the US to control the longer dates in its own market. If it cannot do this, it will spill over to our longer-dated bonds.

"I worry that we may end up over-stimulated in a short amount of time and then the RBNZ will have to look at unwinding some of the stimulus. For now, though, the liquidity provision is necessary."

PAUL CABLE ANZ

> “The market is lacking confidence and there is a question of whether further fund redemptions may flow. It is hard to feel confident now about a pipeline of issuance. But the market can turn quickly.”
>
> **DEAN SPICER** ANZ

■ **CROY** New Zealand had the good fortune of going into this with government debt so low that even if the reserve bank’s balance sheet absorbed the whole market and everything that came down the pike in the next few years, it would still have a relatively small balance sheet by global standards – and in comparison to commercial-bank balance sheets. I’m obviously not saying this will happen, but it demonstrates the upward scalability the RBNZ has.

■ **BARTON-HILLS** This is not a new cycle. It is the same that we have seen consistently since the mid-90s. It is just that the quantum each time is going up and it is doing so at an exponential rate. At some point, one of these cycles will not work.

The numbers right now are unfathomable and we do not know what the outcome will be. The playbook has not changed – central banks just keep bringing in more tools to ease conditions even further.

Davison On the subject of wider QE, is the RBNZ likely to broaden its buying programme to the likes of Kāinga Ora – Homes and Communities and the Local Government Funding Agency (LGFA)? From there, is it likely to move into the credit market, in the form of a bank funding facility?

■ **CROY** The irony is that if the RBNZ takes care of the government bonds and uses other facilities to help liquidity for banks and smaller businesses, we could see larger issuers missing out. This is exactly what we do not want.

While the RBNZ does not particularly want to take on the credit risk, the alternative of doing nothing and watching the repricing that has gone on across the high-grade credit market undermine everything it is trying to do is probably too much to bear.

I go back to what I said before: part of the reason the RBNZ package focused on government bonds to start with is simply because this situation was thrust upon us quickly. The initial response has been to keep it pretty vanilla, but it is evolving rapidly.

Davison What are the likely consequences of QE for capital-markets activity in the New Zealand domestic sector? It seems likely that the RBNZ is going to suck up quite a lot of government-sector supply and corporate funding is going to be reintermediated through the banking system. Should we expect a prolonged hiatus for bond issuance in New Zealand?

■ **SPICER** The closest thing I can remember to what is occurring now is when Ireland guaranteed its banks and the whole world realised it had to follow suit. We are seeing a similar global response now. The reality is that we would be at risk in New Zealand if we find ourselves out of step with the actions being taken globally.

We need to cover the semi-governments, such as Kāinga Ora and the LGFA. This will, hopefully, bring confidence back and could potentially encourage confidence in other parts of the market.

In the absence of this, it is particularly hard to see how regular issuance would restart. One observation I would make is that the commercial paper market can only get cover on the short-dated end now. The market is lacking confidence and there is a question of whether further fund redemptions may flow.

It is hard to feel confident now about a pipeline of issuance. But the market can turn quickly. If we got further support from QE, it would be a welcome step in the right direction. •

> “The US is a big boat. It is also massively important to the global financial system and it does seem to be acting a bit late and giving mixed messages in response to the crisis. This is a real concern, because the US dollar is the safe haven.”
>
> **SHARON ZOLLNER** ANZ

Illiquidity bites New Zealand credit market

The New Zealand dollar corporate market appears to have battened down the hatches in the face of the COVID-19 storm. The specifics of local demand have shielded New Zealand from worldwide volatility on occasion but market participants say the low-rate environment now leaves it more vulnerable to global moves.

BY MATT ZAUNMAYR

New Zealand credit was already off to a slow start in 2020 with just two new deals – from Bank of New Zealand (BNZ) and Westpac New Zealand – coming to market even before COVID-19 hit in earnest. In late February, Transpower New Zealand expressed its intent to bring a tap of its March 2025 line to market in mid-March – but pulled the deal as volatility bit.

Dean Spicer, head of capital markets New Zealand at ANZ in Wellington, tells *KangaNews* corporate issuers are unlikely to be forced into volatile markets. "Most of New Zealand's corporate borrowers have come into this period with healthy maturity profiles and good funding diversity. They are well positioned and can weather some extended volatility," he says.

Secondary marks suggest New Zealand was outperforming its global peers in the early coronavirus-driven maelstrom – as tends to happen during negative market moves. But local participants say this does not necessarily reflect a robust environment.

Mark Brown, Wellington-based head of fixed-income portfolio management at Harbour Asset Management, says little actual trading was happening. "Price makers are being defensive and marks are likely best-endeavours estimates, rather than true reflections of any market appetite," he said in mid-March.

FIXED PORTFOLIOS

Fund managers gain one practical benefit from the lack of trading, explains David McLeish, head of fixed income at Fisher Funds Management in Auckland. "If assets are less volatile because they simply stop trading, this can help keep things from getting out of hand," he says. "Less volatility reduces the risk of panic and this should reduce redemptions from funds, allowing managers to maintain positions without having to liquidate."

This dynamic also has risks, though. McLeish notes that if fund managers need to sell out of positions, the bid for those assets could be depressed or there might be no buyers at all.

But a sell-off does not appear likely, at least in the near term. Portfolio managers appear to be working on the principle that their holdings are largely locked in, given all-pervasive illiquidity (see p58). Brown says Harbour made some changes to its positions when initially analysing the potential fallout from COVID-19. However, prices have moved sufficiently that the firm thinks the risks to specific companies are not evident enough to justify selling at current levels.

DIMINISHED RETAIL

The large contingent of retail investors buying New Zealand corporate bonds has sheltered the market from global volatility in the past. The market was open for business even in the shadows of the financial crisis in 2009. However, New Zealand was in a fundamentally different yield environment then. The average coupon on unrated corporate deals in New Zealand has come down sharply in the last two years, in line with the cash rate (see chart 1).

Mike Faville, head of debt capital markets at BNZ in Auckland, tells *KangaNews* retail investors will in all likelihood show less demand for unrated corporate bonds with rates at historic lows.

Shaun Roberts, head of debt capital markets at Forsyth Barr in Wellington, says unrated deals could come to the market with yield of less than 3 per cent, although he acknowledges margins have widened to offset the fall in rates. Argosy Property priced a deal at less than 3 per cent in late 2019 but that was in less volatile conditions. A sell-off in swap rates could push yields higher, Roberts notes.

Historically sticky bank deposit rates in New Zealand provide stiff competition for retail corporate bonds, particularly in times of market stress. Unrated corporate debt with potential coupons at about 3 per cent would have to compete with major banks offering 12-month term deposits at 2-2.6 per cent.

Still, intermediaries predict corporate deals – even unrated ones – will be possible when market stability returns. Most of the market expects highly rated names to reopen offshore markets, but Mat Carter, Auckland-based director, debt capital markets at Westpac Banking Corporation New Zealand Branch, asserts that there is retail cash available to be put to work in New Zealand for unrated corporates if coupon hurdles can be met.

"The key consideration is achieving an appropriate balance between the minimum coupon and the credit margin," he comments. The Reserve Bank of New Zealand (RBNZ) is bottoming out the cash rate, which could help crystallise investor acceptance of a lower-for-longer rates environment, Carter adds.

Roberts adds that when conditions stabilise the current volatility may encourage more corporate treasurers and boards to reconsider the structure of their debt funding. In this case, the efficiency, diversification and tenor benefits of capital-market transactions could bring them into favour.

This could be particularly relevant in sectors where major banks may be less willing to lend because of tougher regulatory capital requirements the RBNZ imposed at the end of 2019.

FACILITATING FUNDING

In the near term at least, Faville says, if companies have funding needs or maturities to refinance they will probably be inclined to access bank lines rather than risk a public debt capital markets transaction.

New Zealand corporates that need funding would be well served by a return to stability offshore. Carter tells *KangaNews* New Zealand will probably look for stability and green shoots overseas – ideally in increased offshore primary supply.

Spicer says opportunities in New Zealand debt capital markets will return once there is some global stability. The market will then play a large role in identifying opportunities to facilitate bank and corporate deal flow.

Fund managers agree one prerequisite for comfort in the New Zealand credit market is probably offshore deal flow. Until this emerges, Harbour's Brown says, managers will remain cautious.

McLeish says Fisher, which manages domestic and global funds, was beginning to see buying opportunities as early as late March, as credit spreads were by then close to where they were in the sell-off of early 2016 when concerns about a slowdown in China were reverberating through markets.

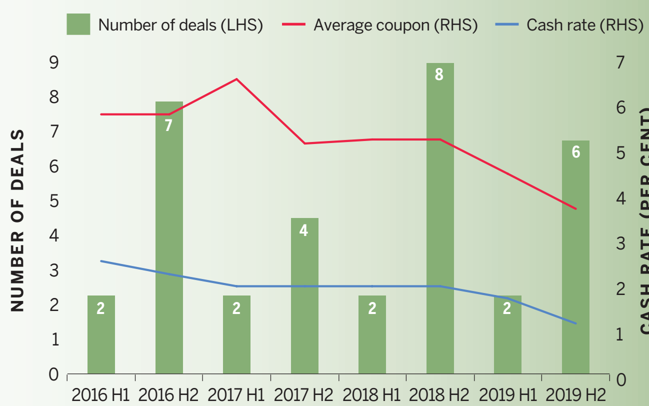
"To put this further into context, since early 1999 – when our data series begins – global investment-grade credit spreads have been higher than now only about 30 per cent of the time," McLeish comments. "After a period of extreme overvaluation, global corporate bonds are finally starting to offer some value."

But Vicky Hyde-Smith, Wellington-based head of New Zealand fixed income at AMP Capital, says it is still too early to be taking on risk. "We are trying to marry credit levels with the broader economy so where the market moves from here depends a lot on the growth outlook," she comments.

It is still early for assessing the human and economic cost of COVID-19 and measures to stop the pandemic continue to cause disruption. New Zealand will be led by larger markets, McLeish asserts. Furthermore, given New Zealand credit tends to outperform as global corporate bond prices fall, he argues the local market may land at unattractive levels compared with global options once volatility subsides internationally.

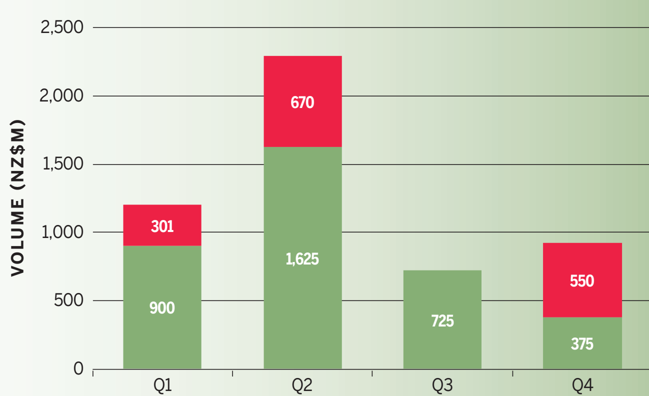
If there is a rebound for New Zealand credit, the second quarter appears to be when investors should have plenty of cash to put to work as corporate and financial institution redemptions will be peaking for the year (see chart 2).

CHART 1. NEW ZEALAND UNRATED CORPORATE DEALS



SOURCE: KANGANEWS 12 MARCH 2020

CHART 2. NEW ZEALAND CREDIT MARKET 2020 REDEMPTIONS



SOURCE: ANZ, KANGANEWS 3 MARCH 2020

But judging the point when global markets might stabilise is difficult, given the nature of the crisis. Iain Cox, head of fixed interest and cash at ANZ Investments in Auckland, tells *KangaNews* the focus is on mapping the spread of COVID-19 and trying to assess the potential political and economic impact.

Cox noted the likelihood of more government reactions such as in Italy – where the whole country has been put into lockdown – and restrictions on businesses, even ahead of New Zealand's own highly restrictive lockdown.

A flight to quality might be expected from fund managers and their end investors in this environment. The expected increase in supply from the high-grade sector might compound this, as could a relative widening in price for some of New Zealand's high-grade names, Hyde-Smith asserts. New Zealand Local Government Funding Agency and Kāinga Ora – Homes and Communities have both indicated increased funding requirements.

Cox says it would be natural for some investors to move into more conservative portfolios, though this is not necessarily the right strategy if they are investing for the long term. He adds that the current environment provides vindication for taking a strategy with high-grade credit that treats bonds as the defensive assets they are designed to be, rather than as equity-like instruments. •

Mutual ADIs position for the future

The second annual **KangaNews Mutual Sector Wholesale Funding Seminar** took place in Sydney on 25 February. Discussions covered the sector's performance and competitive position, access to wholesale funding markets, the potential for additional-capital issuance (see p72) and how mutuals can incorporate technology to add efficiency in the treasury function.

STEPHEN ROBERTS LAMINAR CAPITAL

The bushfire crisis eliminated the federal government's idea of balancing the budget and winding down government debt at all costs, and now with the coronavirus it will not blink twice about providing fiscal stimulus to industries affected. The government will go further down the fiscal track – it would be very unusual if it did not.

RICHARD MCCARTHY PERPETUAL CORPORATE TRUST

Today's digital platforms manage data and reporting that would support a multiseller securitisation programme more efficiently and effectively than ever.

KING&WOOD MALLESONS 金杜律师事务所 · LAMINAR CAPITAL · Perpetual · S&P Global Ratings

MATTHEW FINDLAY LAMINAR CAPITAL

Issuers can gain many benefits from participating in multiseller deals – from geographic diversity and scale to more frequent issuance. The large mutuals, and some smaller ones, all have the technology in place for multiseller securitisation.

MARTIN SAUNDERS CHALLENGER INVESTMENT PARTNERS

If smaller tickets come frequently, we can spend more time getting involved with and backing a securitisation programme. But if we look at a deal only every five years – when we have already been paid back – we have to get back up to speed with the programme and the business. There is much benefit from issuing frequently.

ELIZABETH STEENSON S&P GLOBAL RATINGS

We generally classify mutuals as nonbank financial institutions and the arrears and loss performance for this cohort is consistently below that of other classifications. It has a lot to do with the characteristics and attributes of the loans written, because mutuals have high-quality residential mortgage loan books.

PAUL SMITH KING & WOOD MALLESONS

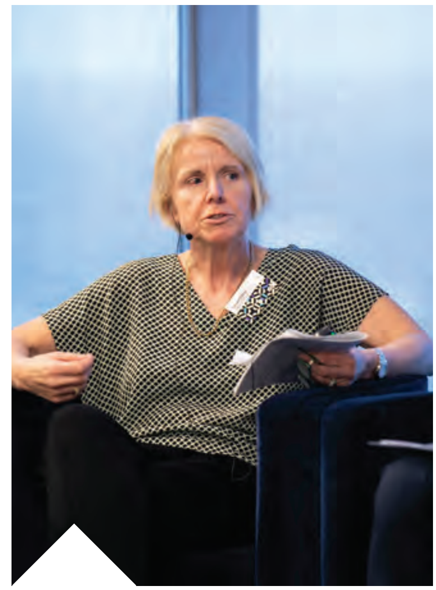
Mutuals' experiences with securitisation have ranged from warehouses to full issuance. Many mutuals have also looked at repo-eligible transactions. Much of the basic framework is relevant if a mutual is looking to the ultimate stage of public securitisation.

CORIN MILLAIS
TEACHERS MUTUAL BANK

We don't get a pricing benefit for our ethical debt issuance though it may come in the future. We undertook RIAA certification for other benefits: to build market experience, pioneer ethical investment free of fossil fuels, increase diversity, bring in ethical investors and showcase how ethical practice underpins the mutual-bank model.

MATTHEW MACREADIE ABERDEEN STANDARD INVESTMENTS

We went from green bonds to social bonds to sustainability bonds in the labelled framework. Now we are moving to impact investing and looking at what an issuer is doing as a whole, such as its progress on reducing carbon emissions against certain benchmarks.



LOUISE O'BRIEN BANK AUSTRALIA

Issuing sustainability bonds is an effective way to communicate Bank Australia's purpose to investors, and it enables us to talk about the impact assets we have on our books and the portfolio we are building. By linking these assets to a sustainability bond, we can talk to investors in detail and tell them our story.

ROBERT CAMILLERI
REALM INVESTMENT HOUSE

Technology is a big part of the resources we would need to manage a larger amount of money effectively. It allows analysts to do what they are good at – which is analysing data, not scrubbing it.

KING&WOOD MALLESONS 金杜律师事务所 LAMINAR CAPITAL Perpetual S&P Global Ratings

MATTHEW NEECE
PERPETUAL CORPORATE TRUST

We are coming to a point where core technologies within cloud platforms can support specific processes mutuals would benefit from, including credit risk, stress testing of portfolios, efficient deal execution and the ability to achieve scale through technology.

RAY JOKHAN 86 400

We can stay ahead and keep costs down because we started from scratch with no legacy systems. The technology we use is scaleable and malleable, which makes it easy to get reports when we want them.

NIGEL BRADSHAW VOLT BANK

It is well known that legacy systems weigh down established banks. They also have legacy ESG systems that act as a drag. As a neobank, we have an opportunity to build ESG into our business model from day one.

Mutual banks' funding evolution

Going into the COVID-19 crisis, the Australian mutual and customer-owned banking sector already faced problems it had been grappling with for years, especially lower-for-longer rates. The industry gathered to discuss funding and capital challenges at a KangaNews event in late February.

BY CHRIS RICH

On 25 February, KangaNews hosted its second Mutual Sector Wholesale Funding Seminar in Sydney. The event took place well before the escalation of the COVID-19 crisis and it highlighted existing challenges for the sector that economic disruption will only exacerbate.

Mutual banks enter the crisis in good shape from a capital perspective. Despite ongoing consolidation in the sector, however, many still do not have access to public capital markets to strengthen their capital and funding positions. This may be hindering market-share growth (see box on p73), especially as low interest rates squeeze margins in the sector.

Low interest rates are creating challenges for all Australian financial institutions. But the effects are acutely felt by the mutual sector, whose institutions lack the size and scale of household-name Australian banks.

In a report published on 19 February, *Australia's Mutuals to Grind Through Tough Operating Conditions*, S&P Global Ratings predicts low interest rates will weigh on mutual banks' margins and earnings over the next two years. Further policy easing by the Reserve Bank of Australia in response to COVID-19 will not help.

Net interest margin is becoming increasingly important to mutual banks' profitability, S&P states. Speaking at the KangaNews event, Lisa Barrett, Melbourne-based director, financial institutions at S&P, said: "For two-thirds of the mutuals we rate, return on assets is now below the level of internal capital generation they need to maintain high loan growth. As a result, there is downward pressure on capital. Right now, it is not significant enough to raise concerns from a rating perspective – but it is a trend we have noted."

CAMERON RAE LAMINAR CAPITAL

"If an investor is offered a security with a dividend capped at 50 per cent of the previous year's earning with essentially no secondary market, and which could end up being a perpetual zero offering, what premium is that investor going to want above major bank shares?"

LISA BARRETT S&P GLOBAL RATINGS

"For two-thirds of the mutuals we rate, return on assets is now below the level of internal capital generation they need to maintain the high loan growth they are seeing. As a result, there is downward pressure on capital."

CAPITAL POSSIBILITIES

There are options for mutual banks seeking to build capital. The issue is pricing an instrument that serves mutuals' needs in a cost-effective way while also appealing to a large enough investor base.

The *Treasury Laws Amendment (Mutual Reforms) Act 2019* was legislated in April last year. It is designed to pave the way for a fundamental change the way mutual entities raise capital and potentially forms an important plank of sector growth.

The law introduced the mutual capital instrument (MCI). This is a bespoke type of share that mutuals can issue. It also allows for the issuance of additional-capital securities that convert to MCIs. There had been no issuance by mid-April, however.

Ian Paterson, partner at King & Wood Mallesons in Sydney, speaking at the KangaNews seminar, said there

MUTUAL SECTOR PRIMER

Mutual banks are soundly capitalised but lack of market access may be holding up their growth aspirations. Only a handful are active in debt capital markets.

After the Council of Financial Regulators announced its intent to adjust the timing of regulatory measures for authorised deposit-taking institutions (ADIs) on 17 March, Michael Lawrence, Sydney-based chief executive at the Customer Owned Banking Association (COBA), said the mutual sector was in a strong position to cope with the disruption from COVID-19.

The sector is well capitalised, he noted, with an average capital ratio of 17 per cent – substantially higher than the "unquestionably strong" benchmark of 10.5 per cent the Australian Prudential Regulatory Authority (APRA) announced in 2017.

Mutuals also have an average liquidity ratio of 16 per cent, compared with APRA's minimum of 9 per cent for liquidity holdings.

The number of mutual and customer-owned banking institutions in Australia has been declining for a long time – almost halving to 66 in the decade ending December 2019, APRA states. The sector's combined assets are A$129 billion (US$79.3 billion), which pales in comparison with the major banks' combined asset value of A$3.7 trillion.

The sector did, however, receive a boost from recent negative publicity for the majors. The final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was released on 4 February 2019. The headline-grabbing admissions throughout the inquiry lured some major-bank customers to switch to the mutual sector.

Indeed, growth data from 2019 shows the mutual sector outstripping the majors by a substantial amount across three key categories, for a total asset growth differential of 9.4 per cent.

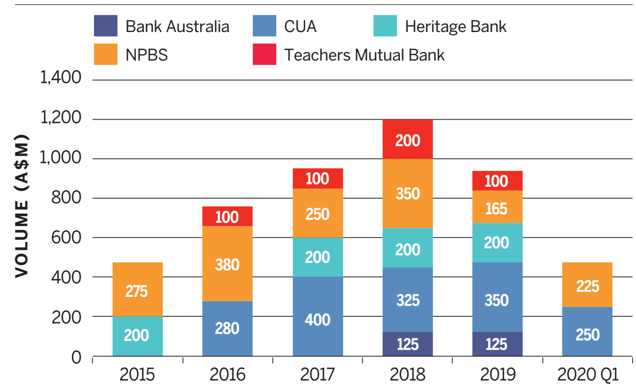
But the mutual sector has not made much headway with increasing its overall market share in the wake of the royal commission. APRA's statistics show mutuals' portion of the market in their core residential mortgage business was 4.5 per cent as of 31 December 2019, up just slightly from 4.4 per cent in December 2018 and 4.2 per cent in December 2017.

Moreover, the share of deposits the mutuals sector holds was 3.5 per cent as of 31 December 2019, unchanged from December 2018 and only 0.1 percentage points higher than in December 2017.

Accordingly, not many institutions are capital-markets relevant. Only Bank Australia, Credit Union Australia (CUA), Heritage Bank (Heritage), Newcastle Permanent Building Society (NPBS) and Teachers Mutual Bank have issued benchmark-sized senior deals in the past five years (see chart).

Beyond Bank, IMB, P&N Bank and People's Choice Credit Union (PCCU) are the only other sector issuers of benchmark size to feature in debt capital markets, all of them having issued securitisation deals.

AUSTRALIAN MUTUAL BANKS BENCHMARK-SIZED SENIOR BOND ISSUANCE



SOURCE: KANGANEWS 1 APRIL 2020

are still impediments to wide-scale issuance of MCIs. "The MCI legislation was intended to be facilitative, not prescriptive – and there isn't an MCI product out there. There remains work to do to develop product to suit particular types of issuer."

Paterson pointed out there is less detail in the legislation supporting MCIs than, for example, the Australian Prudential Regulation Authority provides for a mutual equity-interest product that authorised deposit-taking institutions (ADIs) would issue.

He suggested that the MCI risks becoming a purely theoretical benefit. "There are a lot of favourable developments that don't translate to markets. Take the simple corporate bond regime, for example. It is good law, but it doesn't mean we necessarily get a vibrant retail corporate bond market."

Also at the KangaNews event, Brian Reid, Newcastle-based group treasurer at Newcastle Permanent Building Society (NPBS), said the bank was monitoring MCIs but saw no imperative to look at additional forms of capital at this stage because its organic capital growth is still quite strong.

Reid explained: "Using an MCI to invest in a balance sheet composed of mortgages with a 5 per cent return on equity is probably not going to work that well, given the spread institutional investors will require to invest in MCIs. On the other hand, MCIs offer strategic optionality. This may be useful when looking at opportunities for capital accretion, such as certain large investments or acquisitions."

Cameron Rae, managing director at Laminar Capital in Melbourne, said at the seminar that the MCI proposition is marginal for wholesale investors. "If an investor is offered a security with a dividend capped at 50 per cent of the previous year's earnings – so if earnings decline, the dividend is going to be capped automatically – with essentially no secondary market, and which could end up being a perpetual zero offering, what premium is that investor going to want above major-bank shares?"

Ray Lee, head of credit at Kapstream Capital in Sydney, agreed there would have to be a significant premium for investors to be interested in MCI product. He told seminar attendees he

IAN PATERSON KING & WOOD MALLESONS

"The MCI legislation was intended to be facilitative, not prescriptive – and there isn't an MCI product out there. There remains work to do to develop product to suit particular types of issuers."

BRIAN REID NEWCASTLE PERMANENT BUILDING SOCIETY

"Using an MCI to invest in a balance sheet composed of mortgages with a 5 per cent return on equity is probably not going to work that well, given the spread institutional investors will require to invest in MCIs."

prefers mutuals to issue tier-two paper to diversify their additional capital in Australian dollars.

S&P concludes most mutuals will find it difficult in the medium term to generate incremental return on equity from new projects or growth that exceeds the cost of issuing MCIs.

Another avenue available for mutuals is capital-relief securitisation. Matthew Findlay, Melbourne-based head of treasury advisory at Laminar, said at the seminar that establishing securitisation as a core component of funding strategy is important if a mutual wants to include capital relief in its programme.

"Some of the capital-funding strategies we have seen appear ad hoc compared with what we see elsewhere in the market. Mutuals have sometimes been opportunistic in when they issue securitisation deals. Doing this misses out on the long-term value that consistency of issuance provides," Findlay explained.

Capital relief from securitisation requires selling the whole capital stack. While Findlay reported that Laminar has seen significant growth in the number of investors willing to buy down the credit spectrum, he said wider investor engagement was predicated on having a consistent issuance programme.

DEPOSIT MARKET

The mutual ADI sector is also facing challenges in the wider funding market. Part of mutual banks' traditional appeal is that they service local communities that larger operators under-serve. But S&P says competition for deposits is eroding this historical edge.

Reid noted that Australia's ageing population is both a risk and an opportunity. About 60 per cent of NPBS's funding base comes from customers aged 50 or older. But as Reid pointed out, the wealth of Australia's older citizens will be transferred to the next generation over the coming years. "We are working on broadening our product offering and services to facilitate the transfer of intergenerational wealth. This represents a tremendous opportunity for us," he added.

There is also emerging competition from neobanks, especially in the deposit space. Laminar's Rae pointed out that neobanks have been offering much more attractive deposit margins as they seek to build their own funding bases. "All of a sudden, term deposits in the wholesale space are not a cheap source of funding," he said.

Mutual banks can respond to price competition with better customer relations. "In retail deposit markets, NPBS focuses on 'customer behaviouralisation', which provides another lens on the value of retail deposits," Reid explained. "With term deposits, there is a wide spectrum of accounts and, in many instances, funds sourced from our home market tend to have stickiness well beyond the contractual term."

ADAPTING TO THE CHALLENGES

Deposit competition could require mutuals to update their funding approach. Rae said mutual banks, particularly smaller ones, tend to write loans before making an ongoing funding plan – having traditionally been able to rely on a flexible and bountiful deposit market. "This is where lenders can end up scrambling to raise a certain amount of term deposits," he explained. "They can then end up having to pay overs – which of course increases their cost of funds."

Instead, mutual banks need to start thinking about a more strategic funding approach. This has been NPBS's plan. Speaking after the bank's A$225 million (US$138.3 million) five-year transaction priced on 21 January 2020, Reid told *KangaNews* the borrower targets a weighted-average term profile of 3-3.5 years. This aligns well with the roughly 5-6 year maturity profile of its primary asset, residential mortgages.

The real challenge for NPBS, Reid added, is balancing its 80-85 per cent deposit-to-loan ratio with institutional investors' needs. "We have positioned our term-funding programme to align the needs of our customer base with the longstanding relationships we have with key investors. This means we take a long view, rather than trying to chisel out every last basis point."

Kapstream participated in NPBS's recent transaction and Lee says the firm did not have an issue with the mid-term tenor. "We like things anywhere from 3-5 years because that is where the curve is the steepest," he said at the KangaNews seminar. "With rates so low, the curve is flat and we don't pick up a lot going past five years." •

MUTUAL INTEREST

Greg Hammond is perhaps still best known to Australian debt-market participants for his former role as a partner at King & Wood Mallesons (KWM). More recently, Hammond has become a key player in the mutual space, including as a director at G&C Mutual Bank and as the author of a report into the sector that has sparked much discussion on issues including capital for mutual entities. Hammond spoke to *KangaNews* shortly after the KangaNews Mutual Sector Wholesale Funding Seminar (see p68 and p72).

Your report – *Reforms for Cooperatives, Mutuals and Member-owned Firms* – was published in July 2017. How did you come to take the position of independent facilitator for this report?

I retired as a partner of KWM, where I had been working with the mutual sector for 10-15 years, in June 2014. The work I had been doing focused on how mutual ADIs [authorised deposit-taking institutions] raise capital, how they comply with APRA [the Australian Prudential Regulation Authority]'s framework and several other regulatory issues.

Shortly after I retired, a few mutual ADIs asked if I would consider sitting on their boards. I opted to join the board of a small one: G&C Mutual Bank. I have been on the board for more than five years. One reason I joined was because G&C has a reputation for trying innovative things to develop its business model. Capital forms an important part of this strategy.

It was through my role at G&C that the federal government asked me to undertake the review. The government reached out to COBA [the Customer Owned Banking Association] and the BCCM [Business Council of Co-operatives and Mutuals] for people who might be able to conduct a review of the barriers that impede mutuals from accessing capital. They put my name forward.

How have you engaged with the report's issues and recommendations?

When the review was completed, I continued discussions with federal Treasury on how to implement it and engaged COBA and BCCM on how industry would respond to various proposed government initiatives. There were several exposure drafts and consultation papers and I was involved in those discussions. Legislation was passed in April 2019.

Since then, I have continued my involvement with COBA and BCCM on what mutuals need to do to take advantage of the new regime and educating the sector, investors and other interested parties on what the legislation enables and what it doesn't.

What are your observations on how the legislation has been taken up? We are yet to see the issuance of a mutual capital instrument (MCI), for instance.

The legislation covers more than just mutual ADIs. Many of the mutuals thinking of issuing MCIs don't fall under the remit of regulators like APRA and, therefore, have greater freedom to think about how they might issue.

It wouldn't surprise me if the first few MCI issues came from non-ADI mutuals, partly because they would have a quicker process. They would not have to go to as many regulators for sign-off – and we know from experience that novel capital instruments take some time to get through APRA. The regulator's processes are thorough for all types of ADI.

On the other hand, I don't think the early issuance will necessarily be the same type of instrument mutual ADIs will end up using.

The MCI was designed to take the place of ordinary shares. With ordinary shares, the issuer's business management and governance are as important as the terms of the shares. This means it will be, I think, a different type of investor that

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is looking out for the MCI product. A fixed-income type investor might look at MCIs as a hybrid-like instrument that provides a predictable return. The other end of the spectrum is people interested in impact investing: the issuer's impact on the community, what it is going to do with the money and so forth.

ESG [environmental, social and governance] investors appear to have some interest in the MCI product. The MCI could be more of an ESG investment play than anything else in three to four years.

There has been some issuance of pooled capital instruments by mutual ADIs in Australia, albeit not for several years. Why did this market fizzle and what does the MCI add that this type of issuance did not offer?

The original transaction was a dual additional tier-one (AT1) and tier-two issue that occurred in 2006 – after several years of planning. A group of more than 20 mutual ADIs did the deal, through two special-purpose vehicles. The tier-two issue was refinanced in 2012 and the AT1 redeemed in 2016.

Neither of those issues was a common equity tier-one (CET1) transaction. The problem that has confronted the mutual ADI sector, and still confronts it, is that regulators increasingly put higher value on CET1 capital. Deductions come off CET1 and banks have to maintain a relatively high proportion of total capital as CET1.

Quite a few mutuals have executed tier-two deals and I expect this to continue, in the same way the majors have continued to issue tier-two paper. But there is a limit to how much tier-two, and AT1 for that matter, a mutual ADI can issue – not to mention a limit to how much it helps them.

There are other capital-relief methods, such as securitisation. There are about 25 mutual ADIs with current securitisation programmes but they don't use them much – because they don't need to. Again, I think there is a limit to how much capital-relief activity a mutual ADI would want focused in that area.

Then there is the issue of ratings. S&P Global Ratings rates about 15 mutual banks. Moody's Investors Service and Fitch Ratings each probably rate a similar number – with crossover, of course. Many mutual ADIs have not felt compelled to go through the rating process.

I also don't think the MCI will end up being an investment-grade product, given the current triple-B band ratings of mutual ADIs. As such, it wouldn't necessarily require going through a rating process – although a successful MCI issue could enhance corporate credit ratings.

> "ESG investors appear to have some interest in the MCI product. The MCI could be more of an ESG investment play than anything else in three to four years."

This would suggest the MCI may be a purely retail product. Does this seem likely?

This comes back to whether the MCI is an equity instrument targeted at a specific subset of investors – because there will never be a huge capital return for MCIs – or whether issuers are targeting fixed-income investors looking for a hybrid-like product.

Issuing to existing members is a possibility. People immediately think this takes mutuals to retail, and that is probably the ultimate goal. But many mutuals, particularly those that are regional or closely aligned to their communities, have high-net-worth individuals and local corporate members that qualify as wholesale investors. This may be a completely different investor market, outside the existing one, for the MCI.

A small regional building society in the UK issued £15 million (US$18.5 million) of the local equivalent of MCIs and placed it entirely with the local council's superannuation fund. The purpose was to enhance the issuer's ability to lend on mortgages in the local area, which the local council wanted. This is a completely different market and issuance strategy.

There are also discussions about creating an open-ended fund to invest in MCIs. Whether there are patient investors that are willing to go into an open-ended fund is uncertain. But it is not uncommon to create a fund with the expectation that there will be only a cash-type return for the first 12 months while the portfolio builds – and then a better return over time. It might be in the mutuals' interest to arrange this type of fund.

The biggest buyers of AT1 and tier-two deals from ADIs in the wholesale market are often other ADIs. Mutual ADIs have invested in this type of product as well and they could consider redirecting their interest to supporting other mutuals.

Are you disappointed at the pace of development of the MCI market?

I have a different opinion – I'm excited by how quickly it is moving. When the legislation was passed, no mutual in the country could have issued MCIs immediately afterwards. They all needed to amend their constitutions in order to do so.

There was concern that members would not understand the product and would block the changes. Some amendments are quite small and some are more significant. My understanding is that six mutuals have now made the necessary changes and these approvals have gone through with 80-95 per cent of members voting in favour.

All credit to the mutuals that took it to their AGMs. This is high support from members, which should encourage other mutuals to amend their constitutions. The pool of potential issuers should grow as a result. There has not been a large pool of potential issuers to date.

Bringing a new instrument to market can be a double-edged sword. An issuer will probably pay more for being first than if it is in the third or fourth round of transactions. On the other hand, there will be some PR benefit to moving early and a few mutuals may be happy to issue first, even knowing it will cost slightly more.

Overseas, issuers have paid more for the first issuance while the second and third tranches have been a better economic proposition.

It would be much easier if mutual ADIs were able to raise capital for that purpose.

Quite a few mutuals are equity investors in digital financial institutions such as Society One and 86 400. I wouldn't be surprised to discover there are mutual equity investors in several other entities of this type. Again, the lack of ability to raise CET1 hinders mutuals' capacity to take on these investments.

Will mutual ADIs be able to undergo digital transformation without prejudicing the mutual value proposition? Having a regional branch network is still important for many mutual bank customers.

There is still value in branches but there is also generational difference to consider. The next generation doesn't value a building as previous generations have.

share away from the major banks, for the most part. How similar is the opportunity set for mutual ADIs?

The mortgage rates mutuals offer tend to be cheaper than the major banks'. But I don't think the shift has been cost-driven. There has been a breakdown of trust. We are beginning to see the transfer have an impact on market share. It will be fascinating to see what impact open banking will have on top of this.

Most borrowers require a competitive price – they are not going to move to another bank otherwise. But it comes back to the mutual sector's value proposition of being community oriented. Institutions invest in their community and transfer their financial benefits to members.

ESG concerns resonate with the younger generation more than they did

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The motivation for the review was that it would be beneficial for the sector to have access to more capital. This rationale seems only to have increased with the challenges to mutual-sector profitability and thus the ability to generate capital. How much more important is externally issued capital in today's business environment?

Perhaps unsurprisingly, the banking royal commission and similar factors have helped the mutuals. The mutual ADIs' growth in its traditional product, home mortgages, is above system growth. There is leakage from the majors to mutual ADIs.

Expanding portfolios requires capital. The challenge of the digital space has also opened up potential cost. Mutuals are increasingly looking at investing in online platforms and, for mutual ADIs, this involves a deduction from CET1.

There is a range of other considerations, though. The federal government's First Home Loan Deposit Scheme has 25 mutuals on the panel, which is guaranteed half of the 10,000 support places the government has made available. First home buyers are the younger generation – there won't be many older people who meet the criteria. This will open new ways for mutuals to gain a foothold with younger generations.

Younger people also have less loyalty than older ones when it comes to financial institutions. It is a great opportunity to attract someone to a new offering – and it is also a challenge to keep them.

The nonbank sector has been performing well in Australia in the past few years and has been taking market

with mine. If one of the majors succeeds in breaking the mould around trust, that is probably the biggest threat to the mutual sector.

Most mutuals are sponsors of events in their communities and this generates goodwill. It would not surprise me if Heritage Bank, for instance – which is heavily embedded in its local community – encountered investment wealth in its home area that would be prepared to invest if the bank issued an MCI.

This would not be unique. There are strong mutuals in regional Australia, and the major banks do not have a good name in regional Australia. They are closing branches. I know of one regional mutual that has mortgage pricing at the high end of the mutual sector but growth among the highest. This is because it has been generating loyalty in the communities it serves. •

FEATURE

Anatomy of a taxonomy

In March, Europe's technical expert group on sustainable finance (TEG) delivered the final report on the EU's taxonomy for climate change mitigation and adaptation. The taxonomy – and the green bond standard (GBS) that is expected to follow it – will have global ramifications for sustainable finance including opportunities and challenges for Australasian market participants.

BY LAURENCE DAVISON

The taxonomy is the product of a big goal, and one which has come to dominate the high-level thinking behind sustainable finance markets. Following the Paris Agreement in December 2015, European governments, financial institutions, investors and companies had a tangible concept of the task in front of them but no obvious roadmap to guide the reallocation of capital that would be needed to achieve it.

Nathan Fabian, chief responsible investment officer at the UN-supported Principles for Responsible Investment in London and a member of the TEG, explains that the EU reached the point where it had very well defined goals for the next 10 years of sustainable finance. These included a requirement for roughly an additional €175-290 billion [US$194-321.4 billion] a year to fund climate goals alone – most of which would have to come from the private sector.

"The EU realised it had to align its policy settings with these goals, and that it would have a really big problem if no-one could agree which investments contributed and which didn't," he tells *KangaNews*.

The EU elected to follow a path of trying to help the sustainable finance market flourish, including by promoting lower transaction costs over time. In this context, it recognised that the benefit of a common language and benchmarks is high once market participants have adopted them. The guiding principle of what followed is that it should be an investment in a more efficient market.

The TEG was created by the European Commission with this in mind. It started work, in July 2018, with the task of developing the EU taxonomy, an EU GBS using the taxonomy as the basis for measuring project impact, methodologies for climate benchmarks and related disclosures, and guidance on improved corporate disclosure.

The TEG published its final report on the GBS in June last year. The taxonomy establishes a classification system for environmentally sustainable economic activities, under which an economic activity must "substantially contribute" to one of six environmental objectives, "do no significant harm" to any of the other objectives, meet minimum regulatory safeguards and comply with technical screening criteria.

This is an extraordinarily ambitious project. It seeks to weave detailed environmental performance thresholds that go down to the level of individual economic activities into a legislative and regulatory regime governing a rigorous sustainable finance market – and to do so in a way that does not create excessive barriers to entry or other cost.

The taxonomy explicitly incorporates environmental goals by creating performance thresholds at the economic-activity level. This is a new way of thinking about environmental, social and governance (ESG) integration, Fabian tells *KangaNews*.

"Most ESG scoring to date has been based on process and has been risk-based – asking whether an entity is taking factors into account and making informed judgements about them based on the potential implications," he explains. "The new layer is

"This is much more than just a technical classification of sustainable economic activities. It is a very practical effort to provide guidance including on actual metrics for environmental thresholds."

NICHOLAS PFAFF INTERNATIONAL CAPITAL MARKET ASSOCIATION comparing the decisions entities are making – as a result of their processes – with alignment with specific environmental goals. It's complementary, but it adds an extra layer of data in order to provide clarity on an activity's environmental performance."

Nicholas Pfaff is the London-based managing director, market practice and regulatory policy, and head of sustainability at the International Capital Market Association (ICMA) as well as a member of both the TEG and the EU GBS working group. He adds: "This is much more than just a technical classification of sustainable economic activities. It is a very practical effort to provide guidance including on actual metrics for environmental thresholds for manufacturing."

Updates in the final taxonomy report include expanding the explanation of climate adaptation activities and giving practical guidance on how large European companies will be able to report on their taxonomy-aligned activities. It also attempts to give more detail on the all-important requirement that activities do no significant harm, which plays a major role in governing outcomes that currently lie beyond the scope of the taxonomy.

BROAD DEPLOYMENT

The risk with a piece of work as detailed as the EU taxonomy is that it could become unnecessarily – if inadvertently – restrictive. It was a work in progress for more than a year and the sustainable finance market continued to evolve rapidly throughout. In particular, sustainable debt is waking up to the potential of holistic sustainability scoring as a supplement to or step beyond use-of-proceeds instruments like green, social and sustainability (GSS) bonds.

Fabian acknowledges that basing environmental thresholds on economic activities, as the EU taxonomy does, may at face value be much closer to a use-of-proceeds approach. But, he insists, there is no reason why it cannot also be used as the basis for entity-level scoring.

If a bond was offered on a broader basis, for instance around environmental governance or performance methodology, an additional component could be analysis of what proportion of the issuer's activity meets environmental objectives today. It would be relatively simple, Fabian says, to have standards about improving the proportion of an issuer's activities that must meet the thresholds over time.

The same would apply to debt instruments that explicitly measure an issuer's environmental transition. Fabian continues: "A typical understanding of transition is that an entity is not meeting standards now but has a commitment to doing so in future. The thresholds in the taxonomy should help with understanding of the performance of underlying assets in a much more precise and comparable way."

This type of flexibility was always in the TEG's thinking. Eila Kreivi, director and head of capital markets at European Investment Bank (EIB) in Luxembourg and member of the TEG and EU GBS working group, explains that the taxonomy is asset-class blind: it can be used for equity, funds, fixed income, loans and more.

Kreivi adds that during the development phase the TEG explored a test case of a corporate that analysed all its business areas to see whether or not they were taxonomy-aligned. She says the company concluded that it was feasible, though execution took some time the first time around.

"As the taxonomy is updated with other environmental areas, it will be increasingly possible to analyse a company and its activities in a holistic manner," Kreivi insists.

The fact that the taxonomy will be incorporated into the EU GBS to some extent masks the fact that the TEG was always aware that wider deployment would be key to achieving the overarching goal of building a bigger sustainable finance market.

"Classical green bonds are still largely about capex, but not all issuers have significant capex needs," Kreivi points out. "Borrowers that do not can use the taxonomy in a different manner, for example to set a target of improving the taxonomy-aligned share of revenue or other indicator. This can be used as a rigorous and verifiable KPI."

There may be some limitations to the taxonomy's scope, even so – and in many cases these also relate to the pace of development of the sustainable finance market as well as the taxonomy's tight focus on environmental activities (see box on p80).

INTERNATIONAL IMPLICATIONS

At face value, the taxonomy does not have a direct impact on companies outside the EU, including bond issuers. Reporting against the economic activity thresholds will be compulsory for EU-domiciled companies but of course this jurisdiction does not extend globally. The GBS will not be mandatory, even for issuance of instruments by EU companies or within EU borders.

Optional or not, market participants expect widespread and enthusiastic adoption of the taxonomy and GBS in Europe.

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>
> **EILA KREIVI** EUROPEAN INVESTMENT BANK

TAXONOMY LIMITATIONS

The EU taxonomy was developed with environmental goals front of mind. It does not yet cover social principles in such detail, and the subjective nature of assessments in this area could cause difficulties down the road.

The ever-evolving sustainable finance market has most recently seen bond issuers seeking to use sustainability instruments to fund the fight against the impact of COVID-19.

International Finance Corporation was the first mover, with the pricing of a US$1 billion three-year social bond on 11 March. It also subsequently printed A$200 million (US$122.9 million) of Kangaroo social bonds with the same purpose (see p9). Other issuers of similar instruments include African Development Bank, Council of Europe Development Bank, European Investment Bank and World Bank.

These transactions all followed the International Capital Market Association (ICMA)'s social bond principles but fall outside the purview of the EU taxonomy. David Jenkins, head of sustainable finance at National Australia Bank, says the taxonomy is a hugely significant piece of work but is not yet ideally suited to innovative funding instruments and issues like those being faced with the COVID-19 pandemic.

Nicholas Pfaff, head of sustainability at ICMA and member of the EU technical expert group and green bond standards working group, agrees that virus prevention measures probably could not fall under the auspices of the taxonomy as currently construed. For the time being, issuers – as was the case with the recent spate of supranational COVID-19 related social bonds – fall back on the ICMA social bond principles.

When market participants highlight the taxonomy's focus on climate change they do not intend it as a criticism. The depth of work done to establish performance thresholds for climate-related economic activity is widely acclaimed. In taking a vital next step towards codifying sustainable finance, in effect the EU had to start somewhere – and the environment was likely the best place to do so.

Subjective analysis

Nonetheless, there is still a need for judgement calls in some areas, which comes with potential pitfalls. In particular, the concept of "do no significant harm" ends up having to do a lot of heavy lifting in the taxonomy regime. In effect, it is a catch-all for any economic activity not directly accounted for in the thresholds.

"I suspect a lot of companies could find themselves slipping up when it comes to the do no significant harm and minimum safeguards tests," warns Tania Smith, director, sustainable finance at ANZ. "They are very subjective – there are some quantitative definitions but there is still room for controversy with respect to social issues in particular. I suspect we will see a lot more work in this area."

Pfaff refers to the do no significant harm requirement as a "failsafe". He explains: "The idea is that project owners and investors should take a holistic view of technical criteria, the activity and its social safeguards to establish whether, overall, the project does not cause significant harm."

As an example of this type of judgement, Pfaff cites a company that wants to roll out a series of energy-efficient new buildings. The taxonomy thresholds provide a tool for measuring things like emissions and energy usage, while do no significant harm asks the developer to ensure there is no significant biodiversity impact and monitor how workers on the building are being treated.

Companies seeking to engage with European capital markets will not be able to sidestep the regime even if they do not fall directly under its purview.

Tania Smith, Melbourne-based director, sustainable finance at ANZ, says Australian companies with investors in Europe will likely be asked about their potential alignment with the taxonomy, while any firm that wants to be able to demonstrate global best practice will also have to take note. Smith compares the taxonomy to the UN Sustainable Development Goals (SDGs), in the sense that she anticipates companies will incorporate it into their strategies and reporting of their own accord as well as because of investor expectations.

ANZ's Sydney-based head of sustainable finance, Katharine Tapley, confirms that enquiry from European investors was in evidence even before the taxonomy was finalised in March this year. She reveals ANZ prepared itself for questions from investors about alignment with the taxonomy when it issued its euro SDG bond in 2019, for instance.

Tessa Dann, director, sustainable finance at ANZ in Sydney, adds: "Given the future legislative requirements for EU asset

"We have to work out the shortest distance between two points, by which I mean whether other jurisdictions simply adopt something akin to what the EU has done or invest in a more nuanced and different local version."

NATHAN FABIAN PRINCIPLES FOR RESPONSIBLE INVESTMENT managers to disclose alignment with the taxonomy, it will be in the interests of any issuer going to Europe to provide the information necessary to demonstrate alignment with the taxonomy where possible – even if it is not looking to issue a green bond."

The impact of the taxonomy will be more than just another reporting requirement for issuers seeking access to European investors. Europe is the acknowledged global leader in sustainable finance and market participants within the union and beyond universally agree that a development of the taxonomy's scope will have a worldwide impact.

"This is a significant body of work done by the EU and the TEG – nothing of this magnitude and detail has been done before," says Dann. "It will undoubtedly have a global impact, including in the form of other jurisdictions looking to leverage the European work and apply it to regional markets."

To some extent, global relevance is simply the product of the universality of the issues and activities the taxonomy tackles. For Fabian, international uptake of the taxonomy's principles rests on whether environmental performance thresholds is an idea with sticking power.

He tells *KangaNews*: "If it is, investors across all markets will inevitably incorporate it in some way in future. I think it is here to stay, because we are well behind where we need to be on environmental goals – on climate, but also on biodiversity, the circular economy, a range of pollutants and many more environmental factors. To catch up, we need to be very specific in how we compare the environmental performance of economic activities with our goals."

The good news for Australian and New Zealand issuers is that they have a good chance of not falling foul of changing standards in Europe.

This may not be the case for all existing GSS bond issuers. National Australia Bank's Sydney-based head of sustainable finance, David Jenkins, says there has been commentary from second-party opinion providers to the effect that some GSS bonds already in the market may no longer pass muster when the taxonomy is applied to the EU GBS.

There will be a fundamental change to the requirements in the EU a green-bond framework, including more granularity than the existing green-bond principles (GBPs). Under the new standards, use of proceeds must be aligned with the taxonomy. There will also be a more granular definition of reporting that features templates covering the environmental thresholds.

Fortunately, Australasian issuers have tended to align their GSS bond issuance with standards that Jenkins says should hold up even under the scrutiny of taxonomy and GBS equivalence.

"The CBI [Climate Bonds Initiative] standards essentially align with what the EU has done, by starting with the ICMA GBPs and adding minimum thresholds," Jenkins comments. "The vast majority of issuers in Australia and New Zealand have gone down the CBI route and this will make it much easier for them to align with the GBS."

LOCAL EQUIVALENTS

Perhaps the biggest question for Australia and New Zealand is whether seeking to develop local equivalents for the EU taxonomy is a worthwhile goal. In general terms, Pfaff argues, there is a lot of value in referencing the taxonomy.

"It makes a lot of sense for issuers in Asia to look at what the EU says is a technical threshold for sustainability in their economic activity," he says. "They may then wish to take the view that it does not work in their jurisdiction or industry, but they should know that there is a very informed, expert view on what constitutes an appropriate threshold with respect to climate-change mitigation and the Paris Agreement targets in particular."

According to Mushtaq Kapasi, ICMA's Hong Kong-based chief representative, Asia Pacific, the most likely approach individual jurisdictions will take is using the EU's work as a basis for – but not the entirety of – local regimes.

He explains: "I think the EU efforts – the taxonomy and the GBS – will be influential in Asia to some extent but not in their entirety. At the very least, they will be used as a reference point and I think all Asian jurisdictions will evaluate the benefits of the taxonomy and GBS."

This seems to be the way market leaders in Australia and New Zealand are thinking. For one thing, it makes little sense to start from scratch given the scale of the task the EU and the TEG have just completed. Dann thinks any Australian or New Zealand taxonomy equivalent would almost inevitably leverage significantly off the EU's work.

AUSTRALASIAN CHALLENGES

Jenkins reveals the idea of taxonomies is "very much front of mind" for the Australian Sustainable Finance Initiative (ASFI) and the New Zealand Sustainable Finance Forum (NZSFF). Some foundations that would help build a taxonomy on a similar basis to the EU project are already in place.

"Nothing of this magnitude and detail has been done before. It will undoubtedly have a global impact, including in the form of other jurisdictions looking to leverage the European work and apply it to regional markets."

TESSA DANN ANZ

> "Australia will still have the same challenges to arrive at science-based threshold criteria as was the case for the EU taxonomy. Even more so as Australia and New Zealand are looking to develop broader sustainable taxonomies."
>
> **DAVID JENKINS** NATIONAL AUSTRALIA BANK

The EU taxonomy looks at economic activities with reference to the accounting concepts contained in the European NACE – *nomenclature statistique des activités économiques dans la Communauté Européenne* or statistical classification of economic activities in the European Community – code. This is an extremely granular system. It goes, for instance, into the specific means of energy production and the details of types of suppliers in manufacturing sectors.

NACE has been used for many years to measure economic activity in areas including the loan market. Pfaff reveals: "No-one in the TEG could think of a system that would be clearly superior in approach as the basis for the classifications underpinning the taxonomy."

Lack of suitable national standards has been a problem at times in the Australian sustainable finance market. Local development of green mortgages and thus green residential mortgage-backed securities issuance has been hindered by the underdeveloped nature of local building standards and the lack of readily accessible data covering housing emissions and energy efficiency.

There is an Australasian equivalent to NACE, however. Jenkins explains the majority of Australasian bank lending is categorised by Australian and New Zealand Standard Industrial Classification code, known as ANZSIC. It was introduced in 1993 and had its last full update in 2006, though there have been a number of minor updates since.

There would still be challenges, however, even if Australia and New Zealand were content simply to tweak the EU work for local needs. Jenkins says: "Australasian taxonomies are achievable and worthwhile. But the devil is in the detail, in particular whether local versions are supported by regulation and policy as the EU taxonomy will be. This is 'the stick' – and without it the pace of change will be slow."

SOCIAL FACTORS

It also seems likely that Australia and New Zealand will seek to broaden the scope of local taxonomies beyond an environmental focus even in their first iterations. Tapley argues that doing so recognises both the way the two countries' sustainable finance markets have developed and the latest developments in the sector globally.

"Social finance is a really important point," she tells *KangaNews*. "ASFI and NZSFF have a broad approach to sustainability and – as COVID-19 is making very clear – the level of interconnectedness between the different aspects of sustainability is high. We have to use what has been done in Europe as the basis for our own strategy while reflecting the nature of our own regional social and environmental issues."

Tapley believes there will be a version of what the EU has done in Australia and New Zealand, but it will be tailored to suit the local context. The challenges will be around social finance, where targets are often harder to measure. One hope for progress is the SDGs, which Tapley says include targets and indicators that lend themselves quite well to social-impact measurement.

Jenkins adds: "Australia will still have the same challenges to arrive at science-based threshold criteria as was the case for the EU taxonomy. Even more so as Australia and New Zealand are looking to develop broader sustainable taxonomies which address environmental and social categories, not just green ones like in the EU."

Incorporating the social dimension from day one will pose a whole new level of challenge. Participants across the sustainable finance market universally agree that measurement is inevitably a more complex task in the social space. Further, some market leaders are yet to be convinced of the value of jurisdictions attempting to step into territory beyond that explored by the EU.

Fabian cautions: "We have to work out the shortest distance between two points, by which I mean whether other jurisdictions simply adopt something akin to what the EU has done or invest in a more nuanced and different local version. It's hard for smaller markets to differentiate themselves when capital is global."

He continues: "It doesn't seem to make sense for individual countries all to develop their own version of what good environmental performance is and then propagate it in a global capital market. Investors would certainly prefer some level of standardisation, simplicity and efficiency."

Fabian's main concern is the potential for differing jurisdictional definitions of green rather than the development of regimes with wider scope. For instance, China's original plan to develop a green-bond endorsed-project catalogue included clean coal among the eligible projects – a decision that would have been anathema to global markets.

The warning is clear, however: jurisdictions outside the EU should be wary of developing standards that do not readily align with the European baseline or that cause disquiet in the European market. Whether this causes problems for Australasian taxonomy efforts remains to be seen, but Tapley notes that "what is green in Australia might not be green in Germany". •

INVESTA REAPS THE BENEFITS OF BEING A *GREEN FRONTRUNNER*

Investa Property Group (Investa)'s green-debt strategy has matured, bringing realised cost benefits, the A$500 million (US$307.4 million) milestone in green loans and the prospect of all future bank-debt refinancing coming in green format. The issuer stands out in corporate Australia by the way its asset base is largely suitable for use-of-proceeds debt. It has therefore continued to build its green-loan book instead of moving to the sustainability-linked funding approach that is gathering momentum in the loan space.

At the end of February, Investa's Sydney-based general manager, corporate sustainability, **Nina James**, and head of corporate planning and treasury, **Lisa Story**, talked to *KangaNews* about the merits of the strategy and the company's funding plans.

Investa is in the fortunate position of having plenty of assets that are suited to use-of-proceeds green debt. The wider market, meanwhile, is evolving to facilitate sustainable-debt financing based on entity sustainability scoring without the need for asset-level reporting. Why does use-of-proceeds still make most sense to Investa?

■ **JAMES** There are two ways to access green debt products. One is if you already have a stable of high-performing assets and the other is if you are on a journey to having them. We are in the former category.

We have certified high-performing green buildings so we can hit the required targets and access green debt immediately. If an issuer is building a portfolio of assets to be developed it is creating high-performing buildings and could go for the sustainability-linked product, which provides credit for progress toward the final state.

How much of Investa's debt could be labelled as green at the moment, and is the company planning to make its whole programme green over time? If so, how quickly can this happen and how will you fund the assets that do not yet qualify?

■ **STORY** About 40 per cent of our debt is labelled green at present. Going forward, all our loans will be refinanced in the form of green loans. I do not see us having any more discussions about 'grey' loans.

It is more wait-and-see in capital markets because of varying levels of investor engagement and education in different markets. The Australian market has good demand for green product but it can blow hot and cold. There is no guarantee it will be open when we need to issue.

It is unclear whether we could issue in green format if Australia were cold and we turned to the USPP [US private placement] market. Notwithstanding Sydney Airport's recent sustainability-linked USPP deal, that market is still evolving in this space.

We are sensitive to price and want to get the best result for the funds we manage so we would need to assess our options. Our intention would be at least to explore a green bond for each transaction.

■ **JAMES** Our green-debt framework allows us two years to improve any asset we acquire so it meets our environmental requirements. The portfolio is assessed as a weighted average. Not every building has to hit the target but the whole portfolio on average does. There is some buffer in the setup that allow us to do what we do well, which is improving buildings' energy and environmental performance.

We want our debt not only to allow this but to enable it. This was critical in setting up the framework.

Many borrowers seem to be focused on trying to identify assets that can be used for labelled transactions, whereas it sounds like Investa has the assets but is uncertain whether some capital markets want this kind of debt. Is this right?

■ **STORY** We need to act in the best interests of our unit holders so we are focused on price coming into each transaction. We do not want to go to a market that is less mature in the ESG [environmental, social and governance] space, like USPP, where the bookbuild for a green-bond deal might not be as strong and therefore we would not be able to tighten the price.

We see ourselves as a leader in this space and it is incumbent upon us to educate the market so investors can understand the benefits of what we are doing. Then, when we do a transaction, they will have the education and this will help with the bookbuild.

It is difficult to imagine that an issuer would be penalised for a green-bond transaction, even in a market that is less engaged with the asset class as the USPP investor base appears to be. You seem to be suggesting that the response would be negative rather than, at worst, neutral.

STORY Some investors in the US have such limited knowledge they may steer away from a transaction. If a grey product were identical, other than in 'greenness', they might gravitate to the grey product through lack of understanding. This would affect the bookbuild.

I was at the USPP conference in Miami in January and the level of interest from investors varied. Two or three were interested in our ESG credentials and we talked about green finance. Their understanding was good. Many others were just listening.

Our sense is that USPP investors are starting to increase their ESG awareness, perhaps as recently as in the past 12 months. Does this match Investa's experience?

STORY Yes, it is improving. I think the market will get to the point where issuers have the confidence to go with green-bond transactions, and that these will perform as expected in price and demand once there has been more education and more experience with how the asset class works.

To what extent are debt investors in general interested in Investa's overall corporate sustainability strategy, given all its green issuance is tied to specific assets? In theory, if securities are linked to asset-level performance, investors might not be concerned about the asset owner.

JAMES I think the asset-based assessment and wider corporate strategy go hand in hand.

STORY I agree. The information investors request from us when it comes to unsecured facilities is probably the same as it would be for a borrower with secured facilities. Investors want this information, and particularly so with green products.

JAMES At corporate level, we provide an annual sustainability report. Within this is the annual green-bond status report, which shows the emissions profile of the portfolio and confirmation that we are still achieving the CBI [Climate Bonds Initiative] target our green-debt framework requires.

Sitting alongside this is GRESB [Global Real Estate Sustainability Benchmark] reporting and UN Principles for Responsible Investment reporting. Many investors also send us their own surveys, often related to the TCFD [Task Force on Climate-related Financial Disclosures]. Our intention is that there will be an ongoing annual note on our TCFD progress in our sustainability report.

Investa recently announced that it has surpassed A$500 million in labelled green loans. Is it now broadly accepted among banks that green facilities should be provided at a discount to vanilla lending?

STORY This is certainly our experience. The attractiveness of pricing will always come down to how banks assess the risk of our portfolio versus others.

Part of my job as treasurer is to test that banks' risk assessments reflect the fact that all our assets are green certified and that we have stickier tenants as a result.

It is a safer loan for banks than one to a company with an equivalent number of buildings but fewer green credentials and thus tenants that are less sticky.

We hear that many big businesses now require high environmental standards when they move to new premises. Is this trend a big part of Investa's business proposition?

JAMES It is. We see tenants with ambition around values such as health and wellbeing, along with environmental requirements. There are some sophisticated organisations around the country and when they are doing new leasing deals they look at the buildings they occupy in great detail.

But there are other drivers, too – such as the TCFD. This is yet to hit debt markets but it will come quickly, and it will be at scale when it does.

Equity investors are scrambling to address TCFD reporting requirements this year and they need to run various scenarios against their portfolios to assess the financial risks of climate change. It strikes me as logical that debt investors will soon be doing the same work, in which case there will be a heavy bias towards green debt because it is risk-mitigated. This is a logical evolution.

Would Investa have any interest in evolving its debt programme into sustainability format rather than remaining purely green certification? In other words, is there any value in incorporating a social aspect?

JAMES We opted to use CBI certification in the beginning, as a way

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>
> LISA STORY

of getting third-party verification for the hard work we do in climate-change mitigation. It is a tidy way of saying what we have is verifiable and audited.

We continue to lean towards this, rather than going broader with sustainability bonds, because it is more difficult to articulate the metrics for social targets. You can potentially dilute the message.

If CBI came up with a verification that allowed us to go broader than our climate-change mitigation work, we would be open to that conversation. But it always comes back to the fact that we can move through the certification process cleanly and efficiently because we have high-performing assets.

Governments that are doing social infrastructure projects are looking for ways to have a conversation with their investors, which makes a sustainability programme more suitable. Our building portfolio means the CBI certification is the best way.

Investa has four bilateral green loans: one apiece with ANZ, Commonwealth Bank of Australia, HSBC and Westpac Banking Corporation. Why has the company opted for bilateral rather than syndicated debt?

STORY We have unsecured debt and we prefer bilateral facilities with common terms because we can just plug in and plug out. It gives us maximum flexibility.

We see syndication as a step backwards because we would need to report to the facility agent, and get approvals and consents. It is more restrictive.

How have you decided on lenders for green loans?

STORY We have the big four Australian banks and two Asian banks in our lending group. We also have a financial risk-management policy that sets limits on bank weighting and we operate within those parameters.

Aside from this, the decision on which bank comes down to balancing the book. We will look at pricing when we write a new facility and if there is a bank that wants to do a green loan, we will go with that one.

Every time we have an opportunity to borrow money, for example to fund an acquisition, we approach each of the banks. We are sensitive to both price and greenness.

JAMES Banks are setting their own targets for allocating capital to green products. This means the relationship managers we deal with are looking for opportunities to place this type of capital. Australia stands apart from the US and other parts of the world in this regard.

Debt markets do not tend to offer a first-mover advantage. What does Investa believe it gains from being a market leader in this space?

JAMES The fourth pillar of our carbon-reduction strategy – which has a net-zero by 2040 target – is industry engagement. We saw this as an opportunity for leadership and it made sense to get credit for the hard work we have done over 15 years to improve our environmental performance.

It also made sense for us to move this forward into our debt profile. As an early mover we faced risks, but these were negligible – as was the cost of pursuing certification. I often hear organisations bringing up cost as a reason for not pursuing ESG funding, but I wonder if this is a result of them not doing due diligence to understand what the costs are. They are not a big deal.

There was no pricing differential for green-debt products initially – it was not possible to join the dots and say there was a pricing benefit. But it was worth it for us regardless, and it has now been proven that we were right to take those steps.

STORY The Australian Sustainable Finance Initiative is also making progress. The second report is likely to come in the next couple of months. It is good to see interest in creating a local roadmap.

The government is also interested in the roadmap. We were in Canberra late last year and met with departments working in this space. Progress is being made everywhere.

JAMES It is also exciting to see corporates take responsibility and action. Business is taking this on – and at speed. The massive rise in power-purchasing agreements is evidence that business is willing to set its own targets and make meaningful decisions. When government comes to the party, it will probably be to pick up the laggards.

When might we next see Investa in debt capital markets?

STORY Investa Commercial Property Fund (ICPF) has just cleared its redemptions and is raising capital. It should complete this in the first half of the year. After that, ICPF will be looking to re-evaluate its debt book and debt capital markets could be part of this. We target WADE [weighted-average debt expiry] and a good way to ensure this is to look at debt capital markets for seven-, 10- and 12-year debt. •

"Equity investors are scrambling to address TCFD reporting requirements this year. It strikes me as logical that debt investors will soon be doing the same work, in which case there will be a heavy bias towards green debt."

NINA JAMES

Australian corporates push the boundaries of sustainable funding

An extended issuance hiatus could slow progress, but Australian corporate borrowers continue to show willingness to engage with new sustainability-linked products. Sydney Airport and Wesfarmers have completed new sustainability-linked funding – the former as the first such issuer in any global bond market.

BY MATT ZAUNMAYR

Sydney Airport's market leadership, and the willingness of US private placement (USPP) investors to provide structural flexibility, were crucial to the execution of the world's first sustainability-linked bond (SLB) with two-way pricing. Deal sources are bullish on proliferation of the product over time.

The A$100 million (US$61.7 million) sustainability-linked tranche was part of a A$600 million equivalent deal, priced on 12 February, in Australian dollars, euros and US dollars, with maturities from 15-30 years (see table). MUFG Securities (MUFG), National Australia Bank (NAB) and Scotiabank led the transaction.

Sydney Airport's group treasurer, Michael Momdjian, says the entire transaction was well received, pricing inside the tight end of guidance and with a four times oversubscription. The deal's foreign currency exposures are 100 per cent hedged over the life of the bond. The maturities incorporate four months of free delayed settlement.

Pricing on all tranches compared favourably with recent prior USPP and Australian dollar public-market transactions, leads and issuer add.

There were 14 investors. While several institutions indicated strong interest in the SLB tranche, MetLife Investment Management and Northwestern Mutual took down all the SLBs.

STEPS UP AND DOWN

The SLB tranche marks progress in debt capital markets' attempts to address environmental, social and governance (ESG) considerations. Sydney Airport and its leads say the USPP deal is the first in any market to include both a pricing step up and step down based on whether the issuer meets ESG-related targets.

Internationally, 2019 saw two SLBs issued by Italian energy company, Enel. However, these included only a potential step up in pricing – a penalty to the company if it misses ESG targets. The inclusion of a step down when issuers do meet targets has been more difficult for investors to accept.

Other developments in ESG-linked debt instruments during 2019 included Sydney Airport's landmark sustainability-linked loan (SLL). This was the largest-ever SLL in the Asia-Pacific region and the first in Australia to include step-up provision.

Some market participants believe two-way pricing is crucial for the development of SLBs. "The premise of our SLL and SLB was to drive behavioural change that would incentivise better sustainability performance and discourage worse sustainability performance – not just one or the other," Momdjian tells *KangaNews*.

The USPP market has long been willing to accommodate novel deal structures. Sydney Airport's lead managers say this made it a suitable place for a world-first transaction of this

"The premise of our SLL and SLB was to drive behavioural change that would incentivise better sustainability performance and discourage worse sustainability performance – not just one or the other."

MICHAEL MOMDJIAN SYDNEY AIRPORT

nature, even if US investors have not always been leaders in ESG instruments.

Geoff Schmidt, general manager, corporate finance North America at NAB in New York, argues that attitudes towards ESG have changed among USPP investors over the last 12-24 months.

"The USPP market is the perfect environment to test these structures," Schmidt says. "The investors are buy-and-hold, and have a sophisticated understanding of credit and deal structures. The wide adoption of foreign currency tranches and delayed settlement have proven this. Wider adoption of sustainability-linked structures can also take place going forward."

MUFG's New York-based director, private placements, Peter Brooks, adds: "USPP investors are able to provide bank-like terms for a bond-format transaction, which means USPP can lead public markets on instruments such as SLBs. We hope this successful inaugural deal opens the door for discussions with more issuers."

The structure garnered buy-side interest beyond the investors that participated. Momdjian says more than 10 accounts expressed an interest in understanding and analysing the SLB proposition.

"Some investors were not yet ready to participate, while others were keen but were priced out of the transaction," Momdjian explains. "One investor participated in the SLB and not the vanilla tranches, suggesting the SLB component actually increased demand."

DEAL STRUCTURING

Sydney Airport's SLL from 2019 began as a refinancing of its vanilla loan facility before any sustainability-linked targets or step-up and step-down provisions were included. This ensured the SLL would be priced at least at the same level as a vanilla loan, rather than attracting any premium for its more novel functions.

The SLB deal process featured a similar approach. Sydney Airport included a 20-year vanilla tranche that priced at the same level as the 20-year SLB. Not only does this ensure the bond is priced in line with conventional debt, it also makes explicit any premium or discount incurred from missing or meeting ESG targets.

The SLB and SLL are both based on an ESG risk rating determined by Sustainalytics. Momdjian says this allows Sydney Airport to drive improvement across the ESG spectrum, rather than just through internally derived targets.

The issuer believes the active leadership it has demonstrated in the ESG arena made it the ideal first mover for the structure in the USPP market, while its SLL provided a platform from which it could align the structure and targets of an SLB debut. Momdjian says the participation of more than 10 banks in the SLL likely made USPP investors more comfortable with the latest deal.

The transaction is also the issuer's third visit to the USPP market so investors are familiar with the credit and acknowledge its strong fundamentals, the leads say. Schmidt says Sydney Airport's strong credit was especially important because it was the first issuer to offer this structure.

SYDNEY AIRPORT USPP DEAL STRUCTURE

TENOR (YEARS)	VOLUME	SUSTAINABILITY LINKED
15	€50m	N
15	US$52m	N
20	A$220m	N
20	A$100m	Y
30	A$120m	N

SOURCE: SYDNEY AIRPORT 17 FEBRUARY 2020

The deal was in the pipeline for a while, as investors requested more education to help them get to grips with – and appropriately price – the SLB component. "This included the ability of investors to receive hedge-accounting treatment on their Australian dollar swaps and the ability of their back and middle offices to facilitate two-way coupon movements," Brooks comments.

He adds that the participating investors are market leaders in providing structural flexibility for complex transactions and in their focus on sustainability. They can also invest in Australian dollars, making them ideal candidates.

POTENTIAL PROLIFERATION

SLBs have many moving parts. Issuer targets, verifier and certifier requirements, and investor demands all need to be considered. However, Schmidt says the USPP market should understand the structure now the first deal has been completed. Deals could proliferate as a result.

"Once the structure is understood, it is just a matter of bringing buyers and sellers together," Schmidt comments. "This tranche was driven by two investors but many more are interested in ESG-linked deals."

From the issuer side, the great promise of SLLs and SLBs is that they can potentially be applied to a bigger proportion of a company's debt than use-of-proceeds products such as green bonds and green loans. If investors and issuers widely accept SLLs and SLBs, the ESG-linked debt universe could expand rapidly.

Momdjian says banks and Australian investors have already asked Sydney Airport about how the deal was structured and executed. Further sustainability-linked financing for the issuer will depend on whether such deals can help meet its core objectives. "We are focused on negotiating tight pricing before overlaying any sustainability-linked elements," Momdjian asserts.

WESFARMERS HITS LOAN MARKET

Meanwhile, SLLs continue to gain traction in Australia. Wesfarmers is the latest borrower to establish a facility linked to environmental and social goals, which it says are ambitious and will improve its overall credit profile. Wesfarmers closed a bilateral A$400 million SLL with Commonwealth Bank of Australia (CommBank) on 13

March. The loan features margin steps up and down based on two target metrics, one of which is environmental and the other social.

Naomi Flutter, executive general manager, corporate affairs at Wesfarmers in Perth, says the issuer chose the SLL specifically because it fits with the company's general debt portfolio and does not carry the extra administrative costs of a use-of-proceeds financing instrument.

Bank sources have expressed significant confidence about SLL growth precisely because the product is a more natural fit for Australian corporates – which typically have loan-predominant debt books and limited supply of green-qualifying assets.

The ability to incorporate social targets into the loan was also important. Flutter explains: "There are plenty of opportunities to borrow money linked to environmental targets. This is a good development. But sustainability is linked to Wesfarmers' core purpose of bringing satisfactory returns to shareholders and this is fulfilled only when the needs of all stakeholders are met. This includes workers, our supply chain and the communities in which we operate."

abatement is difficult but these are the areas where there is the most benefit from applying these loans," he comments.

Wesfarmers' social target is to increase representation of Aboriginal and Torres Strait Islander people in its workforce to 3 per cent. The demerger of Coles from the group caused the proportion of indigenous employees to fall to about 1.6 per cent, Flutter says.

Wesfarmers wants to rectify this. "We learned a lot through the process of increasing Aboriginal and Torres Strait Islander employment in Coles and we are now seeking to apply this to our other businesses so we can once again be in line with the benchmark," Flutter comments.

Wesfarmers will gauge its progress against the loan targets by whether it achieves milestones it has in place for every six months relative to a baseline level set at 31 December 2019.

THE WAY FORWARD

The SLL has been vaunted for its potential to greatly expand the set of companies that can be incentivised to improve ESG performance through funding.

"What we are doing makes our business more sustainable and our credit more robust. This should be reflected in the margin we pay on borrowing."

NAOMI FLUTTER WESFARMERS

SLLs must set ambitious targets to achieve the desired impact of transforming finance and materially benefiting the wider community by meeting climate-change and social challenges. Wesfarmers' SLL uses internal metrics for its targets. All the company's sustainability goals, including those linked to the loan, are reported on and EY audits them yearly.

Mark Peacock, head of sustainable finance at CommBank in Sydney, tells *KangaNews* discussions with Wesfarmers emanated from the company's existing commitments to sustainability, which include targets across its business and an integrated sustainability report. The SLL's criteria align with Wesfarmers' broader sustainability targets but were developed specifically for the transaction.

The environmental goal is to reduce the emissions intensity of ammonium nitrate production over the tenor of the loan. Ammonium nitrate is an explosive used in bulk resources sectors, including iron-ore mining. The aim is to help Wesfarmers meet the sustainability target it has put in place for its chemical businesses, which is to beat the mean emissions intensity of peers by 2025.

Peacock says this is the most difficult part of the Wesfarmers business in which to abate emissions, and this is specifically why CommBank wants to incentivise improvement in this area. "There are many industries and sectors where emissions

Peacock says inbound enquiry on the product is now huge, but he stops short of saying there will be an immediate explosion in its use. "Demand for the product is rising and it is certainly encouraging to see a greater diversity of borrowers using these loans to improve performance. Many more corporates have interest but there is still work for a lot of them to do on reporting infrastructure and setting targets."

The SLL product also has the potential to expand the universe of other sustainability-funding products, such as green bonds. These need to be linked to specific assets that already have proven environmental performance. Some borrowers suggest employing such use-of-proceeds products is a desired end state for companies, while SLLs are for companies transitioning to that state.

Wesfarmers would be more likely to increase its funding through general-purposes debt products like SLLs than take on the extra administrative costs of use-of-proceeds funding, Flutter says. "We see more benefit in directing those funds towards further emissions-abatement initiatives or social targets," she explains.

The overall benefit of undertaking sustainability funding is clear. "What we are doing makes our business more sustainable and our credit more robust," Flutter says. "This should be reflected in the margin we pay on borrowing." •