CORPORATE DEBT: CRISIS RESPONSE AND LIQUIDITY RETURN

GOVERNMENT ISSUERS: VIEWS FROM AUSTRALIA AND NEW ZEALAND

SOCIAL BONDS: COVID-19 ISSUANCE CATALYST, BUT FOR WHOM?

KangaNews

VOLUME 15 ISSUE 119 _ **JUN/JUL 2020**
www.kanganews.com

AUSTRALASIAN FIXED INCOME: GLOBAL REACH, LOCAL EXPERTISE

FIXED INCOME INVESTOR GSS SURVEY

A RIDE ON THE *GHOST TRAIN*

AUSTRALIAN AND NEW ZEALAND BOND MARKETS HAVE STABILISED AFTER A ROLLERCOASTER RIDE IN MARCH AND APRIL. ISSUERS HAVE TAKEN ADVANTAGE OF CALMER CONDITIONS, BUT MARKET PARTICIPANTS SAY THERE MAY BE MORE SHOCKS AHEAD.

KangaNews

JUN/JUL 2020 EDITION
VOLUME 15 ISSUE 119
www.kanganews.com

Contents

Head of content and editor
LAURENCE DAVISON
ldavison@kanganews.com

Deputy editor
MATT ZAUNMAYR
mzaunmayr@kanganews.com

Staff writer
CHRIS RICH
crich@kanganews.com

Head of commercial
Jeremy Masters
jmasters@kanganews.com

Head of operations
HELEN CRAIG
hcraig@kanganews.com

Chief executive
SAMANTHA SWISS
sswiss@kanganews.com

Design consultants
HOBRA (www.hobradesign.com)

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

KangaNews, ISSN 1751-5548 (PRINT); ISSN 2207-9165 (ONLINE), IS PUBLISHED SIX TIMES A YEAR BY BONDNEWS LIMITED AND DISTRIBUTED FROM SYDNEY, AUSTRALIA. PRINTED IN AUSTRALIA BY SPOTPRESS, FOR, AND PUBLISHED BY, BONDNEWS LIMITED, LYNTON HOUSE, 7-12 TAVISTOCK SQUARE, LONDON WC1H 9LT, UNITED KINGDOM

Audited Media Association of Australia

cab

CAB average net distribution 3,159 for six-month period ending 31 March 2020.

Contents

Contents

TRANSACTION ANALYSIS

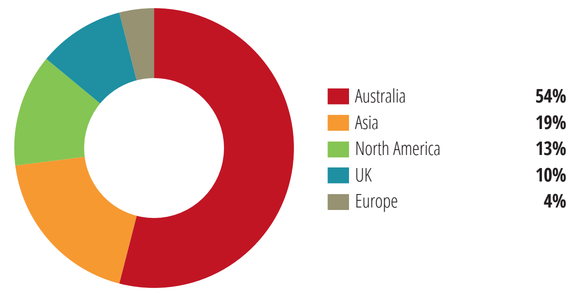
AOFM lands record deal as market picture clears

The Australian Office of Financial Management (AOFM)'s December 2030 syndication provided an opportunity to test capacity amid what the issuer describes as greatly improved market conditions.

The AOFM's A$19 billion (US$13.2 billion) transaction smashed the record for an Australian dollar syndication the same issuer set less than a month previously with its A$13 billion November 2024 deal.

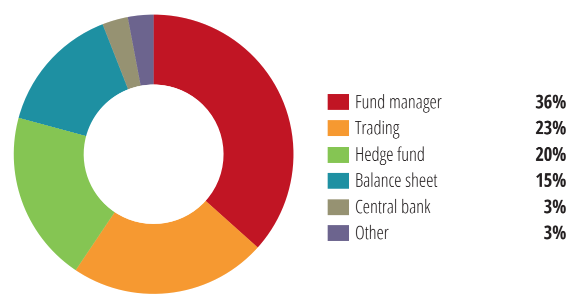
Issuer: **Australian Office of Financial Management**
Issuer rating: **AAA/Aaa/AAA**
Pricing date: **13 May 2020**
Maturity date: **21 December 2030**
Volume: **A$19 billion**
Book volume at pricing: **A$53.5 billion**
Margin: **8bp/EFP**
Indicative margin: **7-10bp/EFP**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, Citi, Commonwealth Bank of Australia, UBS**

CHART 1. AOFM DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT 14 MAY 2020

CHART 2. AOFM DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT 14 MAY 2020

ISSUER INSIGHTS

ROB NICHOLL
CHIEF EXECUTIVE
AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT

"When we announced the deal, we were confident market sentiment had noticeably improved since the 2024 deal [on 21 April] and that the transaction would be well received. This was driven by the recent results of our Treasury bond tenders and the conversations we have had with investors in recent weeks."

"Investors should be able to get confidence from the fact that this market is transparent and the market forces that should work in fixed income are still at play."

"I get the sense there are fewer unknowns about the economic pathway forward in Australia so investors may be perceiving less downside risk. But they are also responding positively to the interim guidance the AOFM has been able to give."

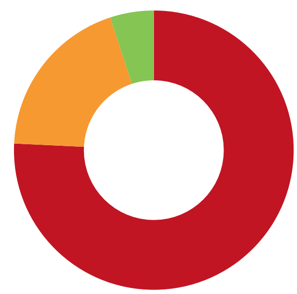
WATC maintains funding strategy despite COVID-19 crisis

Western Australian Treasury Corporation (WATC) says issuing a new 2031 line was always part of its long-term funding strategy even before semi-government borrowers faced a substantially higher funding need in response to the COVID-19 crisis.

WATC's A$1.5 billion (US$1 billion) 10-year transaction was the issuer's first publicly syndicated deal since the escalation of the COVID-19 crisis in mid-March.

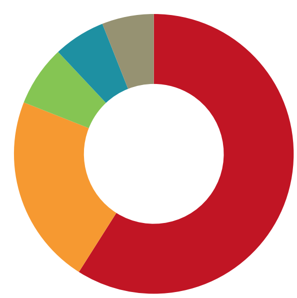
Issuer: **Western Australian Treasury Corporation**
Issuer rating: **AA+/Aa1**
Pricing date: **19 May 2020**
Maturity date: **22 October 2031**
Volume: **A$1.5 billion**
Book volume at pricing: **A$2.6 billion**
Margin: **70bp/June 2031 ACGB**
Indicative margin: **68.2-72.2bp/ June 2031 ACGB**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **BofA Securities, Commonwealth Bank of Australia, National Australia Bank, UBS**

CHART 1. WATC DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: WESTERN AUSTRALIAN TREASURY CORPORATION 21 MAY 2020

CHART 2. WATC DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: WESTERN AUSTRALIAN TREASURY CORPORATION 21 MAY 2020

ISSUER INSIGHTS

KAYLENE GULICH
CHIEF EXECUTIVE
WESTERN AUSTRALIAN TREASURY CORPORATION

"Our funding strategy for this financial year included a new benchmark line beyond 2029. We looked closely at the 2030 and 2031 maturities and we felt the 2031 gave us more time with a 10-year point. COVID-19 did not change these plans."

"Prior to COVID-19, we didn't have the borrowing requirement to justify establishing a new line every year. This may shift next financial year as the implications of the forthcoming state budget are factored in."

VINCE CINQUINA
HEAD OF FINANCIAL MARKETS
WESTERN AUSTRALIAN TREASURY CORPORATION

"The plan was to look at a second half of March launch date. Unfortunately, the market environment turned ugly in that period. After that, we ideally would have launched a week earlier but the AOFM executed its deal then, so the next clear window was the one we took."

MARKET ANALYSIS

SAFA continues to forge AONIA-linked issuance path

South Australian Government Financing Authority (SAFA) has continued in its quest to mould the Australian overnight index average (AONIA)-linked issuance market, introducing longer tenor and larger volume. The market environment has changed markedly in the last few months, including for AONIA, but the issuer says engagement continues to grow.

Issuer: **South Australian Government Financing Authority**
Issuer rating: **AA+/Aa1**
Pricing date: **11 June 2020**
Maturity date: **16 June 2023**
Volume: **A$1.26 billion (US$875.3 million)**
Initial volume cap: **A$1 billion**
Book volume at pricing: **A$1.26 billion**
Margin: **34bp/AONIA**
Indicative margin: **34bp/AONIA**
Lead managers: **N/A**

SAFA's A$1.26 billion three-year, AONIA-linked deal priced on 11 June. The transaction is SAFA's fourth linked to Australia's risk-free rate (RFR) and its first with tenor beyond one year. Pricing came a day prior to the maturity of the issuer's first AONIA-linked transaction, though the new issue is more than twice as large as the maturing line.

The only other Australian issuer to execute a domestic deal priced off the RFR is Commonwealth Bank of Australia, which brought a A$1.5 billion AONIA-linked residential mortgage-backed securities deal to market in November 2019.

Andrew Kennedy, Adelaide-based director, treasury services at SAFA, says the latest deal is a realisation of SAFA's intension to add longer-tenor AONIA-linked funding. SAFA's previous AONIA-linked deals were all at one-year tenor and were not classified as benchmark "select lines" by the issuer.

Despite the longer tenor and larger volume, SAFA is still not ready to call its latest AONIA deal a select line – because, Kennedy explains, it is not expected to have the level of liquidity required of a benchmark term-funding bond.

The issuer chose the three-year point on the curve based on market consultation, to intersect its fixed-rate, even-year select-line maturities, and to match some of its floating-rate client-funding needs.

Despite market upheaval in recent months, and investors still facing various pressure points, Kennedy tells *KangaNews* engagement with AONIA-linked issuance continues to grow in breadth and depth. This is particularly so as many market participants remain conscious of the impending end to compulsory LIBOR publication in offshore markets at the end of 2021.

"We had a lot of open dialogue with investors on this deal and conducted a number of awareness and education sessions. There was a diverse blend of investors in the deal by geography and type, but the primary focus still comes from domestic and regional banks," Kennedy says.

He adds that maintaining the interest of regional-bank investors in the deal under challenging market circumstances was particularly pleasing for SAFA.

Bank engagement with AONIA issuance has become sufficient that Kennedy says picking lead managers would have been counterproductive to SAFA's market development goals. As such, SAFA chose to execute the deal without lead managers, instead inviting bids through its dealer panel.

Kennedy explains: "The wider we can make the conversation around AONIA-linked issuance, the sooner it will be possible to make that conversation, and issuance of this kind, a part of broader market infrastructure."

Investor engagement this time around meant SAFA was compelled to print a volume larger than its indicative cap of A$1 billion, according to Kennedy. This reflected feedback that investors were keen to own the entirety of their bids rather than pegging a bid at a higher volume and expecting scaling. As a result, 100 per cent of the book was allocated to investors.

AONIA PRICING

The AONIA rate itself has been newsworthy since the beginning of the COVID-19 crisis. The Reserve Bank of Australia (RBA)'s increased repo operations have led to much higher exchange-settlement balances. At the same time, the RBA has been remunerating settlement balances at 10 basis points rather than zero as it previously would have done with the cash rate at 0.25 per cent.

The weight of money in exchange-settlement balances relative to transaction volume in the cash market has pulled the interbank overnight cash rate – AONIA – consistently below the official cash rate.

Kennedy says there has been speculation in the market about how long this might remain the case, but tells *KangaNews* it did not lead to any pricing benefit to SAFA in issuance linked to AONIA.

"When we come to the market with these deals, we look at pricing comparable with the bank-bill swap rate [BBSW]. By bringing deals that are either in line with or wider than BBSW pricing, we ensure ongoing investor interest in the transactions," Kennedy explains. •

MARKET ANALYSIS

Kangaroo window opens for smaller issuers to take record volume

Late April and early May offered a pair of consistent but typically smaller Kangaroo issuers opportunities to achieve their biggest-ever deals in Australian dollars (see charts 1 and 2). Deal sources say relative value to Australian semi-government borrowers drove demand.

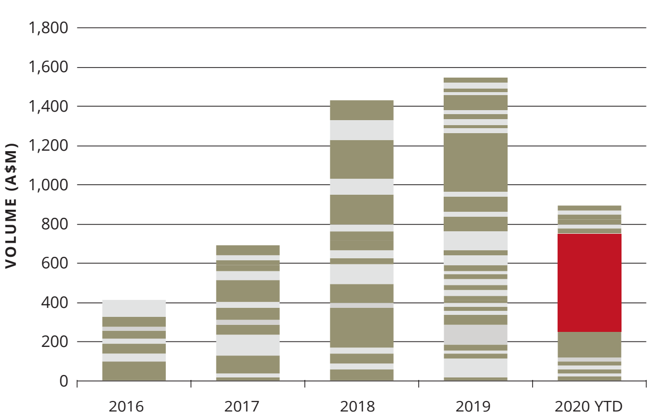
BNG Bank priced the first broadly-distributed new Kangaroo line from a supranational, sovereign and agency (SSA) issuer in 2020 on 30 April, with record volume for the issuer of A$500 million (US$347.4 million). NRW.BANK followed with its own record Kangaroo transaction, for A$625 million on 13 May. BNG Bank's Australian dollar issuance has focused on sub-benchmark-sized tap transactions in recent years, while NRW.BANK has now printed its second large Kangaroo in two years.

Issuer: **BNG Bank**
Issuer rating: **AAA/Aaa/AAA**
Pricing date: **30 April 2020**
Maturity date: **13 November 2023**
Volume: **A$500 million**
Volume at launch: **A$200 million**
Margin: **50bp/s-q swap**
Indicative margin: **50bp/s-q swap**
Lead managers: **Nomura, RBC Capital Markets (RBCCM)**

★

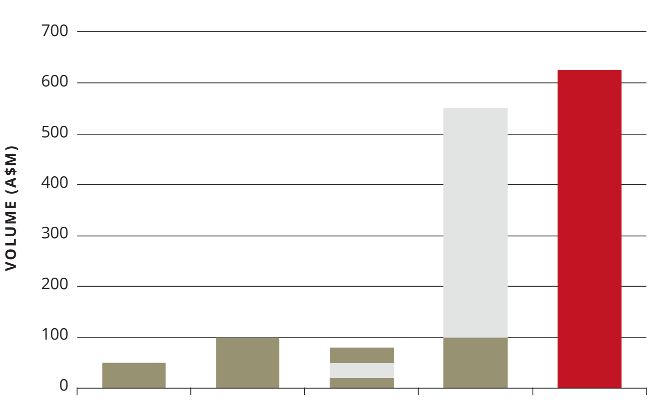
Issuer: **NRW.BANK**
Issuer rating: **AA/Aa1/AAA**
Pricing date: **13 May 2020**
Maturity date: **22 May 2023**
Volume: **A$625 million**
Margin: **53bp/s-q swap**
Indicative margin: **53bp/s-q swap**
Geographic distribution: **see chart 3**
Distribution by investor type: **see chart 4**
Lead managers: **Nomura, RBCCM, TD Securities**

CHART 1. BNG BANK KANGAROO ACTIVITY, 2016-H1 2020



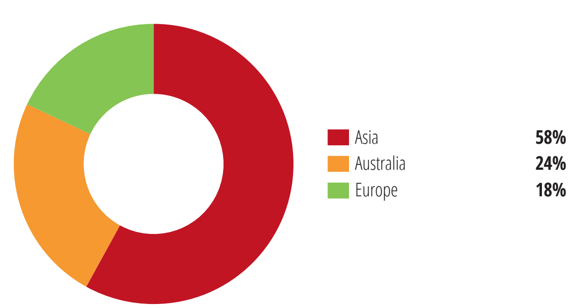
SOURCE: KANGANEWS 2 JULY 2020

CHART 2. NRW.BANK KANGAROO ACTIVITY, 2016-H1 2020



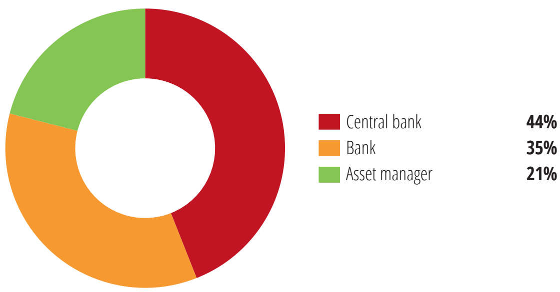
SOURCE: KANGANEWS 2 JULY 2020

CHART 3. NRW.BANK DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: NRW.BANK 14 MAY 2020

CHART 4. NRW.BANK DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: NRW.BANK 14 MAY 2020

TRANSACTION INSIGHTS

BART VAN DOOREN
HEAD OF FUNDING AND INVESTOR RELATIONS
BNG BANK

"There was a lead order from a domestic investment manager, next to orders from central banks and other institutional investors. Within two hours of opening the orderbook we had more than A$400 million of bids and the final size exceeded my expectations."

TATJANA BEUER
DIRECTOR, LONG-TERM FUNDING
NRW.BANK

"It is no secret that we are still paying up in Australian dollars compared with our funding in euros. If you look at the big picture, though, our Kangaroo premium is decreasing. When issuing in a new market we cannot expect to achieve the same levels as our home market, where our strength is well known among investors."

"Investors are looking for safe havens and Germany is one of them. Opportunities for exposure to Germany's public sector are limited and we assume credit lines for our peers are already highly exploited. Investors took advantage of this opportunity to increase German exposure with a new name."

FRANK RICHTER
HEAD OF INVESTOR RELATIONS
NRW.BANK

"When we began discussions with the lead managers a couple of weeks before the deal, we were cautiously optimistic that a three-year transaction would attract demand – but we did not expect such a tremendous success."

"The NRW.BANK social-bond product will be designed with Australian domestic demand in mind. We want to take advantage of our momentum and try to be back in the market later this year, with a social bond."

OLIVER HOLT
EXECUTIVE DIRECTOR, DCM SYNDICATE
NOMURA

"BNG Bank had been eager to execute a transaction for a while. With basis-swap levels aligning to what the issuer has been looking for, as well as robust demand and impending public holidays, this was the right time to go ahead with the deal. Pleasingly, the orderbook grew very strongly, quickly passing the maximum volume and allowing for closure within a few hours of launch."

DANIEL WILSON
DCM SYNDICATE
RBC CAPITAL MARKETS

"The relative value of BNG Bank's deal to Australian semi-government paper led to strong real-money interest – it offered around a 30 basis points pickup to triple-A semi-government bonds. While pricing in the front end of the Australian dollar curve remains sensitive for SSAs, BNG Bank's deal highlights that it can be attractive for some European-domiciled issuers."

TRANSACTION ANALYSIS

Domestic banks return to Australian covered-bond market including first-ever CPT deal

Deal sources say real-money investors embraced Bank of Queensland (BOQ)'s decision to print the first conditional pass-through (CPT) covered bond in Australian dollars. The transaction came two weeks after Suncorp-Metway became the first Australian-domiciled credit issuer to print a new bond deal since the emergence of the COVID-19 crisis, also in covered format.

AUSTRALIAN DOLLAR COVERED-BOND ISSUANCE, H1 2020

PRICING DATE	ISSUER	TENOR (YEARS)	VOLUME (A$M)	MARGIN (BP/SWAP)	LEAD MANAGERS
2 Apr 20	Canadian Imperial Bank of Commerce Australia Branch	3	600	125	CIBC, HSBC, NAB, Westpac
3 Apr 20	Toronto Dominion Bank	3	1,250	125	ANZ, CommBank, NAB, TD, Westpac
8 Apr 20	Bank of Montreal	3	2,000	120	BMO, CommBank, NAB, UBS, Westpac
15 Apr 20	Royal Bank of Canada	3	2,250	100	ANZ, CommBank, NAB, RBCCM, Westpac
20 Apr 20	Suncorp-Metway	5	750	112	ANZ, RBCCM, Westpac
27 Apr 20	Canadian Imperial Bank of Commerce Australia Branch	3	200	125	ANZ, CommBank
7 May 20	Bank of Queensland	5	750	107	ANZ, NAB, UBS

SOURCE: KANGANEWS 2 JULY 2020

The only activity in the Australian credit market in the weeks before Suncorp's print was a clutch of covered-bond issuance by Canadian banks (see table).

Unlike the Canadian issuers, Suncorp has access to the Reserve Bank of Australia (RBA)'s term-funding facility (TFF). The availability of covered-bond funding at five-year tenor – the TFF is only available at three – sealed the deal for Suncorp.

BOQ, meanwhile, established its CPT programme in May 2017. Since then it has issued two deals, both for €500 million (US$565.9 million) – in June 2017 and May last year. This was its first domestic transaction off the programme.

While BOQ could have issued through a soft-bullet structure, as Suncorp did, the issuer says the stability offered by CPT won out.

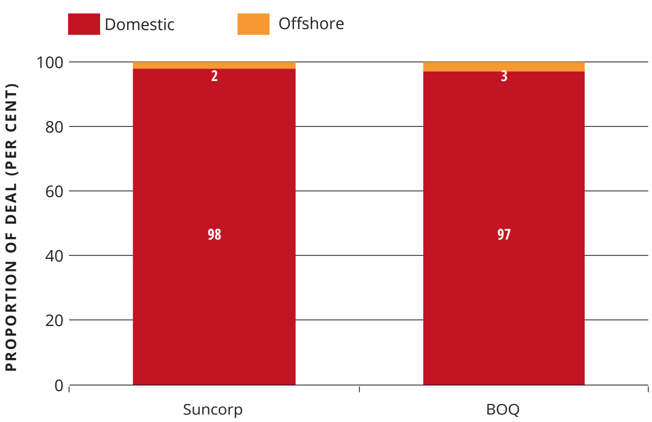
★

Issuer: **Suncorp-Metway**
Issuer rating: **A+/A1/NR**
Issue rating: **NR/Aaa/AAA**
Pricing date: **20 April 2020**
Maturity date: **27 April 2025**
Format: **soft-bullet covered bond**
Volume: **A$750 million (US$521 million)**
Margin: **112bp/3m BBSW**
Indicative margin: **115-120bp/3m BBSW**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, RBC Capital Markets, Westpac Institutional Bank**

★

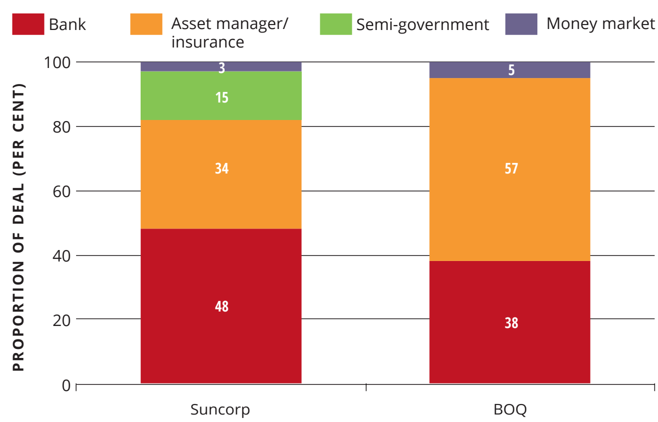
Issuer: **Bank of Queensland**
Issuer rating: **BBB+/A3/A-**
Issue rating: **NR/Aaa/AAA**
Pricing date: **7 May 2020**
Maturity date: **14 May 2020**
Format: **conditional pass-through covered bond**
Volume: **A$750 million**
Book volume at pricing: **A$1.3 billion**
Margin: **107bp/3m BBSW**
Indicative margin: **110-115bp/3m BBSW**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, National Australia Bank, UBS**

CHART 1. SUNCORP AND BOQ COVERED BONDS GEOGRAPHIC DISTRIBUTION



SOURCE: BANK OF QUEENSLAND, SUNCORP-METWAY 2020

CHART 2. SUNCORP AND BOQ COVERED BONDS DISTRIBUTION BY INVESTOR TYPE



SOURCE: BANK OF QUEENSLAND, SUNCORP-METWAY 2020

TRANSACTION INSIGHTS

SIMON LEWIS
TREASURER
SUNCORP GROUP

"A number of fund managers asked us, on a reverse-enquiry basis, about a Suncorp covered bond the week before our mandate announcement. It gave us a high degree of confidence going into the transaction. But we were surprised real-money accounts outnumbered bank balance sheets."

"The stability we have seen in the past few weeks will not be there forever. There will not be an orderly, smooth transition back to normal – that is just not going to happen. This, at best, will be a saw-tooth recovery."

TIM LEDINGHAM
TREASURER
BANK OF QUEENSLAND

"With Suncorp obtaining strong interest at the five-year tenor, we thought the market would receive a CPT transaction at the same maturity well."

"Investors were able to reference the two CPT deals we executed previously in Europe, along with the supporting documentation, to understand how the structure works."

ALLAN O'SULLIVAN
EXECUTIVE DIRECTOR AND HEAD OF FREQUENT BORROWERS AND SYNDICATE
WESTPAC INSTITUTIONAL BANK

"The generally better market tone, improved liquidity and tighter marks supported some fund managers' conviction to participate in the primary market, notwithstanding many remain defensive and focused on keeping cash around them as they rebalance portfolios and pre-emptively prepare for potential hardship-related superannuation withdrawals."

JOSH SIFE
DIRECTOR, CAPITAL MARKETS ORIGINATION
NATIONAL AUSTRALIA BANK

"Strong demand from the asset-manager community reflects the healthy cash positions and overall investment appetite of this cohort and the appeal of the dual-recourse covered-bond structure in these uncertain times."

MARKET ANALYSIS

Securitisation deal flow steady but sure

Primary-market functionality in Australian securitisation is much closer to normal than might have been expected including an orderly flow of deals in June, market sources say. Investor sentiment improved even as the wider impact of COVID-19 on the Australian economy started to become apparent.

First quarter 2020 issuance was on track with the previous year's volume but nosedived once the COVID-19 crisis escalated in mid-March (see chart 1).

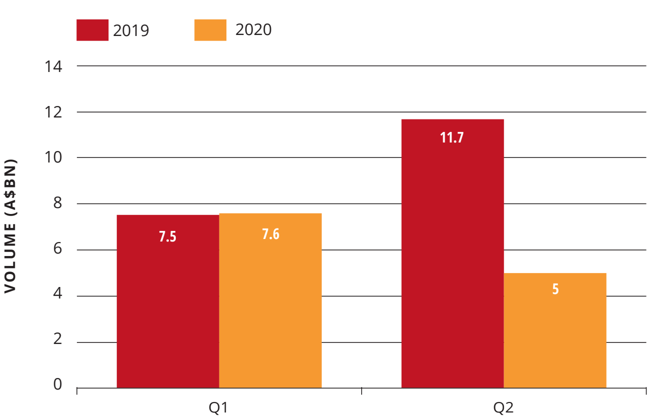
After Firstmac's A$1 billion (US$694.7 million) Mortgage Funding Trust No.4 Series 1-2020 printed on 27 March, it took more than a month for the next primary securitisation deal to land in the market with the arrival of Liberty Financial's A$500 million deal on 8 May. The latter deal included a ¥26.3 billion (US$247.2 million) senior tranche.

In other words, while Q2 volume reached less than half the level of issuance from 2019, the primary-market hiatus during the escalation of the COVID-19 crisis effectively ruled out nearly half the period for new deals. Since the resumption of activity, eight transactions priced (see table) while Metro Finance, Resimac and others had outstanding mandates in the market at the end of June.

The primary flow has exclusively come from the nonbank sector. The last securitisation deal from an authorised deposit-taking institution was a Bank of Queensland refinancing on 16 March, while the only new bank securitisation deal this year was Westpac Banking Corporation's A$2.75 billion Series 2020-1 WST Trust deal on 24 January (see chart 2).

Most transactions enjoyed support from the Australian Office of Financial Management (AOFM)'s Structured Finance Support Fund, but typically in the form of facilitated switch transactions in the secondary market rather than direct investment in new deals. The AOFM bought notes in two Liberty Financial deals and one from RedZed Lending Solutions.

CHART 1. AUSTRALIAN DOLLAR SECURITISATION ISSUANCE



SOURCE: KANGANEWS 30 JUNE 2020

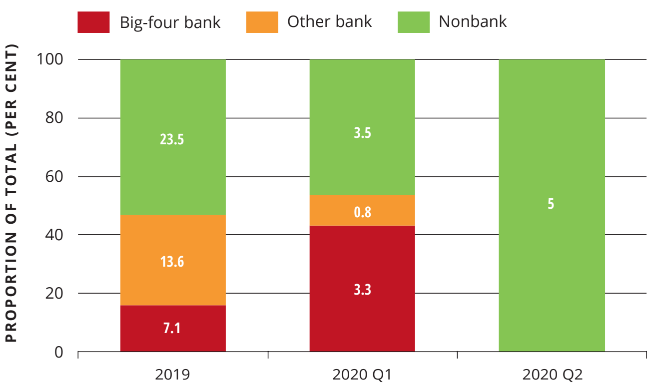
AUSTRALIAN SECURITISATION PRIMARY ISSUANCE (EXCLUCING REFINANCING), Q2 2020

PRICING DATE	POOL NAME	ISSUER	TYPE	TOTAL VOLUME (A$M)	LARGEST TERM TRANCHE MARGIN (BP)	LEAD MANAGER(S)
8 May 20	Liberty Series 2020-1	Liberty Financial	Nonconforming RMBS	500*	50/JPY LIBOR	CommBank, SMBC
12 May 20	La Trobe Financial Capital Markets Trust 2020-1	La Trobe Financial	Nonconforming RMBS	1,250	195/1m BBSW	CommBank, Citi, HSBC, Macquarie, NAB, Natixis
27 May 20	Resimac Premier Series 2020-2	Resimac	Prime RMBS	500	155/1m BBSW	Deutsche, JPM, NAB, StanChar, Westpac
5 Jun 20	Columbus Capital Triton 2020-2	Columbus Capital	Prime RMBS	600	160/1m BBSW	NAB, Natixis, StanChar, Westpac
10 Jun 20	Pepper Residential Securities Trust No.26	Pepper Group	Nonconforming RMBS	700	180bp/1m BBSW	CommBank, Macquarie, NAB, StanChar, Westpac
17 Jun 20	Liberty Series 2020-2	Liberty Financial	Nonconforming RMBS	800	165bp/1m BBSW	BofA, CommBank, Deutsche, NAB, Westpac
18 Jun 20	RedZed Trust STC Series 2020-1	RedZed Lending Solutions	CMBS	300	195bp/1m BBSW	CommBank
30 Jun 20	Bluestone Sapphire XXIII Series 2020-1 Trust	Bluestone Group	Nonconforming RMBS	350	165bp/1m BBSW	CommBank, Macquarie, NAB

* Equivalent, including ¥26.3 billion tranche.

SOURCE: KANGANEWS 7 JULY 2020

CHART 2. COMPOSITION OF AUSTRALIAN DOLLAR SECURITISATION ISSUANCE



SOURCE: KANGANEWS 30 JUNE 2020

MARKET INSIGHTS

FABRICE GUESDE
HEAD OF GLOBAL STRUCTURED CREDIT SOLUTIONS, ASIA PACIFIC
NATIXIS

"At first, no-one knew how investors would react or how anyone was going to react – even immediately after the SFSF was announced. Since then, we have seen repricing compared with pre-COVID-19 levels that has resulted in most investors continuing to evaluate and participate in deals."

JUSTIN MINEEFF
EXECUTIVE DIRECTOR, DEBT MARKETS SECURITISATION
COMMONWEALTH BANK OF AUSTRALIA

"Issuers are coming to market with mandate announcements and providing adequate time for investors to do the credit work. With this visibility, lead-manager groups are able to provide advice around when is the right time to access the market."

"The market has been receptive but everyone is conscious of the potential for volatility – which is why the execution window has been a little shorter than we have traditionally seen."

CRAIG STEVENS
DIRECTOR, SECURITISATION ORIGINATION
NATIONAL AUSTRALIA BANK

"The nonbank pipeline is backed up from the lack of issuance in March and April and we will see those deals come into frame in the next few months."

ALHAD BHALERAO
DIVISION DIRECTOR, DEBT MARKETS
MACQUARIE BANK

"Low volume of RMBS issuance in other markets, such as Europe, and the position Australia is in regarding its response to the COVID-19 crisis suggest offshore investors are turning their attention to the Australian domestic market."

MARTIN BARRY
CHIEF TREASURY AND STRATEGY OFFICER
LA TROBE FINANCIAL

"As events have unfolded, with improving health outcomes in Australia and the economy gradually reopening, investors have become more confident in the bookbuild process."

CHRIS WILSON
CHIEF FINANCIAL OFFICER
REDZED LENDING SOLUTIONS

"Spreads had widened but not enough for us to say we didn't want to do the deal when the opportunity was there."

TODD LAWLER
MANAGING DIRECTOR, TREASURY AND FUNDING
BLUESTONE GROUP

"This market would not be functioning as it is now without the support of the AOFM. It has implemented a multipronged strategy that has stabilised pricing levels, allowing investors to participate in new deals."

TRANSACTION ANALYSIS

Australian corporates find a safe European home in April

A trio of Australian corporate borrowers priced euro-denominated benchmark transactions in April. Toyota Finance Australia was the first mover in this clutch of deals – and the second Australian name to visit the euro market in 2020 – followed in short order by Telstra Corporation and APA Group.

Issuer: **Toyota Finance Australia**
Issuer rating: **AA-/A1**
Pricing date: **7 April 2020**
Maturity date: **21 April 2022, 21 October 2024 & 21 October 2027**
Volume: **€750 million (US$848.9 million), €500 million & €500 million**
Volume at launch: **€500 million, €500 million & €500 million**
Book volume at pricing: **€2 billion, €1.7 billion & €4.5 billion**
Margin: **185bp/mid-swap, 220bp/mid-swap & 235bp/mid-swap**
Indicative margin: **225bp/mid-swap, 245bp/mid-swap & 285bp/mid-swap**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **Barclays, BNP Paribas, Citi, Credit Agricole, Societe Generale**

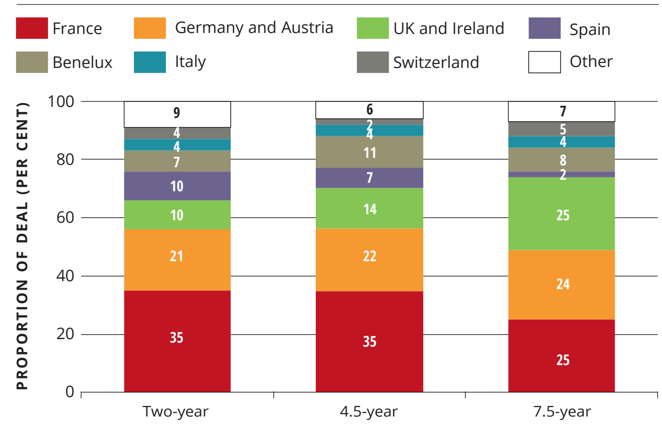
★

Issuer: **Telstra Corporation**
Issuer rating: **A-/A2**
Pricing date: **16 April 2020**
Maturity date: **23 April 2030**
Volume: **€500 million**
Volume at launch: **€500 million no-grow**
Book volume at pricing: **€6.5 billion**
Margin: **115bp/mid-swap**
Indicative margin: **170-175bp/mid-swap**
Geographic distribution: **see chart 3**
Distribution by investor type: **see chart 4**
Lead managers: **BNP Paribas, Goldman Sachs, HSBC, J.P. Morgan**

★

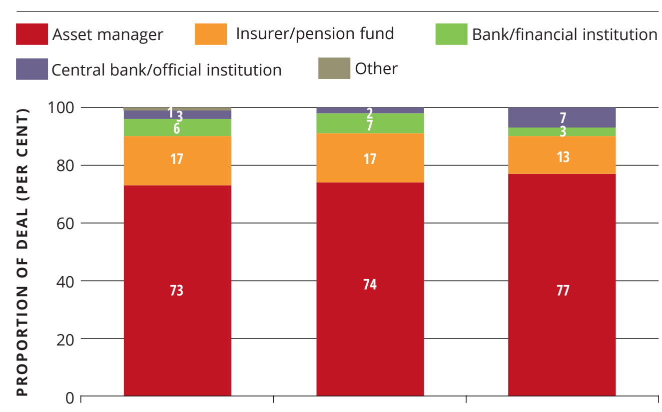
Issuer: **APT Pipelines**
Issuer rating: **BBB/Baa2**
Pricing date: **23 April 2020**
Maturity date: **15 July 2030**
Volume: **€600 million**
Volume at launch: **€500 million**
Book volume at pricing: **€4.1 billion**
Margin: **210bp/mid-swap**
Indicative margin: **250-260bp/mid-swap**
Geographic distribution: **see chart 5**
Distribution by investor type: **see chart 6**
Lead managers: **BNP Paribas, Citi, HSBC, J.P. Morgan**

CHART 1. TOYOTA AUSTRALIA EURO DEAL GEOGRAPHIC DISTRIBUTION



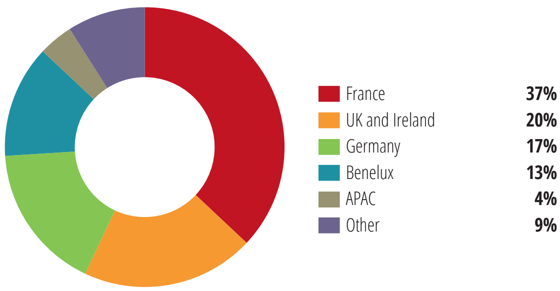
SOURCE: CITI 14 APRIL 2020

CHART 2. TOYOTA AUSTRALIA EURO DEAL DISTRIBUTION BY INVESTOR TYPE



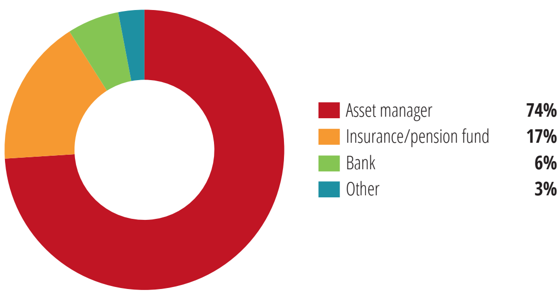
SOURCE: CITI 14 APRIL 2020

CHART 3. TELSTRA EURO DEAL GEOGRAPHIC DISTRIBUTION



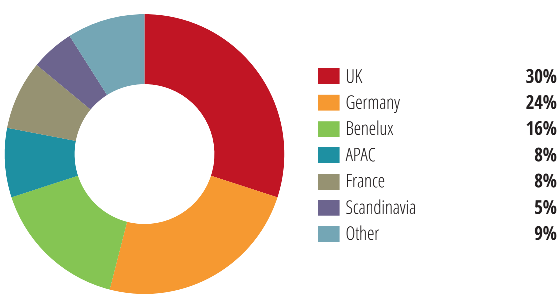
SOURCE: GOLDMAN SACHS 17 APRIL 2020

CHART 4. TELSTRA EURO DEAL DISTRIBUTION BY INVESTOR TYPE



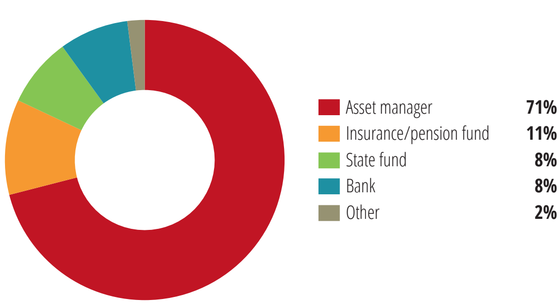
SOURCE: GOLDMAN SACHS 17 APRIL 2020

CHART 5. APA EURO DEAL GEOGRAPHIC DISTRIBUTION



SOURCE: BNP PARIBAS 27 APRIL 2020

CHART 6. APA EURO DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: BNP PARIBAS 27 APRIL 2020

TRANSACTION INSIGHTS

GUY WYLIE
HEAD OF CORPORATE FINANCE AND TREASURER
TELSTRA CORPORATION

"A lot of non-European corporate borrowers have avoided the euro market because they are not eligible for the corporate-sector purchase programme. We came as a high-quality, defensive credit. We would like to see this open the euro market to other Australian issuers in these uncertain times."

CAROL LYDFORD
TREASURER
TOYOTA FINANCE AUSTRALIA

"Our orderbook was the largest for an auto issuer in the euro market in 2020 so far. Toyota Australia also successfully re-opened the two-year tenor market, with the tranche being the first from a corporate in the euro market since early February."

KATE STEWART
MANAGING DIRECTOR AND HEAD OF DEBT CAPITAL MARKETS, AUSTRALIA AND NEW ZEALAND
BNP PARIBAS

"With a rapidly growing book and a cap on volume – which was a key part of the strategy – we were able to drive a much more aggressive pricing outcome for Telstra. We revised price guidance to 125 basis points area when the orderbook was more than €7 billion, and the book largely held together with circa €6.5 billion of demand."

IAN CAMPBELL
MANAGING DIRECTOR AND HEAD OF DEBT CAPITAL MARKETS, AUSTRALIA AND NEW ZEALAND
CITI

"Even though APA had not issued in Europe for nearly five years, some degree of familiarity is still important for issuers looking to print euros. This is why we have seen the likes of APA, Telstra, Toyota and Transurban raise funds successfully."

TRANSACTION ANALYSIS

Shoppers and investors returning to Scentre

The cautious and early emergence of Australia and New Zealand from the COVID-19 crisis enabled Scentre Group to convey a relatively positive forecast to debt investors in its May US dollar 144A deal. The result, deal sources say, was an endorsement of the company and pending antipodean economic recovery.

Issuer: **Scentre Group**
Issuer rating: **A/A2/A**
Pricing date: **19 May 2020**
Maturity date: **28 January 2026 & 28 May 2030**
Volume: **US$750 million & US$750 million**
Book volume at pricing: **US$5 billion**
Margin: **340bp/Treasuries & 370bp/Treasuries**
Indicative margin: **400bp/Treasuries & 412.5bp/Treasuries**
Active bookrunners: **BNP Paribas, Citi, J.P. Morgan, SMBC Nikko**

Scentre has favoured the euro market for its bond transactions in recent years and euros offered the best economics for Australian issuers early in Q2. This time around, though, the volume Scentre was seeking meant the execution certainty of the US market was optimal, according to Kate Stewart, managing director and head of debt capital markets, Australia and New Zealand at BNP Paribas in Sydney. She adds that pricing was similar between euros and US dollars.

The US market has shown its depth and breadth since the beginning of March. Nick Ryan, Sydney-based vice president, debt capital markets at J.P. Morgan, says there has been around an 80 per cent increase in high-grade supply year-on-year so far in 2020 with the majority coming since the beginning of March.

Ryan adds that central-bank purchasing has not had such a profound influence in the US as it has in Europe. "While providing a powerful backstop, the Fed [US Federal Reserve]'s approach is very different from the ECB [European Central Bank] and is not a direct driver of credit-spread performance. Key drivers of US investor participation remain relative value and credit," he says.

Investors' willingness to engage was a key consideration for Scentre, given shopping centres have been some of the hardest hit businesses during the COVID-19 crisis. Luke Spitty, executive director at SMBC Nikko in Sydney, says the marketing approach was crucial for the deal's success.

"The prevalence of essential services inside Scentre's facilities, and the fact they have remained open throughout this period, put the company in a good position," he adds.

Ian Campbell, managing director and head of debt capital markets Australia and New Zealand at Citi in Sydney, tells *KangaNews* it was important to convey Scentre's exact circumstances – and specifically the context of its Australasian asset base – to investors.

A Scentre operational update on 11 May outlined the company's position amid the crisis. Customer visitation to centres in March and April bottomed at 39 per cent of the previous year's level. However, by early May in Australia, 57 per cent of retailers were open, while in New Zealand centres were preparing to reopen as the government dialed back restrictions. Scentre has also implemented cost-cutting measures targeting a 25 per cent reduction in centre operating expenses.

"The marketing window gave Scentre an opportunity to discuss the impact of COVID-19 on its business but also to explain that, with Australia and New Zealand emerging from the crisis quicker than other regions, it is in a good position going forward. It was able to show that foot traffic in its shopping centres over the last two weeks has increased significantly," Campbell explains.

SOLD OUT

Investors' response to the deal is demonstrated by its distribution profile. Scentre received just shy of US$5 billion in orders, allowing for the deal to be upsized and pricing in each tranche tightened – the long-five-year by 60 basis points and the 10-year by 42.5 basis points from initial price guidance.

According to a Commonwealth Bank of Australia research note, all tranches were already trading 15-20 basis points tighter in the secondary market by 22 May.

The final margin for each tranche makes for a favourable all-in coupon when swapped back to Australian dollars, Campbell says. He adds that there were more investors in this deal than in any previous Scentre US dollar transaction.

Spitty says meaningful indications of interest were garnered with feedback from investors after the marketing process. "The book built quickly after launch, with demand from accounts in Asia covering the book and allowing for the extensive price tightening once US investor interest came in," he reveals.

Leads say demand from Asia was skewed to the long-five-year tranche while US investors favoured the 10-year notes. Real-money investors were predominant in both.

Spitty tells *KangaNews* the relatively flatter curve between tranches made the shorter tenor more attractive for some investors. The long-five-year tranche also benefited from cornerstone interest axed at the shorter tenor on FX dynamics when swapped back to the investor's base currency. •

Corporate repo eligibility to have a gradual impact

Australian market participants generally expect only a gradual and marginal impact from the Reserve Bank of Australia (RBA)'s 5 May decision to make certain corporate bonds eligible collateral for open-market operations. Even so, the criteria encompass a massive portion of Australian dollar corporate debt and took the market by surprise.

MARGINS FOR ELIGIBLE SECURITIES PURCHASED BY THE RBA UNDER REPO

SECURITY	AVERAGE CREDIT RATING	0-1 YEAR MATURITY (PER CENT)	1-5 YEARS MATURITY (PER CENT)	5-10 YEARS MATURITY (PER CENT)	>10 YEARS MATURITY (PER CENT)
Australian government	N/A	1	2	2	2
Semi-government	N/A	1	2	2	2
Supranational, sovereign and agency	AAA	2	3	4	4
Australian government guaranteed	N/A	2	3	4	4
Foreign government guaranteed	AAA	2	3	4	4
ADI	AAA	6	7	8	10
	AA-	10	12	14	16
	A-	12	14	16	18
	BBB-	18	22	26	30
	public credit rating	24	N/A	N/A	N/A
Non-ADI	AAA	6	7	8	10
	AA-	10	12	14	16
	A-	12	14	16	18
	BBB-	18	22	26	30
Asset backed					
- Standard	A-1 or AAA	10-15	10-15	10-15	10-15
- Other	A-1 or AAA	15-40	15-40	15-40	15-40
Other securities	AAA	6	7	8	10

SOURCE: RESERVE BANK OF AUSTRALIA 6 MAY 2020

The RBA says: "To assist with the smooth functioning of Australia's capital markets, the [reserve] bank has decided to broaden the range of eligible collateral for [open-market] operations to include Australian dollar securities issued by nonbank corporations with an investment-grade credit rating."

Some market participants believe the RBA's announcement could boost demand in a corporate bond market that was close to silent during the peak of the COVID-19 crisis. Westpac Institutional Bank's analysts estimated in a 6 March note that around A$55 billion (US$38.2 billion) of corporate bonds qualify under the new criteria.

However, others say they are waiting for clarification from the RBA on various aspects of the policy. For instance, it was not immediately clear how capital charges for banks holding corporate bonds for repo purposes will be levied or whether all Australian dollar bonds or only those issued by locally domiciled issuers will be eligible.

The aim of the repo expansion is to help smooth the functioning of the corporate debt market, which has been slower to return to anything near normal function than the government and semi-government sectors. Prior to the RBA announcement there had been no Australian dollar corporate primary issuance since February and yield remained elevated by early May even as major-bank spreads rallied.

Analyst reports suggest the RBA's decision took market participants by surprise, based on the consensus view that the local QE programme had already been effective in alleviating market dislocation.

The margin charged by the RBA to hold nonfinancial securities under repo will be the same as it is for authorised deposit-taking institution (ADI) securities based on credit rating (see table). Joyce Yu, Sydney-based director, credit strategy at Commonwealth Bank of Australia, tells *KangaNews* this could in time provide a boost for corporate liquidity as banks become indifferent between ADI and corporate paper for repo books.

Whether banks are particularly motivated to purchase corporate bonds for repo purposes could depend on spreads. The margins levied by the RBA on government and semi-government securities under repo is magnitudes lower than it is for corporate or financial securities, but currently the return a bank would receive for holding an eligible corporate bond is likely still to make it an accretive position over holding a government security.

Yu explains bank exposure to corporate bonds may also increase gradually as high-quality liquid-asset requirements for banks are raised to 30 per cent from 25 per cent. However, she adds: "The immediate effectiveness of the broadened criteria in helping secondary-market liquidity will depend on banks expanding their appetite for corporate bonds." •

TRANSACTION ANALYSIS

Woolworths nets strong 10-year support in Australian corporate return

Woolworths Group reopened the Australian dollar corporate on 13 May with a dual-tranche transaction that leads say attracted a surprising level of support for 10-year tenor.

Deal sources also say the Australian investor base was keen to show support for corporate issuance in the local market given the new-issuance hiatus over the preceding couple of months and the fact that it had watched some issuers go offshore and print in euros.

Issuer: **Woolworths Group**
Issuer rating: **BBB/Baa2**
Pricing date: **13 May 2020**
Maturity date: **20 May 2025 & 20 May 2030**
Volume: **A$400 million (US$277.9 million) & A$600 million**
Book volume at pricing: **A$1.35 billion & A$1.65 billion**
Margin: **145bp/s-q swap & 195bp/s-q swap**
Indicative margin: **160bp/s-q swap & 210bp/s-q swap**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, Commonwealth Bank of Australia, National Australia Bank, Westpac Institutional Bank**

CHART 1. WOOLWORTHS DEAL GEOGRAPHIC DISTRIBUTION

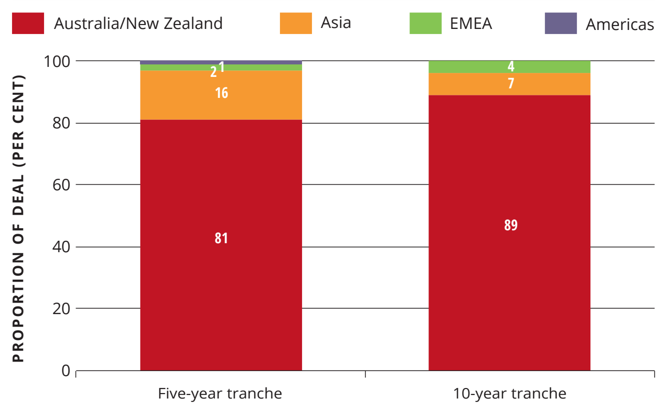
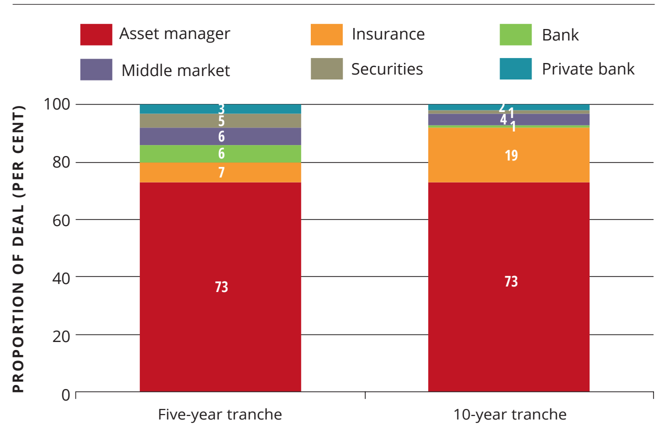


CHART 2. WOOLWORTHS DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: CITI 14 APRIL 2020

ISSUER INSIGHTS

TRICIA HO-HUDSON
GROUP TREASURER
WOOLWORTHS GROUP

Woolworths was the first Australian corporate issuer to return to the domestic market since the COVID-19 crisis. What considerations were top-of-mind before green-lighting the deal?
The key consideration was deciding whether to be the first to set a pricing benchmark for corporate issuers and, for ourselves, where margins should be. We felt it was appropriate to take advantage of market conditions at the time rather than wait until later in the calendar year to complete our refinancing.

Why did you select the domestic market rather than going offshore?
We judged that the Australian dollar market would offer the Woolworths brand good pricing, given our defensive qualities. We were also mindful of a commitment we gave to Australian investors when we issued our green bond last year – that we would continue to support the Australian debt capital markets in the future.

COVID-19 seems likely to change Australian business profoundly. What is likely to come for Woolworths?
We certainly see some future changes in our business as a result of COVID-19, not least of which is the acceleration of e-commerce and digital. We will be able to provide more details in our full-year results.

AsA maintains investor support despite airline-industry woes

Airservices Australia (AsA) returned to the domestic bond market in May at a time of unique uncertainty for the global aviation industry. As a government-owned and triple-A rated corporate entity, AsA also lacks obvious pricing comps. Neither factor proved an impediment to a well-supported transaction, deal sources say.

A less-frequent borrower in debt capital markets, AsA last issued in May 2016 with a A$400 million (US$277.9 million) deal split evenly between seven- and 10-year tenors. The market return was to refinance a A$275 million November 2020 maturity that funds AsA's investment in the OneSky programme – a transformation of Australia's air-traffic management.

Issuer: **Airservices Australia**
Issuer rating: **AAA (S&P)**
Pricing date: **19 May 2020**
Maturity date: **15 May 2030**
Volume: **A$275 million**
Book volume at pricing: **A$1.85 billion**
Margin: **135bp/s-q swap**
Indicative margin: **160bp/s-q swap**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, Commonwealth Bank of Australia**

CHART 1. ASA DEAL GEOGRAPHIC DISTRIBUTION

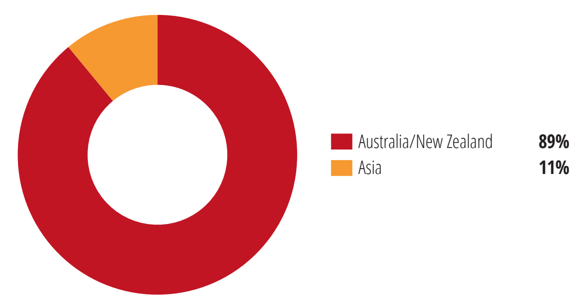
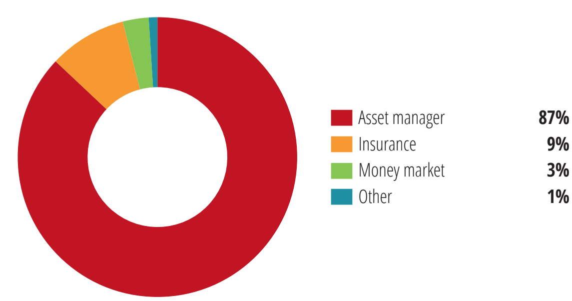


CHART 2. ASA DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: ANZ 21 MAY 2020

ISSUER INSIGHTS

PAUL LOGAN
CHIEF FINANCIAL OFFICER
AIRSERVICES AUSTRALIA

"AsA expects domestic aviation to recover toward the end of the calendar year while international travel will take longer – which is in line with how the broader market is viewing the recovery."

"Over the next five years we will probably need around A$900 million in capital primarily to support the OneSky programme and its various related enabling projects."

"The movement from initial price guidance to where we finally landed was a challenging part of the deal. We want to operate transparently with investors but the market [was] still going through a series of repricing arrangements."

MATTHEW BARTHOLEMEW
TREASURY AND INSURANCE MANAGER
AIRSERVICES AUSTRALIA

"We were always confident we could get a deal done but we didn't know what fair value was. It wasn't until iTraxx started to recover that we realised what our pricing levels might be and became comfortable moving forward with a trade."

TRANSACTION ANALYSIS

Spark's Australian dollar return demonstrates growing corporate confidence

Spark Finance is the first New Zealand domiciled corporate issuer to execute a public debt capital markets transaction in 2020 – and it chose Australia for its 28 May deal. The borrower says establishing and maintaining a funding presence in Australian dollars is a key component of its debt strategy.

Spark last issued in the Australian dollar market in September 2019, when it printed a A$125 million 10.5-year transaction. Spark now has three outstanding Australian dollar lines – the new deal as well as October 2027 and March 2030 bonds – and four in New Zealand dollars. The funds from the new trade will be used to refinance a small sterling bond which matured in April and to term out commercial paper, the issuer says.

Issuer: **Spark Finance**
Issuer rating: **A- (S&P)**
Pricing date: **28 May 2020**
Maturity date: **5 June 2026**
Volume: **A$100 million (US$86.8 million)**
Margin: **140bp/s-q swap**
Indicative margin: **155bp/s-q swap**
Geographic distribution: **see chart 1**
Distribution by investor type: **see chart 2**
Lead managers: **ANZ, Westpac Institutional Bank**

CHART 1. SPARK DEAL GEOGRAPHIC DISTRIBUTION

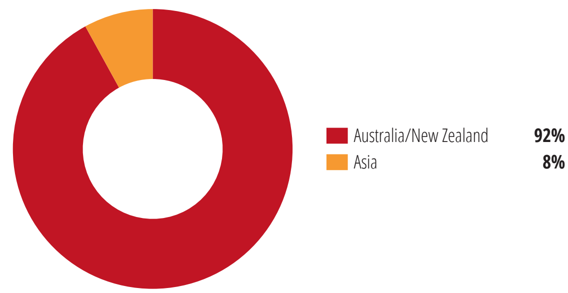
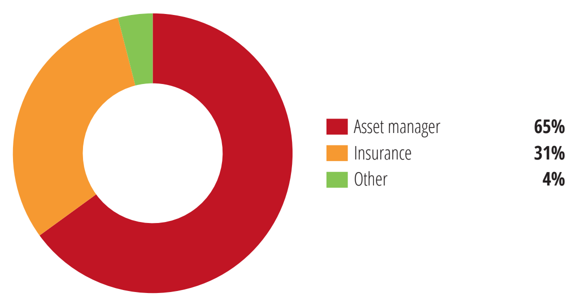


CHART 2. SPARK DEAL DISTRIBUTION BY INVESTOR TYPE



SOURCE: WESTPAC BANKING CORPORATION NEW ZEALAND BRANCH 4 JUNE 2020

ISSUER INSIGHTS

ALASTAIR WHITE
GENERAL MANAGER, CAPITAL MARKETS
SPARK FINANCE

"We were looking to fill a gap in our portfolio and we knew there was demand at that point in the curve in Australian dollars."

"We were confident our credit quality would have allowed us to deliver a relatively well-priced transaction but felt it was appropriate for a blue-chip Australian domestic issuer to reopen the corporate market. As soon as Woolworths issued, it gave us the confidence to launch as we had a line of sight on pricing and guidance on market appetite."

COLLEEN PARK
TREASURER
SPARK FINANCE

"We planned to execute in Australian dollars in March but delayed the deal due to the unfolding crisis. It was always our intention to issue in the Australian dollar market in order to establish and then maintain three to four pricing points in our home markets of New Zealand and Australia."

Inflation-linked bonds a good match for Kāinga Ora

Inflation-linked bonds could come to form a greater portion of Kāinga Ora – Homes and Communities' funding portfolio as the format provides long-term funding matched to its primary revenue stream, the issuer tells *KangaNews* after its debut deal in the format.

Issuer: **Housing New Zealand**
Issuer rating: **AA+/Aaa**
Pricing date: **23 April 2020**
Maturity date: **20 September 2040**
Volume: **NZ$300 million (US$194.5 million)**
Margin: **175bp/2040 NZGIIB**
Lead manager: **ANZ**

On 23 April, Kāinga Ora executed its first-ever inflation-linked bond – a September 2040 maturity – via a reverse enquiry with a real-money investor. It was the issuer's second transaction within a week, following a NZ$1 billion fixed-rate deal issued on 17 April.

The agency has been open to reverse enquiry for longer-dated transactions since it re-entered the bond market in 2018 but this is the first it has executed. Kāinga Ora's Wellington-based treasurer, Sam Direen, says the deal had been in the pipeline for around three months.

He comments: "The investor and intermediary were committed and we were comfortable with the volume and price so we decided to execute the deal now. We did not have appetite for more than this volume so we went ahead in this manner to minimise execution risk."

"We had no indication that we could print a nominal bond of material size beyond around 10-year maturity. We have always said we want to issue long-dated debt and this was an opportunity to do so in a relatively low-rate environment."

SAM DIREEN KĀINGA ORA – HOMES AND COMMUNITIES

SUITABLE PRODUCT

Inflation-linked bonds have always been a niche product in New Zealand. Dean Spicer, head of capital markets at ANZ in Wellington, says the challenge for the asset class is not necessarily demand but the number of issuers for which these bonds are a good fit.

Kāinga Ora's revenue base is primarily residential rents and its asset base is long-term housing stock. Inflation-linked bonds provide a natural funding match. Direen says Kāinga Ora has been eager to have linkers as part of its funding portfolio since it began issuing syndicated debt again in 2018.

"In New Zealand, residential rents make up more than 9 per cent of the CPI basket and are highly correlated with the headline figure – so we have a natural hedge if inflation does rise," Direen comments.

The only other issuer to have placed inflation-linked bonds in recent years is New Zealand Debt Management, which last executed a syndicated deal in the format in 2017. The product is out of vogue with sovereign borrowers as long-dated fixed-rate funding has been available at low yield.

Break-even inflation for government bonds is low, reflecting a market expectation that inflation will remain low for the foreseeable future. This is less of a consideration for Kāinga Ora given benchmark volume at 20-year tenor is not as easy to attain as it is for sovereign borrowers.

"There is not a tactical consideration here because we had no indication that we could print a nominal bond of material size beyond around 10-year maturity. We have always said we want to issue long-dated debt and this was an opportunity to do so in a relatively low-rate environment," says Direen.

Although this deal was narrowly placed it still provides Kāinga Ora with investor diversification. Direen says the issuer has witnessed market sensitivity to changes in its nominal bond requirement and, like other New Zealand high-grade issuers, also saw real-money participation decline steadily over 2019. As a result, it is keen to use additional tools to diversify its investor base and funding portfolio.

After pricing, Kāinga Ora had around NZ$700 million left to raise of its stated programme of around NZ$2 billion for the 2020 calendar year. Direen stresses that it is still committed to providing sufficient liquidity in its nominal bond lines.

The benefits of issuing inflation-linked bonds for Kāinga Ora are such that Direen says 20 per cent of its funding could ideally be done in the format. However, he acknowledges that it is a niche product with a relatively small investor base so issuance will depend on demand as well as portfolio and financing requirements.

Spicer tells *KangaNews* there will be opportunities for further inflation-linked bond issuance for Kāinga Ora, with additional demand potentially coming from offshore investors. "The feedback we have received is that offshore accounts could be receptive to the format and it could open up additional portfolios and bespoke mandates," he comments. •

MARKET ANALYSIS

Technicals supporting Kauri rebound

Kauri issuance rebounded in May-June as more than NZ$2.6 billion (US$1.7 billion) priced, including a rare 10-year transaction with record volume for the tenor. Technical demand drivers were at play but intermediaries suggest positive conditions could remain even as a supply gap closes in the second half of 2020.

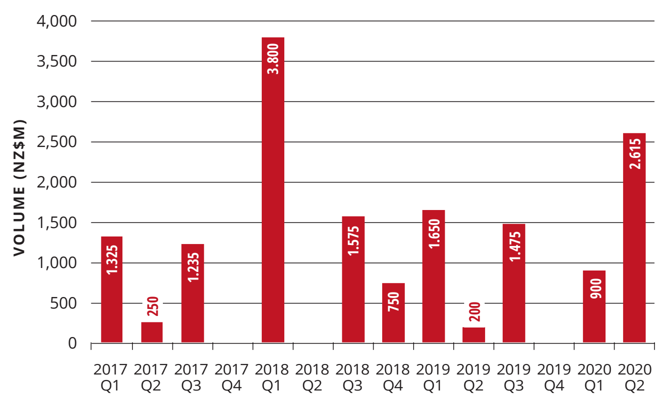
The surge in Kauri supply makes the second quarter of 2020 the largest for Kauri volume since early 2018 (see chart 1). Year-to-date issuance, of NZ$3.5 billion (US$2.3 billion), has already surpassed the NZ$3.3 billion from full-year 2019.

Deals have primarily come with 3-5 year tenor (see table 1), but on 19 June Kommunalbanken Norway (KBN) executed a A$500 million 10-year Kauri that equalled the volume record for a New Zealand dollar deal at the tenor excluding the sovereign borrower (see table 2).

Balance sheets have been the primary deal driver on the demand side, but lead managers say fund managers have also been re-entering the primary market after a period of uncertainty.

Asset managers showed strong interest in Rentenbank's deal priced in May, for example. In NIB's NZ$400 million 23 June deal and in IADB's NZ$200 million 19 June deal, allocations skewed towards bank balance sheets. All deals have been primarily allocated to New Zealand domestic investors (see charts 2 and 3).

CHART 1. KAURI ISSUANCE VOLUME



SOURCE: KANGANEWS 2 JULY 2020

TABLE 1. KAURI TRANSACTIONS PRICED MAY-JUNE 2020

PRICING DATE	ISSUER	VOLUME (NZ$M)	TENOR (YEARS)	MARGIN (BP/MID-SWAP)	LEAD MANAGER(S)
12 May 20	World Bank	450	4	41	ANZ, BNZ
22 May 20	Asian Development Bank	300	3	33	ANZ, TD
26 May 20	Rentenbank	300	5	47	BNZ
27 May 20	International Finance Corporation	65	4	33	ANZ
3 Jun 20	Kommunalbanken Norway	250	5	52	ANZ, TD
12 Jun 20	Municipality Finance	150	3	46	BNZ
19 Jun 20	Kommunalbanken Norway	500	10	71	ANZ
19 Jun 20	Inter-American Development Bank	200	5	43	CommBank
23 Jun 20	Nordic Investment Bank	400	5	43	ANZ, BNZ

SOURCE: KANGANEWS 25 JUNE 2020

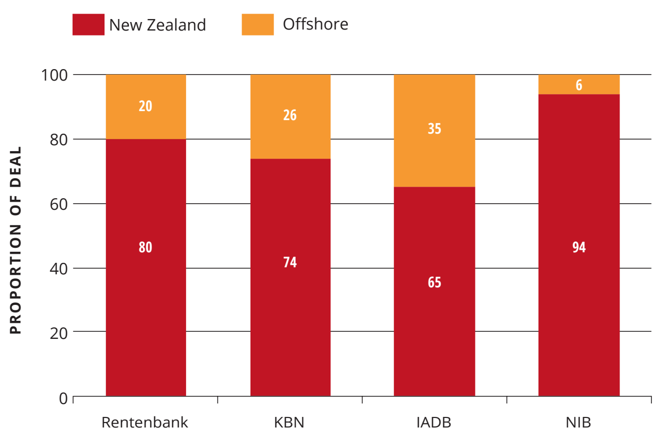
TABLE 2. LARGEST-EVER 10-YEAR PLUS SENIOR NEW ZEALAND DOLLAR DEALS EX. NZGB

PRICING DATE	ISSUER	VOLUME (NZ$M)	TENOR (YEARS)	MARGIN (BP/MID-SWAP)
13 Mar 18	Inter-American Development Bank	500	10	47
23 Nov 18	Chorus	500	10*	180
21 Aug 19	New Zealand Local Government Funding Agency	500	10	48
17 Apr 20	Kāinga Ora – Homes and Communities	500	10	125
19 Jun 20	Kommunalbanken Norway	500	10	71

* Interest rate resets after five years.

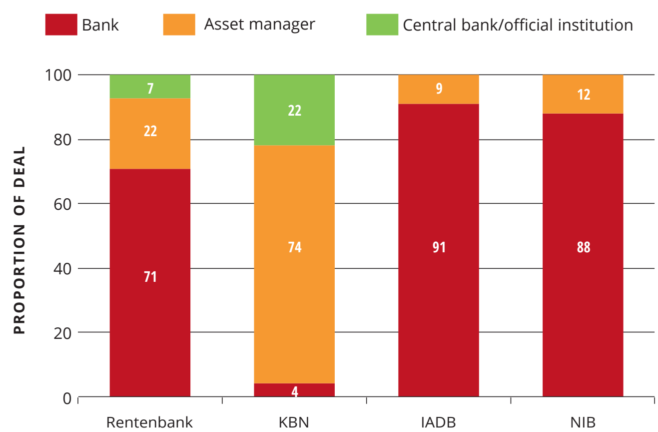
SOURCE: KANGANEWS 25 JUNE 2020

CHART 2. SELECTED KAURI DEALS GEOGRAPHIC DISTRIBUTION



SOURCE: ANZ, COMMONWEALTH BANK, RENTENBANK 25 JUNE 2020

CHART 3. SELECTED KAURI DEALS DISTRIBUTION BY INVESTOR TYPE



SOURCE: ANZ, COMMONWEALTH BANK, RENTENBANK 25 JUNE 2020

MARKET INSIGHTS

STEFAN GOEBEL
TREASURER
RENTENBANK

"We have seen opportunities for Kauri deals in the last two years but unfortunately investor demand never matched the timing of acceptable economics. This time, the all-in cost was flat to the level we established with a US dollar two- and five-year deal in the week prior."

CAMERON WAUGH
DIRECTOR, DEBT CAPITAL MARKETS
COMMONWEALTH BANK

"Technical factors are supporting Kauri spreads including a redemption-supply gap and a proliferation of bank balance-sheet demand. With LGFA bonds tightening as a result of its inclusion in the RBNZ's large-scale asset purchase programme, a window of opportunity has opened for SSAs to meet institutional investor demand."

"SSA pricing has tightened in New Zealand dollars relative to other markets. Meanwhile, wholesale yields in New Zealand have recently moved away from all-time lows and cross-market relative value has improved."

GLEN SORENSEN
DIRECTOR, SYNDICATE
ANZ

"We had the sense that the timing was right for a 10-year deal and that it was likely to have broader appeal. We do not often see 10-year, public Kauri issuance, so the Kommunalbanken Norway deal offered investors a rare opportunity at tenor, yield and healthy spread to NZGB, in a high-quality name that is well-known."

MIKE FAVILLE
HEAD OF DEBT CAPITAL MARKETS
BNZ

"Balance sheets have been the primary source of mid-curve Kauri demand, but complementary demand from fund managers has also been steady as investors seek to redeploy cash following large liquidation of positions in March."

LAURENCE DAVISON
LDAVISON@KANGANEWS.COM

How the future works

Spending several months in lockdown gave us all a chance to contemplate our circumstances and what life might look like on the other side. If the working world does not snap back to the old norms, we will all need to pay more attention to the complexities of the changes we seem to be signing up to.

It has been interesting to hear over the past few months what people in our industry have made of the sudden and in many cases unprecedented switch to working from home.

As someone who has spent more than half their time doing just that for the past half decade or more, it was quite amusing to hear the surprise in people's voices when they described how productive they found themselves after the change. I'm not arrogant enough to think anyone would have considered my working conditions in particular. But it certainly appeared that a lot of office-bound workers really did believe their home-working colleagues weren't – for one reason or another – getting anything terribly productive done as soon as they were out of eye line.

> "WHILE PEOPLE SEEM INCREASINGLY WILLING TO TAKE SOME DEGREE OF RISK IN THEIR PERSONAL LIVES, THE SAME CAN CLEARLY NOT BE SAID FOR THE WORKING ENVIRONMENT. PEOPLE WHO ARE WILLING TO OBSERVE PATCHY AT BEST SOCIAL DISTANCING IN THE PUB ON A SATURDAY NIGHT ARE ALSO UNWILLING TO TAKE THE TRAIN TO WORK ON MONDAY MORNING."

On the other hand, more than three months into this dramatic change in working practices the initial rush of enthusiasm seems to be fading. For every person who comments on the boon of eliminating the daily commute there is another who yearns for the return of a clear delineation of the beginning and end of the working day. For every newly out-of-the-closet (or should that be happily in the closet?) introvert there are many more who are ready to say that, yes, actually sometimes it is nice to share a beer and a catch up with colleagues.

My sense is that people were initially pleasantly surprised at how easy it was to transition to working from home. But in the dark days of late March and early April everyone's horizons were condensed: it was very much a case of getting through each day, whether that be in funding markets or business more generally.

The main issue, I think, is that home working is very good for some things and pretty terrible for others. Personally, I get a lot more done in my home office when it comes to process-based tasks: editing or working with data, for instance. It is also a good environment for individual creativity, which is why I get most of my writing done at home.

On the other hand, trying to bring together new or innovative projects while working remotely is massively more time consuming and prone to problems. Decisions that would be best made collaboratively often end up in one person's hands for lack of easy, brief communication. Alternatively, you have to schedule endless calls and video conferences to achieve what could easily have been covered in five-minute chats across a desk.

The example I keep coming back to is bringing new team members on board. I imagine recruitment has been at an all-time low for much of 2020. But eventually we will need to replace staff or even – perish the thought – increase head count. Anyone who says it will be just as easy to integrate new team members, even experienced ones, via Zoom as it was in person is surely deluded.

As a conference organiser, I am of course also obliged to say there is no real replacement for the richness of an environment in which people from the same industry can meet and mingle freely, sharing information and ideas in a way that helps the market as a whole. KangaNews will continue to provide the content its events are known for via all suitable methods. But this only provides some of the value of a 'proper' conference.

OUTCOME UNCERTAIN

This makes me tempted to say that, in time, we will likely revert to old ways of working – likely with more common mixed arrangements whereby people perhaps spend a day or two a week working at home. Human nature is a powerful mean-reversion tool and if there was a reason for office-based work before COVID-19 there should be no reason not to return to it afterwards.

But I am less confident about this outcome than I was. For one thing, the situation in Melbourne provides a frightening reminder that we will never really be free of COVID-19 until there is some form of medical solution – which cannot be guaranteed, and certainly not in the near term.

While people seem increasingly willing to take some degree of risk in their personal lives, the same clearly cannot be said for the working environment. People who are willing to observe patchy at best social distancing in the pub on a Saturday night are also unwilling to take the train to work on Monday morning.

It's hard to blame them, to be fair: people have every right to take their own risks on their own time but refuse to take them for their employers' sake. The stories emerging from the US about hospitality workers being forced to come back to work in patently unsafe conditions are all I need to know about where the balance of power in employment relationships has shifted and why I don't want it to shift further.

Of course, responsible employers with the option not to force people back to the office will be cautious. Most firms in our industry are not planning a return to full office working this year, if at all.

Perhaps, too, the Melbourne experience will cause people to be less blasé in their personal lives. But I am not sure the appetite exists for prolonged periods of social distancing. In the end, people may decide they would prefer to let the virus run its course, whatever its cost, than submit to months or years of inconvenience.

It will be interesting to see where peer pressure and social norms shift. It's easy for those with spare bedrooms or even holiday homes to pontificate about the joys of a long-term switch to working away from the office. But the graduate in a share house or living with their parents might find the office a superior option. And what about when a big project deadline comes due? Are we all really going to think just as much of the team member who says they aren't coming in to the office when everyone else is there to get the job done?

ECONOMIC IMPACT

The other thing I have not seen discussed at all is the economics of a wide-scale shift to home working. Hundreds of thousands of Australians will be looking forward to healthy cash supplements this year as, for the first time, they add a raft of home-office expenses to their tax returns. Of course many will also have had to upgrade their domestic setup with better internet connections – to the extent such a thing is available in Australia – and printers, desks and the like.

This could all turn into yet another giant redistribution of wealth from the public purse and individuals to companies. Will it become a condition of employment to have a functional home-office setup – including not just office equipment but a suitable workspace? Will the public purse be able to afford to continue to subsidise home-office expenses if they become the norm for many more people?

This all adds inputs to the ongoing equation of how people choose to live. If many more of us start to need extra rooms in our houses from even quite early in our professional lives, the impact on the shape of cities could be radical. New entrants to the workforce may be less able to live in small, inner-city apartments if they need to provide their own home office space from the outset.

We already know that home working is not a luxury afforded to everyone: those in hospitality, manual workers and the like already have to leave the house to work or not work at all. But unless we retain the expectation that a workspace will be provided by one's employer is extended beyond the boundaries of a centralised office, it is easy to see how the move to home working will be one only the most privileged are able to take advantage of in the long term.

When I say 'take advantage of' I mean it in productivity terms, too. The office is at least a relatively egalitarian space where we all get roughly the same equipment and work in somewhat similar conditions. It is hard to imagine the senior manager in their well-appointed home office having the same productivity struggles as a new graduate squeezing a laptop onto the same kitchen table as his or her three housemates.

The problem is we are adapting to circumstances we did not ask for or anticipate, which gives us even less scope than usual to work out how we actually want to address a different future. We need to start doing so, however, unless we want to see yet another example of unconstrained passing of value up the wealth and privilege chain.

> “THIS COULD ALL TURN INTO YET ANOTHER GIANT REDISTRIBUTION OF WEALTH FROM THE PUBLIC PURSE AND INDIVIDUALS TO COMPANIES. WILL IT BECOME A CONDITION OF EMPLOYMENT TO HAVE A FUNCTIONAL HOME-OFFICE SETUP – INCLUDING NOT JUST OFFICE EQUIPMENT BUT A SUITABLE WORKSPACE?”

One way to start would be to enshrine in all our expectations, and perhaps even in law, the concept that the employer is responsible for providing the necessary space and equipment employees need to do their job adequately. In all likelihood, this means centralised office space: if you want to ask your boss to buy you and your colleagues bigger houses so you can fit in home offices by all means do so – and please let me know how it goes.

Such rules could be overridden on a temporary basis in the event that offices become unusable. A state of emergency brought on by a pandemic would be a perfect example of a time during which it would be acceptable for employers to require – temporary – flexibility.

But the reality is we seem to be moving from an assumption that employers cover the cost of the workspace to a place where this may no longer be the case. We should at least discuss the consequences before the cost defaults to people who are less able to bear it. •

KangaNews Market People of the Year 2019

The KangaNews Market People of the Year are the individuals who voters in the KangaNews Awards 2019 believe went above and beyond their roles to contribute to the development of the Australian and New Zealand debt markets. There are no restrictions on the firms, positions or seniority of winners – voters are simply asked to consider who contributed most to the market in either or both 2019 specifically or across the span of a career.

KangaNews is pleased to reveal the seven Market People of the Year for 2019 and to offer its congratulations to the winners.

ANDREW KENNEDY
SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY

The process of base-rate migration is a major focus in global markets, and one of Australia's breakthrough transactions of 2019 was SAFA's AONIA-linked print. Andrew Kennedy has been the leading advocate of engagement with the topic in the Australian market, and he is recognised for his commitment to forging new ground on behalf of SAFA and for the benefit of the wider market. Voters note in particular Kennedy's willingness to engage with market participants over an extended period to develop critical mass for product evolution.

MICHAEL MOMDJIAN
SYDNEY AIRPORT

The Australian capital market and corporate Australia more generally might be described as 'fast followers' in the ESG space. Sydney Airport has been the exception for its willingness to take not just a national but a global lead, and Michael Momdjian has been behind much of this leadership in the funding space. The airport's most notable step in 2019 was completing Australia's first-ever syndicated sustainability performance-linked loan, but Momdjian's role goes beyond transactions as a high-profile, engaging advocate for sustainable finance in the corporate sector.

ROSS PENNINGTON
CHAPMAN TRIPP

There can hardly be a significant development in the New Zealand capital market that Ross Pennington has not had some hand in developing or refining. From the Kauri market and bank capital to sustainable finance and securitisation, Pennington is arguably New Zealand's most prominent market thinker and a leading advocate with government and regulators. The words of one awards voter say it best: "No-one has given more of their discretionary, unpaid time to the betterment of the capital markets than Ross Pennington. Along with his time comes incredible experience, invaluable insights and sizeable intellect. He's so passionate about getting the right settings and selflessly pursues them."

KAREN SILK
WESTPAC NEW ZEALAND

Karen Silk has not just overseen the renaissance of Westpac's New Zealand debt market business but is also a leading voice in the development of a national sustainable-finance market in her role as co-chair of the New Zealand Sustainable Finance Forum (NZSFF). In October 2019, the publication of the NZSFF's interim report demonstrated the breadth of thinking behind the project, which seeks to achieve no less than full market incorporation of negative externalities across issues as diverse as climate, biodiversity and labour practices. New Zealand can become a world leader in this space and Silk is at the head of the charge.

BIANCA SPATA
FLEXIGROUP

In recent years, flexigroup has built a presence in the Australasian securitisation market that belies its scale as an issuer – including clear leadership as an issuer of green asset-backed securities (ABS) notes. KangaNews Awards voters recognise Bianca Spata for steering flexigroup to this position of prominence, which in 2019 included issuing Australia's first ABS deal to feature certified green notes right down the capital structure and printing record volume of securitisation in New Zealand. Spata is also a keen industry advocate including through the Australian Securitisation Forum's Women in Securitisation and New Zealand subcommittees.

KATHARINE TAPLEY
ANZ

Katharine Tapley is a trailblazer in the Australian sustainable-finance market, acclaimed by one KangaNews Awards voter as "a clear market leader in all things sustainability and sustainable finance [whose] stewardship and knowledge in this area have been instrumental in promoting and cultivating sustainable finance across Australia and New Zealand". Whenever a new or innovative transaction emerges in Australasian sustainable finance, there is a good chance that ANZ has been involved – and that Tapley was a driving force behind it.

MARAYKA WARD
QIC

Pushing the cause of sustainable finance will require ongoing engagement from the buy side, with investors in the box seat when it comes to using capital to promote superior ESG outcomes. Marayka Ward is one of the Australian investment sector's leaders – domestically and in global forums. Interesting, engaging and generous with her time and insights, the fixed-income investor community could not ask for a better champion when it comes to describing and delivering its sustainability drivers and a detailed account of what is possible in the context of fiduciary responsibilities.

KANGANEWS AWARDS 2019

GBP SBP update pushes sustainable-debt frontier

The Green and Social Bond Principles (GBP SBP) is further broadening the scope of its focus on sustainability in fixed-income markets, via a June update to the social-bond principles (SBP) (see p50) and the launch of sustainability-linked-bond principles (SLBP).

BY MATT ZAUNMAYR

The update to the SBP comes two years after the initial principles were released and amid the COVID-19 pandemic, which has brought renewed focus to the potential use of social bonds in addressing health, education, employment and other outcomes with social benefit (see p47).

The new SLBP are designed to provide the impetus for more entities to consider sustainable financing options, while the update to the SBP is particularly relevant in the context of addressing the COVID-19 crisis.

The launch of the SLBPs is a significant development for the GBP SBP, which is moving for the first time to provide guiding principles to bond instruments without specific use of proceeds (UOP). Instead of identifying specific assets, an SLB requires a holistic assessment of an issuer's overall sustainability credentials and its plans to improve them over time. Such instruments have already been used by a few borrowers, including Sydney Airport, but the hope is that they will prove useful to a much broader range of issuers than UOP instruments.

Tanguy Claquin, member of the GBP executive committee and head of sustainable banking at Crédit Agricole in Paris, says: "One of the key messages here is that the GBP SBP as a forum is asserting itself as the backbone of all sustainable fixed-income markets, looking at all instruments that are dealing with sustainability in fixed-income markets – beyond UOP bonds."

SUSTAINABILITY FRONTIER

The key differentiators of an SLB are its forward-looking character and the focus on an issuer's sustainability strategy as a whole.

The new SLBP define an SLB as any type of bond instrument for which the financial or structural characteristics can vary depending on whether the issuer achieves sustainability or ESG objectives. In this sense, SLBs are a forward-looking, performance-based instrument, with issuers committing explicitly to future improvements in sustainability outcomes within a pre-defined timeline.

Market users say the launch of the SLBP – which are voluntary process guidelines that outline best practices – is an acknowledgement by the GBP SBP of where the vanguard of sustainability finance in debt markets has moved to. SLBs were inspired by the sustainability-linked loan (SLL) product, which incentivises borrowers to meet environmental, social and governance (ESG) targets without having to identify specific UOP for the funding.

This opens sustainability-linked funding to any borrower that can prove it has legitimate plans to meet ESG targets, rather than just those that have sufficient and appropriate capex for a UOP green, social and sustainability (GSS) bond or loan deal.

SLLs have proven immensely popular with corporates and have grown rapidly in the last two years. Issuance of SLBs has been scant so far, with just a couple of deals executed in late 2019 and early 2020. But interest in the product is great. Acknowledging this, GBP SBP set up a taskforce in October 2019, which was converted to a working group in January 2020.

The working group comprised more than 40 organisations and several hundred people. Marilyn Ceci, member of the GBP executive committee and head of green bonds at J.P. Morgan in New York, says a key question to address was why the SLBP are important and how they can further enhance the development and growth of SLBs.

"For issuers that have enough capex to issue UOP instruments, SLBs will present an opportunity to broaden and complement existing UOP instruments. GSS bonds are instruments that commit capital to specific projects, while with SLBs the idea is to commit to a particular outcome."

MARILYN CECI J.P. MORGAN

She comments: "The green-bond product, which has been very successful to date, has left out a certain segment of the market. For issuers that have enough capex to issue UOP instruments, SLBs will present an opportunity to broaden and complement existing UOP instruments. GSS bonds are instruments that commit capital to specific projects, while with SLBs the idea is to commit to a particular outcome. This is quite different."

Lars Eibeholm, chair of the GBP SBP executive committee and head of treasury and sustainability at Nordic Investment Bank in Helsinki at the time of the announcements, adds that issuers of SLBs should not see the lack of specific UOP as meaning the targets for the new product will be easy to meet. "The requirements for issuing an SLB are there to ensure integrity is maintained and issuers remain transparent. This is exactly what these principles are trying to achieve – to make sure issuers are not taking a shortcut."

The SLBP have been drafted with five core principles, designed to ensure the ambition and integrity of the product. These are the selection of KPIs, calibration of sustainability performance targets (SPTs) to assess the KPIs, bond characteristics, reporting and verification. KPIs need to be relevant, core and material to the issuer's overall business, measurable or quantifiable, externally verifiable and able to be benchmarked as much as possible using an external reference.

With regard to calibration of SPTs, Orith Azoulay, member of the GBP SBP executive committee and global head of green and sustainable finance at Natixis in Paris, says this is a mixture of recommendations around "what ambitious means" for a target, and how targets should be disclosed to investors.

She explains that the working group tried to incorporate a lot of comments from its members to set a framework around the targets, which need to present a material improvement beyond business as usual for the issuer on each KPI. "Where possible, it needs to be compared to a benchmark or external reference, will have to be consistent with the overall ESG strategy of the issuer and will need to be determined on a predefined timeline set before or concurrently with issuance of the bond," Azoulay adds.

Pre- and post-issuance reporting is expected. Azoulay continues: "This involves transparency toward investors on a regular basis – at least annually – on where the issuer stands on its various KPIs and of course the verification-assurance report relative to the targets. It encompasses any information that will enable investors to monitor the level of ambition of the SPTs."

To help issuers, a transparency and disclosure checklist is integrated into the principles.

Verification encompasses the required independent and external review of an issuer's performance against each target and KPI by a qualified external body – which needs to be made publicly available.

Azoulay comments: "This is considered a necessary element of the SLBP. Pre-issuance external review – what we usually call a second-party opinion – hasn't been considered as necessary but it is recommended to address compliance with the five core principles as well as the level of ambition of the targets."

The bond characteristics component refers to the financial or structural characteristics of an SLB, which GBP SBP says should vary depending on whether or not the KPIs reach the SPTs. The variation must be commensurate and meaningful relative to the issuer's original bond financial characteristics, according to Azoulay. She describes this as "a cornerstone of this instrument". The most common example of such a variation is the coupon, which could increase if targets are missed or decrease if they are achieved.

TRANSITION TOOLS

SLBs are intended to be a financing tool borrowers and investors can use to incentivise transition to a more sustainable economy. GBP SBP set up the SLB working group alongside the climate transition finance (CTF) working group, which is looking more broadly at transition finance tools such as transition bonds. Transition bonds are a UOP instrument, more like a green or social bond in character than an SLB.

The establishment of SLBP ahead of transition-bond principles should not be inferred as a bias from SBP GBP towards SLBs for the future trajectory of the market, though. According to Azoulay, the SLBP will be complementary to the work of the CTF working group.

The CTF working group's remit was much wider than that of the SLB working group. Its aim, first and foremost, is to address the definition of transition and the types of financing that could be called transition, rather than to come up with principles, Azoulay says.

She adds: "SLBP will be useful food for thought for CTF work. The next step on our end is to work closely with the CTF working group to see how the SLBPs can help envision one of the ways a transition can be funded." •

"The requirements for issuing an SLB are there to ensure integrity is maintained and issuers remain transparent. This is exactly what these principles are trying to achieve – to make sure issuers are not taking a shortcut."

LARS EIBEHOLM GBP SBP EXCOM

Global FIs step into Australia's big-four bank supply void

The Australian dollar market hit a sweet spot for global financial-institution (FI) borrowers in the second half of May despite the ongoing absence of the biggest local issuers. Intermediaries say the supply gap has caused a technical pricing squeeze that attracts issuers, while offshore FI pricing remains attractive for real-money investors relative to local names.

BY MATT ZAUNMAYR

The Australian FI market has steadily returned from the COVID-19 crisis and issuance has progressed down the capital structure since April. A clutch of Canadian banks reopened the market with covered-bond deals. Suncorp and Bank of Queensland followed with their own covered bonds (see p12).

More recently, benchmark senior-unsecured issuance has returned. The second half of May saw a consistent flow of deals from international bank borrowers either through local entities or in Kangaroo format (see table).

Adam Gaydon, Sydney-based head of syndicate at ANZ in Sydney, tells *KangaNews* a Macquarie Bank tier-two transaction on 21 May was the final piece of the puzzle for Australian FI market recovery, as it demonstrates institutional-investor willingness to engage across the capital spectrum.

"It has been important that every primary deal that has come since the market was reopened in April has performed in the secondary market. This has given investors confidence and there are now very few accounts that have yet to re-engage with primary issuance," Gaydon explains.

PRICING DYNAMICS

The Australian dollar FI market has been reshaped by the COVID-19 crisis – in particular in pricing dynamics. Traditionally, issuance has been dominated by major-bank supply which offered other FIs – whether local and global – a clear and consistent benchmark for pricing when coming to market.

Substantial prefunding at the start of calendar 2020 and increased deposit flows since the COVID-19 crisis began has effectively nullified the major banks' call on wholesale debt capital markets. Whatever funding gap remains for the major banks can be filled using the Reserve Bank of Australia's low-rate term-funding facility (TFF), though even this had not been called on for substantial volume by the end of H1.

In fact, the TFF does not appear to have been a major drain on the Australian dollar market's FI supply. By 27 May only A$5.8 billion (US$4 billion) had been drawn from the facility since it became operational in late March.

Market participants still expect the major banks will remain absent for the time being, though. As a result, major-bank senior-unsecured bonds have rallied in the secondary market since April. Offshore FI names have tightened relative to major-bank spreads in turn, in response to the lack of supply.

Apoorva Tandon, head of Asia syndicate at TD Securities in Singapore, says this has made pricing in Australia attractive for issuers relative to offshore markets. At the same time, some international credits now offer investors a much larger spread pickup to the major banks than was the case before the crisis.

Josh Sife, Sydney-based director, capital markets origination at National Australia Bank, says the UBS Australia and Credit

AUSTRALIAN DOLLAR DEALS BY INTERNATIONAL BANKS, 12 MAY – 26 JUNE 2020

PRICING DATE	ISSUER	FORMAT	TENOR (YEARS)	VOLUME (A$M)	MARGIN	LEAD MANAGERS
12 May 20	UBS Australia Branch	Senior unsecured	2.5	1,500	105bp/BBSW	ANZ, CBA, NAB, UBS, Westpac
19 May 20	Credit Suisse Sydney Branch	Senior unsecured	3	1,750	115bp/BBSW	ANZ, CBA, CS, NAB, TD, Westpac
26 May 20	Groupe BPCE	Senior preferred	5	650	160bp/swap	NAB, Natixis, Nomura, TD
27 May 20	BNP Paribas	Senior nonpreferred	5	250	210bp/swap	BNPP, CBA, NAB, Westpac
2 Jun 20	Sumitomo Mitsui Banking Corporation Sydney Branch	Senior unsecured	3 & 5	2,400	95bp/BBSW & 115bp/swap & BBSW	CBA, Macquarie, SMBC, TD, Westpac
3 Jun 20	Canadian Imperial Bank of Commerce	Senior unsecured	3	800	135bp/swap & BBSW	ANZ, CIBC, NAB, Nomura

SOURCE: KANGANEWS 29 JUNE 2020

Suisse Sydney deals, like the Canadian bank covered bonds in April, launched with pricing in line with global markets. But he adds: "The senior-unsecured deals were able to generate strong demand through the bookbuild and were able to eventually price well inside these levels, both achieving a 15 basis points price tightening from launch."

LIQUIDITY RETURNS

The first phase of FI issuance, which focused on Canadian bank covered-bond deals, was driven by demand from bank balance sheets. Measures taken by the RBA, such as its government bond purchasing programme and expansion in repo operations, have created a huge amount of liquidity for repo-eligible securities, says Sife.

The buying base for FI deals broadened as the market moved through May, however, and the majority of all transactions was taken by investors outside the bank sector (see chart 1).

In early May, the RBA expanded its repo-eligibility criteria to include investment-grade corporate bonds (see p19). Tandon says this could provide a further demand tailwind for offshore FIs that are not Australian authorised deposit-taking institutions (ADIs) as the new repo criteria could include such names under a corporate designation.

Demand from investors in Australia and Asia has been robust for the recent FI transactions (see chart 2). According to Tandon, Australian dollar liquidity has built up among the Asian investor base, driving some demand for the recent transactions.

Australian dollar FI supply is still well down on previous years – but not to the extent that may have been expected with the absence of major-bank supply (see chart 3). Meanwhile, KangaNews data show there was A$10.9 billion of Australian FI maturities between 20 March and 31 May.

The global banks that have issued through their local branches, UBS and Credit Suisse, are eligible to draw from the TFF through those branches. However, ADIs are only able to draw 3 per cent of the volume of their loans outstanding at 31 January 2020 through the facility.

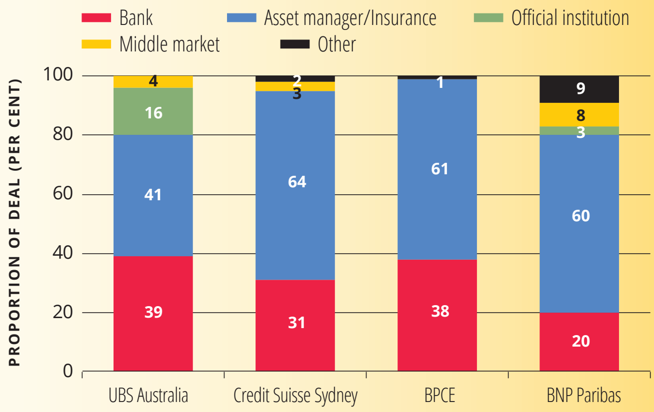
According to Australian Prudential Regulation Authority (APRA)'s monthly ADI statistics for April 2020, Credit Suisse has A$4.7 billion of outstanding loans and finance leases to Australian residents while UBS has A$5.5 billion. This would allow A$141 million and A$165 million of funding through the TFF.

APRA statistics show other banks that frequently fund through Australian branches, such as Bank of China, Bank of Communications, Royal Bank of Canada and others would have access to similar volume or less, when their Australian dollar debt capital-markets funding volumes are typically much higher.

The utility of the TFF for these banks is therefore likely limited. By comparison, Commonwealth Bank of Australia could access A$20 billion of funding through the TFF if it needed to, according to APRA.

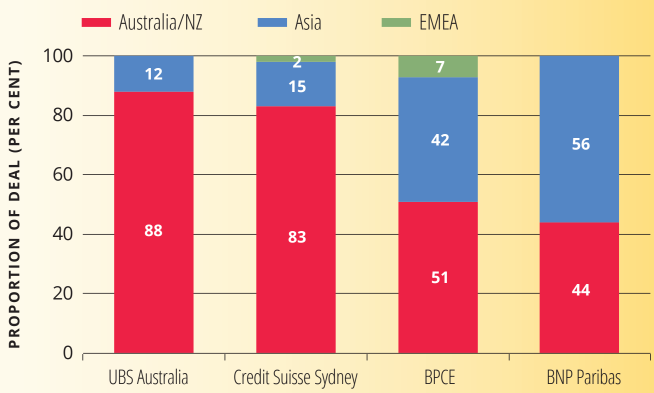
Sife adds that liquidity conditions have been so strong in recent months that most banks have not started drawing on their TFF allowance. "The fact that most issuers are holding off drawing down on three-year funding at 0.25 per cent is an indication of how well funded the local bank sector currently is. This dynamic is creating opportunities for global FI borrowers to step in and fill the void." •

CHART 1. AUSTRALIAN DOLLAR BANK DEALS DISTRIBUTION BY INVESTOR TYPE



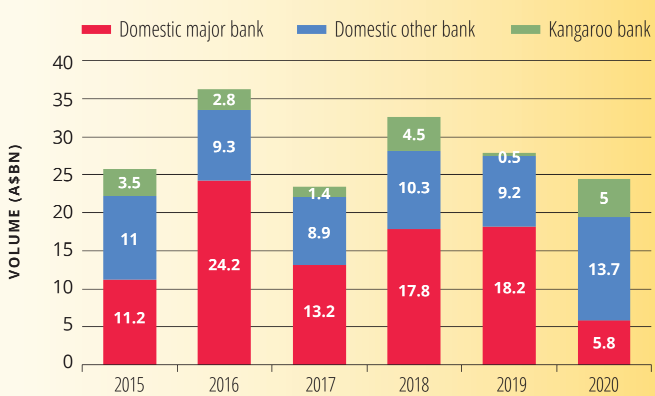
SOURCE: KANGANEWS 1 JUNE 2020

CHART 2. AUSTRALIAN DOLLAR BANK DEALS GEOGRAPHIC DISTRIBUTION



SOURCE: KANGANEWS 1 JUNE 2020

CHART 3. AUSTRALIAN DOLLAR BANK DEAL SUPPLY 1 JAN – 31 MAY



SOURCE: KANGANEWS 1 JUNE 2020

DECODING GSS IN AUSTRALIAN FIXED INCOME

In May, **Commonwealth Bank of Australia** (CommBank) and *KangaNews* undertook a ground-breaking research project to learn more about Australian fixed-income investors' green, social and sustainability (GSS) strategies. The results of the Fixed-Income Investor GSS Survey shine the spotlight on a market that has evolved significantly but remains a work in progress.

BY HELEN CRAIG AND LAURENCE DAVISON

More than 40 investment firms completed the survey. All are Australian-based fixed-income investors, representing the full swathe of the institutional market from boutique funds to the local operations of global investment behemoths (see chart 1).

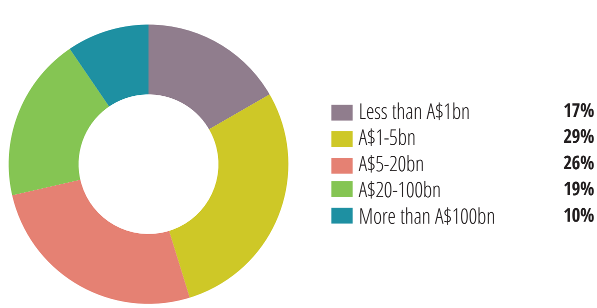
This is more than a representative sample: *KangaNews* is confident the bulk of Australian domestic fixed-income real money is represented in the survey.

Unlike many environmental, social and governance (ESG) surveys, the CommBank-*KangaNews* project does not focus on specialist investors. The Australian investor base includes ESG focused funds but the survey's aim is to incorporate these with views from mainstream fixed-income managers.

More than 90 per cent of survey respondents say their firms manage less than 5 per cent of their fixed-income assets under specific ESG mandates. On the other hand, more than 70 per cent of respondents indicate they apply an ESG overlay to more than 10 per cent of assets under management and more than 40 per cent have this approach across all their funds (see chart 2).

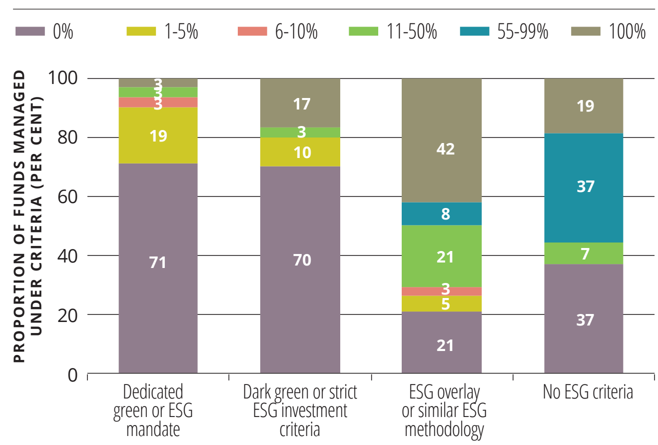
Despite representing the views of mainstream institutional investors, the survey suggests the Australian buy side is deploying a wide range of ESG practices. Negative screen remains the most widely used – nearly 90 per cent of survey respondents indicate

CHART 1. TOTAL FIXED INCOME ASSETS UNDER MANAGEMENT, COMBINING RATES AND CREDIT



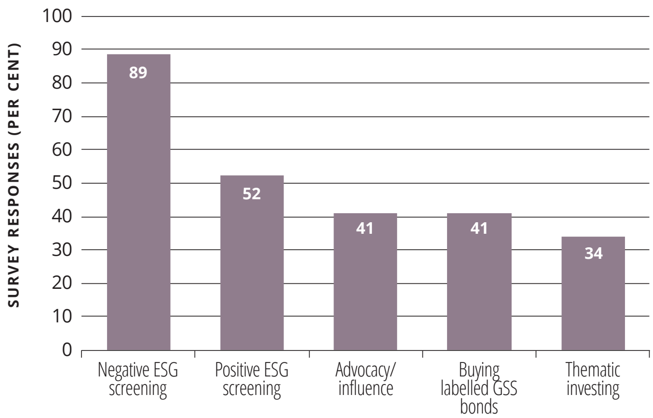
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 2. PROPORTION OF FIXED-INCOME FUNDS MANAGED ACCORDING TO ESG CRITERIA



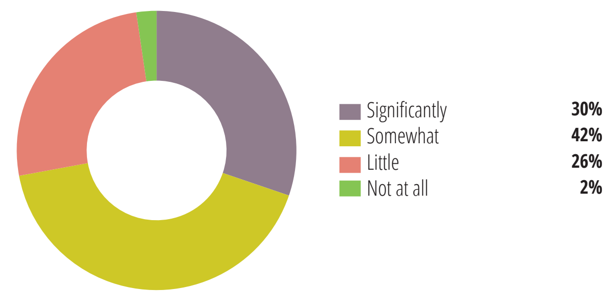
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 3. WHICH APPROACHES DOES YOUR FUND USE WHEN APPLYING ESG TO INVESTMENT STRATEGY?



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 4. EXTENT TO WHICH ESG FACTORS (EXCLUDING NEGATIVE SCREENING) INFLUENCE INVESTMENT DECISIONS



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

they use this approach – but there is also significant takeup of positive screening, advocacy and influence, participation in labelled GSS bond deals and thematic investing (see chart 3).

Investors also insist they do more than pay lip service to ESG factors. Nearly three-quarters of survey respondents say they play a "significant" or "somewhat" of a role in the investment process. Most individual ESG practices influence fund managers' pricing decisions or produce outright red or green lights to buy (see charts 4 and 5).

The techniques most likely to produce a pricing output are positive screening and thematic investing: 40 per cent or more of investors say these approaches result in preferential or punitive pricing. It is harder to judge the precise impact of ESG approaches on pricing, however: the survey does not show how widely specific practices are deployed across an investor firm's portfolios or suggest the proportion of aggregate funds that use each technique.

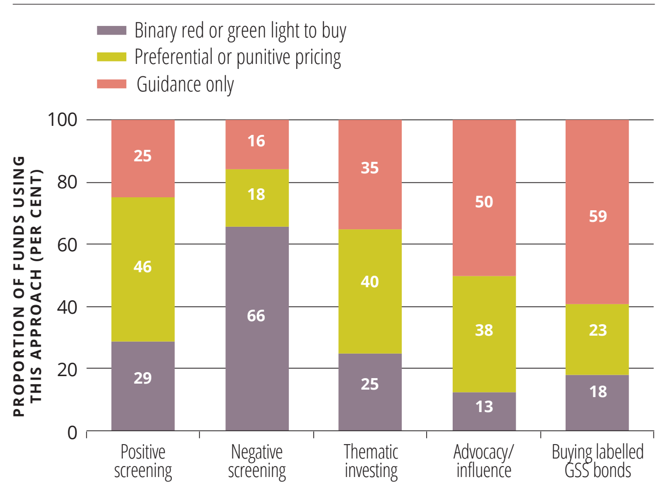
While the majority of survey responses indicate an unwillingness to pay a premium for GSS bonds, there are signs that a growing number is becoming willing to do so – at least at the margin.

At times, Australian market participants have suggested GSS bonds perform better in the secondary market and they may also print at tighter levels in the euro market in particular. Roughly 40 per cent of Australian fixed-income investors say they would contemplate paying some premium for labelled issuance, though 90 per cent would not offer a discount of more than 5 basis points (see chart 6).

Interrogating the data more deeply sounds another relatively positive note. While the subset of funds willing to pay a really significant premium for GSS bonds tends to comprise ESG specialists or boutique operations, the 29 per cent of funds willing to pay a 1-5 basis point increment are overwhelmingly large, mainstream asset managers.

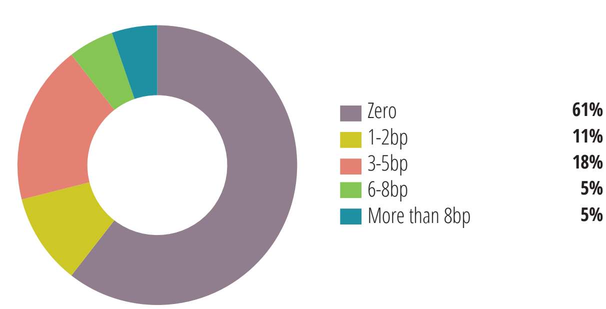
Seeking preferential pricing does not appear to have been a major motivating factor for issuers of GSS bonds in Australia so far, though. Anecdotally, most if not all issuers say their reasons

CHART 5. OUTPUT OF ESG SCREENING TYPES



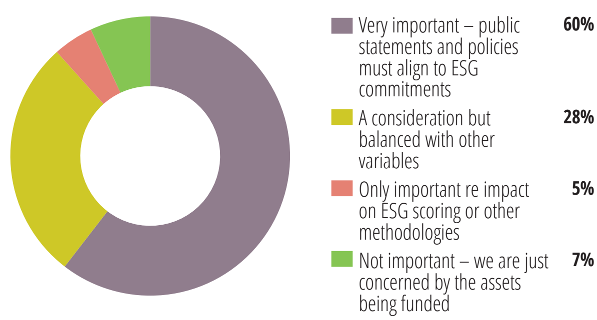
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 6. WHAT INCREMENTAL PRICING PREMIUM WOULD YOU BE PREPARED TO PAY, IF REQUIRED, FOR A GSS BOND RELATIVE TO AN IDENTICAL BUT UNLABELLED BOND FROM THE SAME ISSUER?



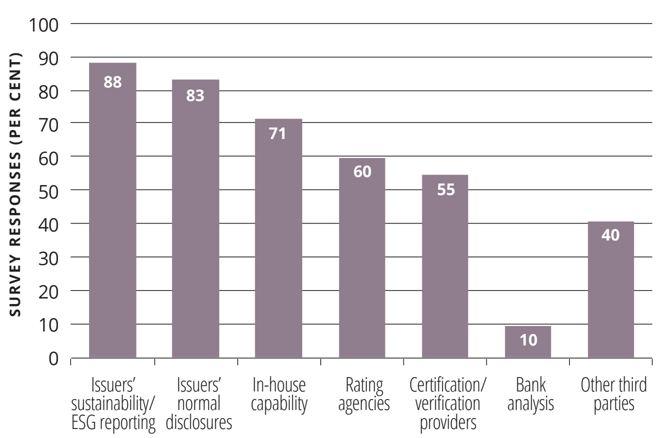
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 7. HOW IMPORTANT IS AN ISSUER'S OVERALL APPROACH TO ESG IE 'WALKING THE TALK'?



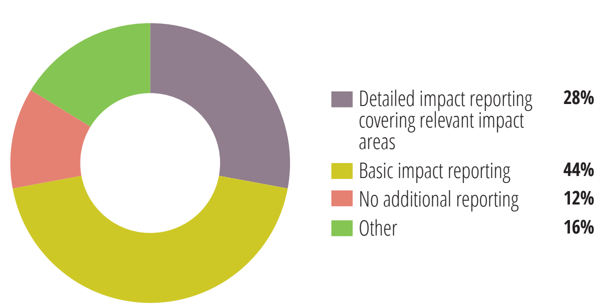
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 8. SOURCE OF INFORMATION AND DATA FOR ESG ANALYSIS



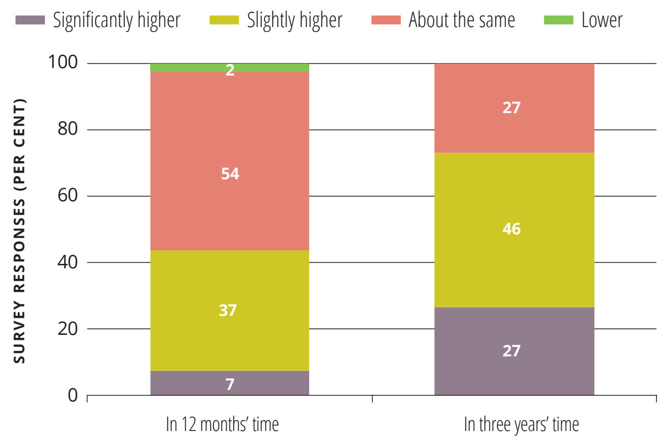
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 9. WHAT LEVEL OF ESG AND OTHER GSS INVESTMENT SCREENING REQUIREMENTS DO YOU HAVE?



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 10. PROJECTED CHANGE IN DEMAND FOR GSS PRODUCT



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

for coming to market with labelled issuance are not primarily economic and only one transaction has demonstrated a superior pricing outcome for green notes. Other issuers believe they have reduced the new-issue premium by using GSS format, though.

It has been suggested that labelled GSS issuance should be regarded as an interim step, bringing ESG to the forefront but eventually being superseded by a broader deployment of tools and practices by issuers and investors. Taken together, the survey data suggest the Australian fixed-income buy side is moving towards a broader application of ESG principles. Investors certainly report that they expect issuers to demonstrate a genuine commitment to their own ESG strategies (see chart 7).

Investors are also asking for a wide range of information to support their ESG analysis: more than half of those surveyed use all of issuers' sustainability reporting and normal disclosures, their own in-house capabilities, rating agencies, and third-party certification and verification providers to inform their ESG analysis (see chart 8).

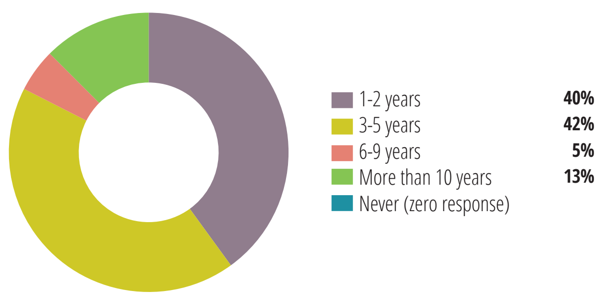
On the other hand, only 28 per cent of investors demand "detailed impact reporting covering relevant impact areas" – the majority requiring only basic impact reporting or no additional reporting at all (see chart 9).

LOOKING FORWARD

Australian investors clearly believe ESG is here to stay in the debt market. Despite the suggestion that differential pricing may be hard to come by, none expect labelled GSS issuance to be a flash in the pan. A healthy majority expect demand to grow over the next three years (see chart 10). The nearer-term outlook is somewhat less positive, however – and pricing may be critical here.

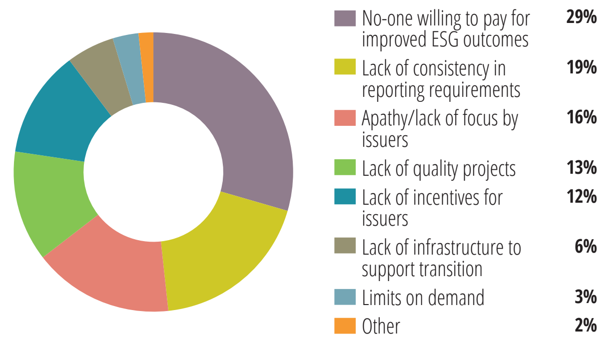
The key issue may be time, in the sense that price-based preference for good ESG performance will still take a number of years to assert itself. This perhaps chimes with the idea that the market is already moving towards a broader – and hence likely more complex – understanding of ESG risk on an entity level.

CHART 11. HOW LONG WILL IT TAKE BEFORE POOR ESG PERFORMERS STRUGGLE TO ACCESS CAPITAL WITHOUT PAYING A MATERIAL PREMIUM?



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 12. MOST SIGNIFICANT BARRIERS TO GROWTH IN THE GSS MARKET (WEIGHTED AVERAGE OF RESPONSES)



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

Only 40 per cent of survey respondents believe borrowers with poor ESG performance will need to pay a material premium to access capital in the next two years, though more than 80 per cent believe such a premium will emerge in the next five years (see chart 11). Meanwhile, "no-one willing to pay for improved ESG outcomes" is the most frequently named barrier to the growth of the ESG market (see chart 12).

One solution might be two-way pricing on debt instruments that measure issuers' ESG performance. Such securities are in their infancy, but Sydney Airport became a global leader by printing a sustainability performance-linked bond in the US private placement market at the start of 2020. More than half the respondents to the CommBank-*KangaNews* survey indicate they would at least consider purchasing this type of bond, and mandate change could take that number to 80 per cent (see chart 13).

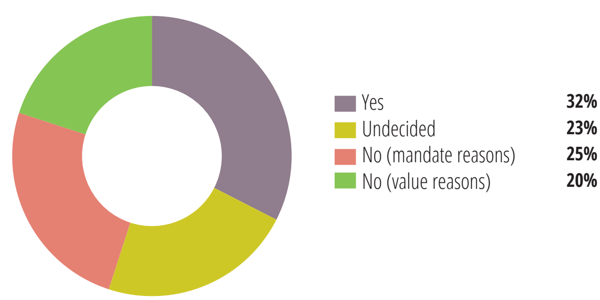
Importantly, those investors that would contemplate buying sustainability performance-linked product with two-way pricing incentives suggest they would consider offering a solid discount for positive ESG outcomes. Unlike standard GSS bonds, the survey suggests more than half of Australian investors would consider a pricing discount of 5 basis points or more for this type of security (see chart 14).

Investors are also generally willing to explore options for transition finance. While just 16 per cent of survey respondents say they are "very keen" to support brown-to-green transition instruments, a further 53 per cent say they would at least consider such issuance subject to credit and sector criteria (see chart 15).

In this case, virtually all Australia's largest fixed-income fund managers say they are at least "open" to supporting transition finance, should issuers meet other ESG criteria. Perhaps surprisingly, most of the investors saying they are "very keen" to see this type of issuance are also large, mainstream asset managers. In fact, specialist ESG managers are more likely to be restricted to asset-level allocations.

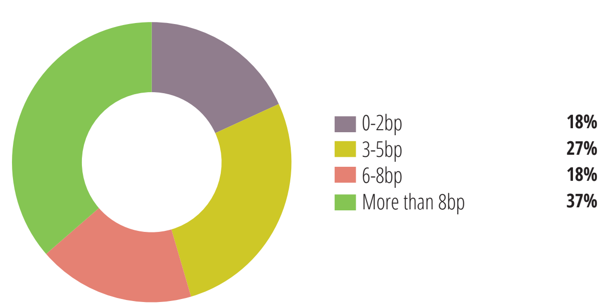
However, transition-based products do not feature heavily on the list of investors' most preferred ESG approaches for

CHART 13. WOULD YOU BE PREPARED TO BUY A BOND OR LOAN PRODUCT WITH A TWO-WAY MARGIN ADJUSTMENT IF AMBITIOUS ENVIRONMENTAL OR SOCIAL TARGETS ARE MET AND IT ALIGNED WITH YOUR INVESTMENT STRATEGIES AND ESG PRIORITIES?



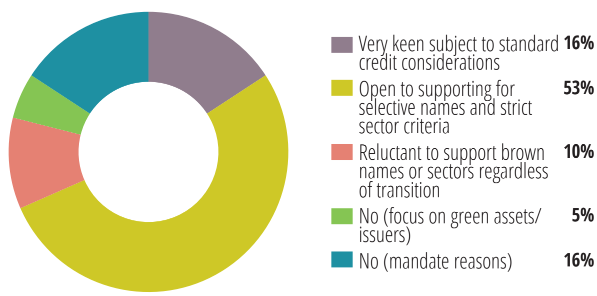
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 14. IF YES [SEE CHART 13], WHAT DISCOUNT WOULD YOU BE PREPARED TO ACCEPT?



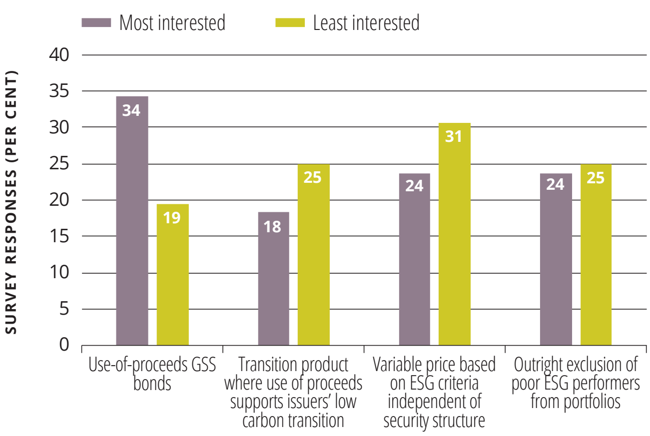
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 15. WILLINGNESS TO BUY BONDS FINANCING AN ISSUER'S TRANSITION TO GREEN FROM BROWN



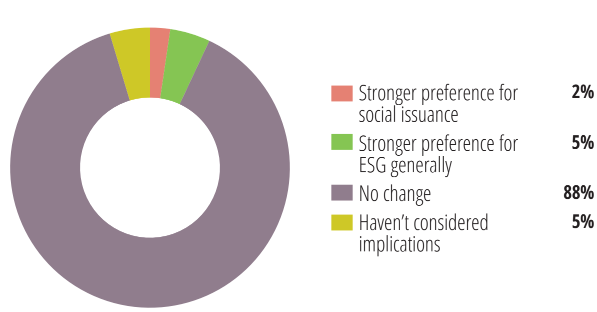
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 16. INTEREST IN FURTHER DEVELOPMENT OF ESG INVESTMENT APPROACHES



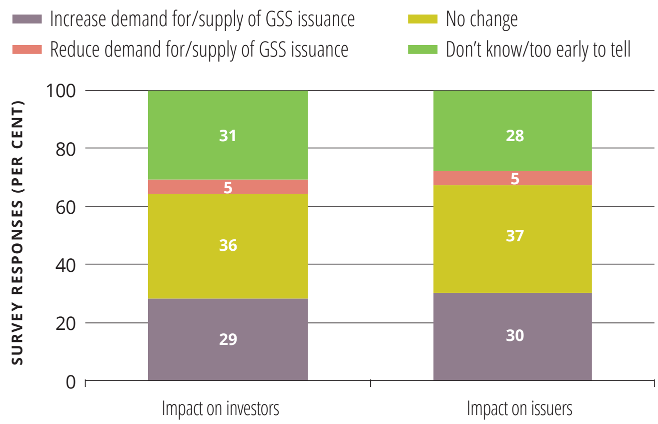
SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 17. HOW HAS COVID-19 CHANGED YOUR INVESTMENT APPROACH WITH RESPECT TO GSS SECURITIES?



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

CHART 18. WHAT IMPACT DO YOU THINK COVID-19 WILL HAVE ON THE OVERALL GSS MARKET?



SOURCE: COMMONWEALTH BANK OF AUSTRALIA, KANGANEWS JUNE 2020*

further development. Fewer than 20 per cent name these as such, compared with the 30 per cent-plus that name use-of-proceeds GSS bonds as their area of most interest for further development (see chart 16). Meanwhile, 31 per cent of investors say instruments with variable price based on ESG performance are the area of ESG debt in which they are least interested in seeing development.

One area where the Australian investor base is clearly still working through the likely impact on capital-market practices and investment approach is the COVID-19 pandemic and its economic consequences. Global commentary has focused on the pandemic as a potential catalyst to expand social finance in particular (see p50) – but the vast majority of Australian fixed-income investors say COVID-19 has not changed their investment strategy or that they have yet to consider its implications (see chart 17).

The timing of the survey may mean investors have yet to work their way through the implications of COVID-19 in full. The optimistic argument says the pandemic could make capital markets think about social issues in the same way as they have started to do about the climate crisis while simultaneously providing a real-world demonstration of what not taking sufficient climate action could mean for economies and markets.

On the other hand, even market leaders in the social-bond space say it carries complexities that have yet to be worked through in full. It should perhaps not be surprising to find that Australian fixed-income investors were not, as of May 2020, ready to draw conclusions about the impact of COVID-19 on their investment practices.

A reasonable number – around 30 per cent – of fund managers believe that COVID-19 will spark greater interest in GSS instruments on the part of issuers and investors (see chart 18). Hardly any expect the crisis will prove an impediment to further evolution of the market. •

* All chart data compiled by *KangaNews* June 2020.

FIXED-INCOME INVESTORS **TACKLE GSS** IN DEPTH

Immediately after completing their Fixed-Income Investor GSS Survey (see p34), **Commonwealth Bank of Australia** (CommBank) and *KangaNews* convened a panel of leading Australian fixed-income investors to discuss and add colour to the survey findings. Investors explain why they think as they do on green, social and sustainability (GSS) issues and share views on how the space may evolve in future.

PARTICIPANTS

■ **George Bishay** Portfolio Manager PENDAL GROUP ■ **Lillian Nunez** Executive Director, Debt Investments IFM INVESTORS
■ **Mark Peacock** Head of Sustainable Finance COMMONWEALTH BANK OF AUSTRALIA ■ **James Pearson** Head of Impact and Responsible Investments QBE INSURANCE ■ **Michael Swan** Senior Portfolio Manager, Fixed Interest and Cash CBUS SUPER ■ **Marayka Ward** Senior Credit and ESG Manager QIC
■ **Terry Yuan** Credit Analyst, Fixed Income ANTARES CAPITAL

MODERATOR

■ **Helen Craig** Head of Operations KANGANEWS

ADVOCACY AND ENGAGEMENT

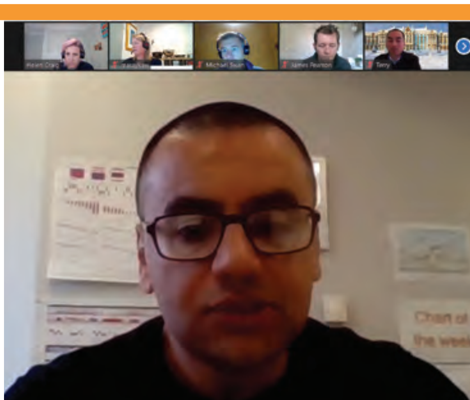
Craig There has been a shift away from negative screening, particularly in Europe, where even fixed-income investors are pushing more for the advocacy and engagement approach. Do fixed-income investors in Australia see value in this approach?

■ **BISHAY** Engagement is incredibly important for us. You have less say if you sell out of a name. Not only do companies need to know where we have concerns as fixed-income investors, but also we work very closely with our equities teams – which clearly have greater influence as company 'owners'. This two-pronged approach is far more effective than simply selling out.

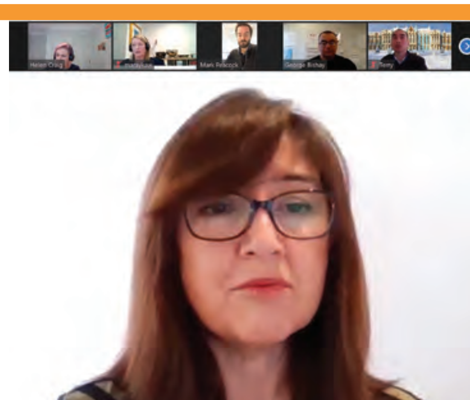
■ **WARD** We don't have the benefit of an in-house equity team so we carry out a lot of engagement directly. Companies want to understand what investors are looking for, though – so we get a lot of benefit from engagement.

We might sit out of transactions if a company fails to meet a target it had previously committed to. When an investor sells out of a company because of ESG [environmental, social and governance] concerns it is important to tell the issuer when and why that is happening. This is where we as investors have the power to start changing corporate behaviour.

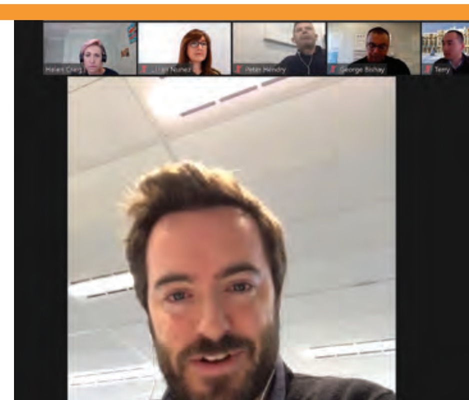
■ **NUNEZ** As fixed-income investors, we have less influence over a company than equity investors. We don't always have access to company management, for example. Rather than starting the ESG engagement process as we are about to exit a transaction,



GEORGE BISHAY PENDAL GROUP



LILLIAN NUNEZ IFM INVESTORS



MARK PEACOCK COMMONWEALTH BANK OF AUSTRALIA

> "We would like to see an improvement in reporting of quantitative data to be able to take this through to our client reporting. As such, we're starting to get comfortable with the concept of contributing in some way to helping to fund transition."
>
> **MARAYKA WARD** QIC

we prefer to get involved up front. We feel this is the debt investor's opportunity for influence.

If it transpires that the company doesn't perform to ESG expectations this is a different story and one that can be addressed on exit. When coming in, we take the opportunity to ask detailed questions in the screening process. In the due-diligence phase we ask about reporting, management behaviour, employee treatment and other policies.

In some situations, we may ask for independent reporting. This information is not always easy to come by so we may ask issuers to provide a quarterly report on various ESG aspects we monitor, such as changes in employment practices. If we see aspects weakening we ask for an explanation. I acknowledge that this is not always easy though, particularly in the public bond space.

Peacock Does this approach change for repeat issuers?

NUNEZ Yes. But if they behave badly we still let them know.

SWAN At Cbus Super we take an advocacy and whole-of-portfolio approach. It is important to engage with the maximum amount of information and people, and doing so makes one think quite differently.

Craig Do issuers appreciate the importance investors place on the engagement factor?

PEACOCK I think so. There is certainly a heightened awareness of ESG and what an issuer is doing at the corporate level across the board. Where issuers see things less clearly is the value or benefit of looking at certifying assets or undergoing a labelling process.

This clearly needs to be something issuers do that is complementary to their actions at a corporate level. But the issuance-level consideration versus the larger corporate-credit perspective is an interesting dynamic.

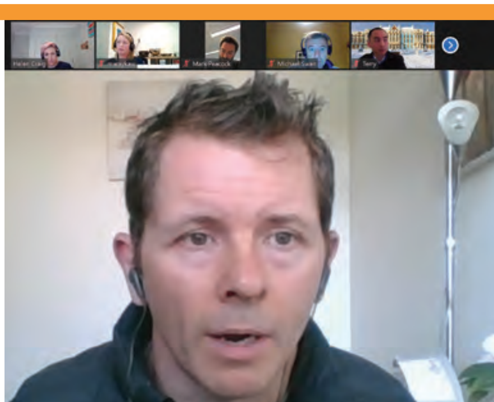
YUAN It seems to be a bit of a gimmick to label a bond green while the rest of a business is not. It can be a bit superficial. Some governments in Australia may support coal mining but will still issue a green bond. The bond may do very well, but it would be nice if the issuer took on a more holistic approach. Perhaps the entire business would achieve a pricing benefit as a result.

Craig Only 30 per cent of survey respondents indicate ESG practices other than negative screening have a "significant" influence on their investment decisions. Does this seem typical to investors? Also, to what extent are different practices deployed across the range of portfolios within fund management firms?

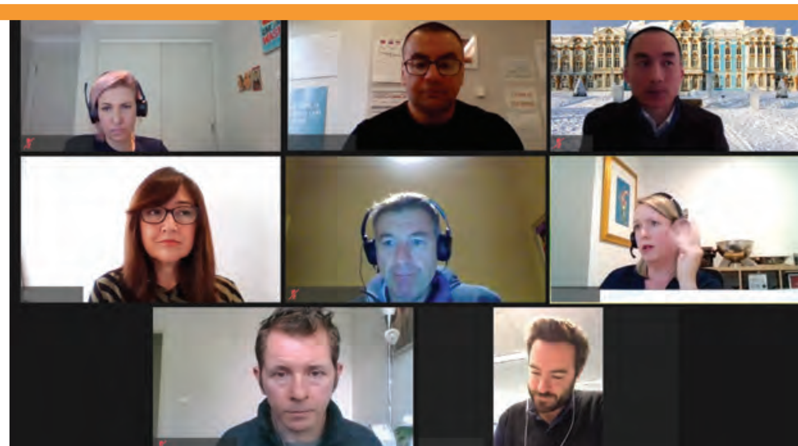
YUAN It is quite simple for us. If we judge that the investment risk – including risk related to ESG factors – is too high, we will not invest. If enough investors deny funding to a particular project it won't get off the ground.

BISHAY I manage dedicated sustainable funds as well as vanilla fixed-income funds, and I manage them similarly at a sector level – with over- or underweights by sector.

Dedicated funds have a hard screen to specific industries and to issuers that don't meet our ESG thresholds. However, the vanilla funds can potentially invest in screened-out issuers for a short time if we perceive valuation compensates for the risk. As soon as the valuation becomes an industry-level credit spread, we're out. ESG factors certainly have an influence on investment decisions and how we view pricing.



JAMES PEARSON QBE INSURANCE



ESG APPROACHES: BEYOND THE NEGATIVE SCREEN

Negative screening is still the single most-used environmental, social and governance (ESG) approach across survey respondents – with 89 per cent of investors deploying negative screens and no other technique used by more than 52 per cent.

CRAIG How rapid is the pace of adoption of other techniques, such as positive screening?

■ **WARD** We have been using negative screening for several years. Some years ago, when British American Tobacco was still an active issuer in Australia, I remember having an argument with a portfolio manager about its bonds. He was intent on not holding them largely due to personal ethical and moral views. There were more smokers back in the early 2000s and my view at the time was that we were going to get paid back on those bonds so why wouldn't we hold them.

Investor sentiment – including mine – has certainly changed. We have a range of formal negative screens – tobacco, munitions, controversial weapons and the like – but we are seeing more client demand for positive screening, particularly from insurance clients. As debt investors, our priority is to ensure we get our money back. Positive screening picks companies that will be sustainable over the longer term.

We also want to invest in companies that will come back to market. We are developing tools that seek out companies that under certain scenarios – such as climate risk – might perform better than their peers.

■ **SWAN** From our perspective, negative screens are first and foremost the path of least resistance. We are pushing more resources into the responsible investment (RI) space and when we allocate capital to any investment negative screen is quick, efficient and easy to deliver. But we are building in other ESG approaches, such as portfolio optimisation.

■ **PEARSON** We have negative screening in our fixed-income portfolio and this reflects the broader QBE position. For example, last year we introduced a negative screen around thermal coal in line with QBE's broad view around climate change.

We became responsible investors relatively late compared with some other asset managers and owners, and we took a broader view around ESG integration within our fixed-income portfolio. We don't have a large equities portfolio so we wanted our responsible approach to be reflected across fixed income.

As well as negative screening, this includes what one might call a negative screen around some ESG ratings data. Examples are thresholds around controversies, or we will mark down or exclude certain credits based on their external ESG data-provider ratings.

We are also focused on the ESG integration component, and thematic and impact investing in a more positive screening sense.

■ **BISHAY** Negative screening can mean many things over and above traditional industry screening of tobacco, thermal coal, controversial weapons and the like. Industry-based screening is the easiest to apply and we have had two

"IT IS HARDER TO HAVE A POSITIVE IMPACT IN INVESTMENT-GRADE FIXED INCOME SO WE ARE NOT SEEING TOO MUCH PRESSURE FROM OUR END INVESTORS TO HAVE POSITIVE IMPACT IN OUR PORTFOLIOS. HOWEVER, THEY ARE VERY INTERESTED IN MORE TRADITIONAL SECTOR-BASED NEGATIVE SCREENING."

TERRY YUAN ANTARES CAPITAL

THE 'WHO PAYS' CONUNDRUM

Craig One of the biggest issues the survey highlights is "who pays for this?" More than 60 per cent of investors say they will not pay any premium for labelled bonds, while lack of willingness to pay for improved ESG outcomes is the most-referenced single impediment to market growth. How do we get past this apparent impasse on pricing?

■ **WARD** It is an interesting question, particularly around investors not wanting to pay for the label. At QIC we don't have dedicated responsible investment funds so we mix all securities in our vanilla portfolios.

We need to have a conversation with clients if certain securities underperform. We do a lot of work on performance attribution of green, social and sustainability (GSS) bonds and we are reaching the stage where for some, mainly corporates, we are comfortable sharing the cost of those labels.

Specifically, this means the cost of the second-party opinion or other structures that support the security. This cost sharing is through pricing during primary issuance.

We look at the performance attribution of labelled bonds versus a vanilla security of similar duration, and one point of interest in the last few months has been performance through the pandemic. While it has only been marginal, we have not found one GSS security that hasn't slightly outperformed.

Initially GSS bonds outperformed because they had a specialist investor base and the notes were put in the bottom drawer. We are relatively comfortable that demand has now picked up. Book sizes are bigger relative to print volumes and there is some outperformance as a result.

We would like to see an improvement in quantitative reporting to be able to take this through to our client reporting.

clients in the last six months say they want to apply a negative industry screen on a couple of specific sectors. I imagine this will continue.

There is another negative-screen type that is easy to confuse with positive screening. If you rate issuers on an ESG basis and screen out the poor performers this is a negative screen – but it can also be viewed as a positive screen for high-quality ESG issuers.

■ **NUNEZ** I don't find the survey response surprising. Investors are moving through different stages of ESG approaches. IFM Investors applies a negative screen that is driven by our clients and covers some of the same sectors others have mentioned. We monitor an issuer's performance from a relative-value perspective and how it manages ESG business relative to its peers.

More recently, we introduced an in-house ESG scorecard that directly contributes to our internal credit rating. We have noticed that rating agencies are beginning to incorporate ESG factors into their broader analysis, too.

We have always considered these factors and now we have a label for them. But we integrate ESG into all our asset classes. We have an RI team to oversee transactions and we use its research and recommendations in our analysis and investment decisions.

■ **YUAN** We have all seen big interest from our end investors for ESG integration into investment processes and reporting.

It is harder to have a positive impact in investment-grade fixed income so we are not seeing too much pressure from our end investors to have positive impact in our portfolios. However, they are very interested in more traditional sector-based negative screening. This could be why there isn't as much positive screening as negative in the survey results.

We like negative screening because it is customisable. ESG factors are subjective, so while everyone is on board with excluding immoral activities, every client will put greater weight of judgement on some things than others. Negative screening is also supportive of concrete limitations – it's designed to give an easy yes or no on measurable factors to a particular asset or sector.

As such, we're starting to get comfortable with the concept of contributing in some way to helping to fund transition – but also because we know these bonds can outperform.

■ **SWAN** From the perspective of a super fund, we want our managers to make these kinds of decisions for us. However, as we continue to internalise investment we increasingly need to make these decisions ourselves. What is in our members' best interests and whether and for what we should be prepared to give up returns are the most debated topics.

Like QIC, we do a lot of work into like-for-like assets, including correlation work to ascertain whether performance is the same. The costs of underperforming are stark in investment-grade credits so we do all we can for our members to try not to underperform. If this comes at a cost of investing in these kinds of bonds, it is something we have to live with.

Having said this, one would hope that, over time, GSS securities should outperform. Cbus has also just announced a dedicated allocation to climate initiatives, which is one way around our 'who pays' conundrum.

■ **PEARSON** I am a little surprised at the 60 per cent figure. I would have expected it to be higher.

We have an ambition to invest US$2 billion in impact investment globally by 2025 and the majority will be in fixed income given the nature of our strategic asset allocation. Our process, though, is that an investment must meet the financial risk-return threshold before we will start to examine the impact. This seems to be echoed by our peers, which are also looking for the market-rate risk-adjusted return first.

Our fixed-income team and banking partners aren't seeing issuers or investors trying to look aggressively at pricing. There is more of a focus on credit rating and positive impact, as well as the transparency and diversity that comes with investing for green, social or sustainability outcomes.

Moving beyond the marketing that comes with GSS bonds and looking for issuers to engage with us and produce higher-quality impact reporting that we can use is going to become a ticket to the game for this type of issuance. The free ride of issuing and getting a headline is no longer sustainable.

■ **NUNEZ** I am not sure yet that the investor market is ready to pay a premium for GSS bonds. From IFM's perspective, the focus first and foremost is on the return for our clients in line with our fiduciary duties, particularly in the current environment of the pandemic.

The data point in the CommBank-*KangaNews* survey that suggests it will take at least two years before issuers with poor ESG performance will have to pay a material premium to access capital sounds about right to me.

■ **BISHAY** As everyone has mentioned, when asset owners or clients of ours allocate money to us the most important focus is performance. It doesn't make sense for us to invest in assets with much tighter spreads that won't necessarily perform in secondary relative to a vanilla equivalent.

Pendal's dedicated responsible investment funds have two objectives: performance and to manage funds in a sustainable fashion. A tighter spread on impact bonds relative to vanilla bonds from the same issuer won't happen until we get sufficient dedicated sustainable funds filling up deal books.

> "Even though we have seen some transactions with active strategies to transition away from a sector or commence with renewable projects or environmental strategies, it is challenging when clients are imposing a screening directive to the sector outright."
>
> **LILLIAN NUNEZ** IFM INVESTORS

ESG RESEARCH AND ANALYSIS

A majority of investors say they use each of issuers' sustainability and general reporting, in-house capabilities, rating-agency research and certification or verification agents to inform their environmental, social and governance (ESG) analysis.

CRAIG Which sources of information are most important, and which have become more relevant over time?

■ **PEARSON** We rely on external research on financial and nonfinancial data. We use research to inform the first wave of screening, which may include various thresholds to help us filter down our universe. Compared with the fundamental research that is available in, say, the equity market, fixed-income ESG research information available is lacking.

There is consolidation in the market and a race for data with improved quality and accuracy. The frequency of the reports and coverage from ESG research providers is still wanting but the range of available information is improving year on year. I expect this to continue as investors are demanding it.

Some of the drive is coming from the issuers themselves. Listed entities such as QBE have a commitment to being transparent and to providing data to enable investors to make informed investment decisions.

■ **YUAN** Every company and sector is different and the credit analysis function is vital given different clients will have different judgements on ESG themes. From my perspective, companies' own sustainability research tends to be the best and most detailed.

Other sources are a bit hit and miss, largely because companies don't engage with them all. At rating agencies it will be analyst dependent. The onus is on the investor to collate information from many different sources to form the picture.

PEACOCK How would investors like issuers to engage with them on issues related to green and sustainability financing, including setting targets? Is having a direct dialogue preferable to a third-party label?

■ **BISHAY** Both. Third-party certification is incredibly important but if an issuer just links to the UN Sustainable Development Goals it is unlikely to meet all our requirements.

For instance, in a recent semi-government bond transaction a very small part of the proceeds is funding upgrades to schools. We are interested in the underprivileged receiving an upgrade and not the average school. From our perspective, the discussion prior to projects being ringfenced is very important.

■ **NUNEZ** The certificate is great but our focus is on assessing management. We are very interested in understanding what a firm represents in its actions, its future business ambitions, what the individuals within the company are looking to do and how it will report ESG. A certificate on its own may not fulfil this need.

■ **SWAN** Anything that can get our dedicated responsible-investment team exposure to management is helpful for us. Hearing it direct, rather than at the end of a chain of whispers, gets a tick straight away.

■ **WARD** It is great to have an independent party's view to inform direct dialogue. It is straightforward for our analysts to see how a credit rating is reached with traditional balance-sheet analysis from rating agencies. On the other hand, one of the drawbacks with some of the specialist ESG ratings research is that the same conclusions can't easily be drawn – some analysis leads to a triple-A rating while another agency might assign a triple-C for the same entity.

It is important that we start to have guidelines, such as Task Force for Climate-related Financial Disclosures style of reporting, so we can begin to compare companies on a like-for-like basis.

As others have said, talking to the companies directly is important. It is also useful for them to understand how investors are using their sustainability and impact reports – that these are viewed as more than a marketing piece.

■ **PEARSON** We value third-party certification but we like to have conversations with management wherever possible.

■ **YUAN** Access to management is most valued.

> "ANYTHING THAT CAN GET OUR DEDICATED RESPONSIBLE-INVESTMENT TEAM EXPOSURE TO MANAGEMENT IS HELPFUL FOR US. HEARING IT DIRECT, RATHER THAN AT THE END OF A CHAIN OF WHISPERS, GETS A TICK STRAIGHT AWAY."
>
> **MICHAEL SWAN** CBUS SUPER

If 50-75 per cent of a book is filled by non-dedicated sustainable funds, these investors aren't going to accept a tighter spread unless they know the bond is going to perform.

I don't think Australia will get to where Europe is for a long time as dedicated impact funds are very small here relative to the rest of the debt market. This is very different from Europe where spreads can be tighter on issuance as the dedicated sustainable investor base is much larger than Australia.

For the many years in which I have been investing in impact bonds, only one issuer has achieved tighter primary pricing in Australia. The transaction priced a couple of basis points tighter than the vanilla curve and, if anything, it underperformed in secondary. We're not going to pursue bonds at a tighter spread relative to the vanilla curve at this stage.

TRANSITION FINANCE

Craig There was some, but not overwhelming, interest in the survey in sustainability performance-linked bonds (SLBs) and transition instruments. To what extent could finance that only rewards the successful achievement of future goals resolve the pricing challenge?

■ **PEARSON** Where I struggle with SLBs and transition instruments is the moral dilemma they present. As responsible investors, we are looking to generate market-rate, risk-adjusted returns and therefore the idea of benefiting from an organisation not meeting ESG targets doesn't sit well.

Perhaps we can do something with an additional coupon payment that is higher because of missed targets. Something that has more of a positive impact, such as contributing the difference to the QBE Foundation.

■ **SWAN** Essentially it's the market's role to determine fair pricing – but realistic targets still need to be set on these instruments.

■ **WARD** We like the concept as it is a way of helping companies to transition. The ability to use these instruments for general corporate purposes should start to bring companies along.

But we also have some concerns. This is not a coupon step-up that compensates for a rating downgrade and the additional credit risk. There might be additional credit risk because the issuer has missed its targets, but really it is a windfall gain for investors because a company has failed to achieve its target.

When including these instruments in a pooled portfolio, we ought to take account of the views of the multiple investors that could benefit from the windfall gain. Some of them will value the extra coupon but it may not sit well morally for others.

■ **BISHAY** My concern is around an SLB where the issuer does not meet the sustainable performance targets and investors sell as a result. In this scenario, the question I must ask is whether the coupon step-up is sufficient compensation for the bond selling off.

The aim should be for the step-up to compensate for the sell off, as otherwise it will be painful for the investor especially because such an instrument would no longer qualify as a GSS bond. I'd be interested to hear what other investors think: let's assume it's a 25 basis points step up – would a bond widen by more than 25 basis points?

> "There is a heightened awareness of ESG and what the issuer is doing at the corporate level across the board. Where issuers see things less clearly is the value or benefit of looking at certifying assets or undergoing a labelling process."
>
> **MARK PEACOCK**
> COMMONWEALTH BANK OF AUSTRALIA

■ **WARD** I think it would.

■ **BISHAY** So, net-net as an investor, we don't want companies to miss their targets.

■ **YUAN** It is still possible to achieve a pricing benefit – it's just an indirect one. If you issue a green bond the book will likely be larger, and if the book is larger the issuer tightens the pricing more. As an investor, you get more pricing benefit anyway.

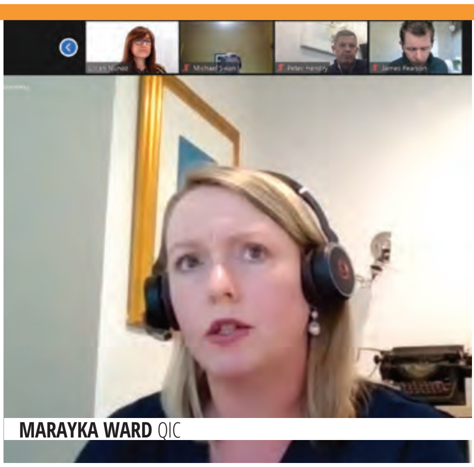
■ **NUNEZ** If the features in such instruments are not doing what they are designed to do, which is to encourage companies to perform sustainably, we would just be penalising our clients by investing in them. I'm just not certain the mechanism is appropriate as currently construed.

Peacock If a spread widens further than the step-up in these instruments, isn't this positive insofar as there is an alignment of interest between investors and issuers?

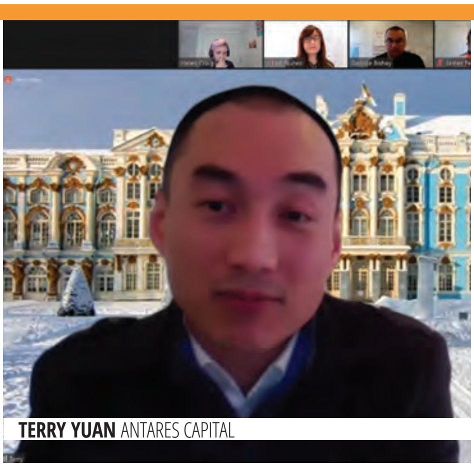
■ **BISHAY** Absolutely. But my aim is to reframe how some people think about the step-up. Some view this as a windfall for investors if the company doesn't meet its objectives. This is not the case: if the company doesn't meet the objectives it has set for itself the bond is going to smell very bad.

■ **PEACOCK** The intent with the step-up – and to a certain extent the step-down – is that targets are set with a wide path for the issuer to traverse. The step-up is therefore designed to kick in if there is a material deterioration – it would have to be a very bad

MICHAEL SWAN CBUS SUPER



MARAYKA WARD QIC



TERRY YUAN ANTARES CAPITAL

> "Moving beyond the marketing that comes with GSS bonds and looking for issuers to engage with us and produce higher-quality impact reporting that we can use is going to become a ticket to the game for this type of issuance."
>
> **JAMES PEARSON** QBE INSURANCE

outcome for the issuer for that scenario to play out. Equally, if the margin were to step down it would imply that the issuer had materially outperformed its trajectory. The guard rails are wide and designed to cover an extreme market spectrum.

BISHAY It is important to ensure the sustainability objectives are not business as usual but stretched, though. If a company is trying to reach zero emissions by a certain time, that time can't be a hundred years away if it is to have value.

Craig Does brown-to-green transition funding raise concerns about greenwashing or is it just that some issuers would fail negative-screen testing and be rendered unsuitable even for transition finance?

NUNEZ For us, a failure of negative screen test is the challenge. We have underlying clients that have said no to coal or other sectors within the portfolio. Even though we have seen some transactions with active strategies to transition away from a sector or commence with renewable projects or environmental strategies, it is challenging when clients are imposing a screening directive to the sector outright.

There may be some movement in the future and some clients may come around to alternative thinking. Let's use power as an example. We can't just say no to a company that is providing coal power to the nation but is also actively shifting to renewables, but we have to say no under a negative screen.

> "My concern is around a sustainability-linked bond where the issuer does not meet the sustainable performance targets and investors sell. In this scenario, the question I must ask is whether the coupon step-up is sufficient compensation for the bond selling off."
>
> **GEORGE BISHAY** PENDAL GROUP

We need to see active transition and we have to find a way to measure it and to articulate what should be a clear transition story to investors.

PEARSON As I mentioned earlier, a focus for QBE is the US$2 billion ambition to achieve in impact investments globally by 2025. The requirements are to meet risk-adjusted returns and to have a positive impact. It's not about premia for 'less bad'. As much as the transition to a low-carbon economy needs to be funded, our programme focuses on positive impacts. It's not to say we wouldn't own brown-to-green instruments in other parts of our fixed-income book, assuming they passed ESG and negative-screening criteria.

BISHAY One of the reasons I look at a transition bond differently from a green bond is that if I invest in a transition bond I am exposed, from an impact perspective, to the full company that could be producing a bucket load of emissions. If it changed the delta, which is what we're all trying to achieve, I still have exposure to a huge amount of emissions.

If I am happy with the credit quality of the issuer my preference, without question, is a ringfenced bond to a specific project rather than general corporate activity.

WARD We would like to fund transition stories and to see companies bring emissions down over time. There is a lot of trust implicit in the targets that companies set as part of their transition plans. It is a bigger monitoring job than a labelled bond and explaining any slippage in timeframe to investors takes resourcing.

Peacock Where will this courage come from? In various parts of the survey we got a reasonably strong sense that member preferences are driving investment decisions.

WARD This is the case for some segregated funds. On the super fund side, rather than being driven by mum and dad superannuants, the trustees are taking more of an active interest in what they are funding. This is being driven by governance principles and the *Modern Slavery Act*.

ESG is part of the analysis process when we look at credit. We are effectively positive screening by knocking companies out where we aren't comfortable with governance or some other practices.

A lot of the passion in getting comfortable with a transition story will come from credit analysts. As a credit analyst, I wouldn't want to have to explain to portfolio managers why I supported this company but the rest of the credit investment universe didn't agree with me. Part of the bravery will come from credit analysts pushing ideas through portfolios. •

From the ashes

COVID-19 has spurred record volume of social-bond issuance and some sustainable-finance experts believe the crisis will be the catalyst for much more widespread adoption of the instrument. Despite the best efforts of advocates, however, the hurdles to habitual use of social bonds, especially in the private sector, remain high.

BY LAURENCE DAVISON

Until 2020, social bonds were very much the baby sibling of the much larger green-bond market – but until 2020 no-one realised COVID-19 was going to change markets, economies and societies forever. Things have changed dramatically inside half a year, and some believe social-bond issuance could be at the start of a major boom.

The green-bond market has certainly developed more critical mass over the past decade. *Environmental Finance* data suggest combined global green, social and sustainability (GSS) bond issuance had surpassed US$1 trillion equivalent by June this year, with around 90 per cent of the total comprising green bonds. The recent surge in social-bond deal flow has taken total issuance through the US$100 billion barrier, though, while sustainability bonds are still only beginning the path to widespread use.

It seems likely that at least a third, and perhaps close to half, the all-time total of social-bond issuance has come to market in 2020. Bloomberg New Energy Finance estimates aggregate social-bond issuance at a somewhat smaller US$83 billion equivalent but pegs H1 2020 volume at nearly US$40 billion (see chart).

Social bonds have also dominated Australian GSS issuance in 2020, but only in the loosest sense of the term. After a record year in 2019, when more than A$10 billion (US$6.9 billion) of GSS bonds came to market, the first half of this year seemed to cause local issuers to place GSS bonds in the too-hard basket.

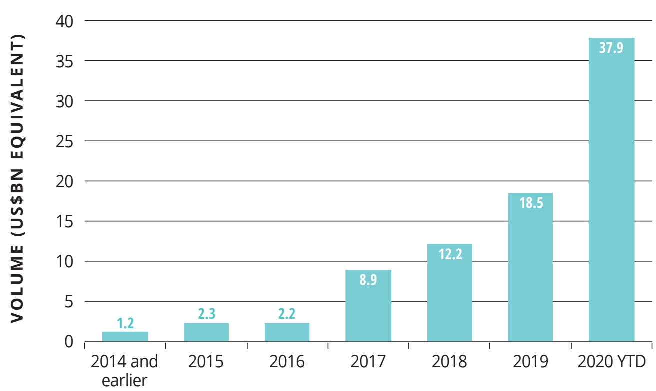
Just A$1.3 billion of GSS bonds printed in Australia in H1 2020 and only one transaction – a A$562 million social bond from National Housing Finance and Investment Corporation (NHFIC) – came from a domestic issuer. The rest of the volume was issued by international supranational, sovereign and agency (SSA) names.

To date, just three issuers have dipped their toes in the water of the Australian social-bond market, for less than A$3 billion. To say the sector has room for growth would be an understatement.

There has been no social-bond issuance in New Zealand, though Kāinga Ora – Homes and Communities conducts all its issuance under a "wellbeing bond" framework that effectively combines social and environmental aspects.

It took some time for Australasian issuers to climb aboard the green-bond bandwagon, too. World Bank issued the first green bond globally in November 2008. The same issuer opened the Australian market in April 2014 and the first green bond from a domestic issuer came from National Australia Bank in December the same year. International Finance Corporation (IFC) printed New Zealand's first green bond in July 2017 and Kāinga Ora – then under its former branding of Housing New Zealand – opened the door to domestic issuance 11 months later.

ALL-TIME GLOBAL SOCIAL-BOND ISSUANCE



SOURCE: BLOOMBERG NEW ENERGY FINANCE 2 JULY 2020

"COVID-19 is tragic but it is also an opportunity. It is like turning on the lights at the end of a party – it allows us to see the wreckage of the preceding hours. In this case, it represents a paradigm shift for social bonds."

DENISE ODARO INTERNATIONAL FINANCE CORPORATION

COVID-19 CATALYST

Global social-bond issuance has exploded in 2020 – and COVID-19 is the cause. An S&P Global Ratings report published in June says April this year was the first month ever in which social-bond issuance surpassed that of green bonds.

Simone Utermarck, director, sustainable finance at International Capital Market Association (ICMA) in London, tells *KangaNews* roughly 70 per cent of 2020's social- and sustainability-bond issuance references COVID-19 in some way. "We have seen a surge in social-bond issuance this year, especially with a COVID-19 theme. The pandemic is rather a 'sad catalyst' but it is great to see the SBP-aligned social-bond instrument being used for this purpose," she comments.

The immediate driver is the funding governments, subsovereign agencies and multilateral development banks (MDBs) in particular are taking on, at frenetic pace, to fund pandemic recovery. The scale of this funding task is impossible to estimate as the crisis continues to unfold, but it is sure to be vast.

To take one example, Joanna Silver, head of sustainable finance at Westpac in Auckland, says the latest estimates are that even in New Zealand – perhaps the world's best performer in the immediate public-health phase of virus management – government net debt could grow to 50 per cent of GDP from 20 per cent by 2023 purely as a result of COVID-19 stimulus.

This seems entirely plausible. New Zealand Debt Management disclosed a sixfold increase to its 2020/21 borrowing programme in May, with the new figure of NZ$60 billion (US$38.9 billion) also being three times greater than any previous New Zealand sovereign funding requirement.

Silver says: "COVID-19 has real parallels with climate change, just with greater urgency. The green-bond market supports the financing of an existential human threat – and we now have an even more pressing social and economic threat that needs addressing. We have a tool to do it, in the form of the social bond."

While the immediate consequences of COVID-19 are horrific – the first-order death and health toll, of course, but also the devastating economic impact of protracted lockdowns and social-distancing measures – they will not be the pandemic's only societal impact. Many believe social structures will change forever, including areas as significant as where people work and live, and how frequently and by what means they choose to travel.

Silver's comments hint at the fundamental source of excitement about the role social finance could play. If the world is at least approaching consensus on the vast investment required to counter and mitigate global warming, perhaps it is also at a tipping point when it comes to understanding how a similar allocation of capital could change social conditions for the better.

COVID-19 could be the catalyst needed to give social issues the same prominence as environmental ones. Denise Odaro, head of investor relations at IFC in Washington and chair of ICMA's social bond principles (SBP) working group, says: "COVID-19 is tragic but it is also an opportunity. It is like turning on the lights at the end of a party – it allows us to see the wreckage of the preceding hours. In this case, it represents a paradigm shift for social bonds."

Embedding a social aspect into sustainable finance is also a focus in Australasia specifically. For instance, while the EU's green-bond taxonomy, as its name implies, focuses almost exclusively on environmental outcomes any forthcoming Australian equivalent is likely to incorporate a social angle from the outset.

Katharine Tapley, head of sustainable finance at ANZ in Sydney, says the Australian Sustainable Finance Initiative (ASFI) is looking at social issues on an equal footing with environmental ones. The idea is not to deliver a local methodology for calculating the impact of social bonds but to introduce harmonisation language around social assets as a starting point.

ASFI's approach is designed to align with how the Australian market and businesses are thinking more generally. Mark Peacock, Commonwealth Bank of Australia's Sydney-based head of sustainable finance, says local big business is evolving its environmental, social and governance (ESG) thinking to reflect a greater emphasis on the social component.

COVID-19 is playing a role, but it is not the only factor. Peacock explains: "The pandemic has brought social finance to the front of mind, particularly in connection with things like the significance of healthcare systems and the impact of high unemployment on housing and welfare. But I think the *Modern Slavery Act* was a also major catalyst for boards, including the requirement on large companies to report on the social impact of their actions."

IMPACT ISSUES

There should therefore be plenty of appetite on the issuer side for the type of funding social bonds can provide. In fact, all else being equal there should be every reason to think the social-bond market could rapidly catch up with and even overtake green bonds. Unfortunately, all else is not equal.

"COVID-19 has real parallels with climate change, just with greater urgency. The green-bond market supports the financing of an existential human threat – and we now have an even more pressing social and economic threat that needs addressing."

JOANNA SILVER WESTPAC

One of the major challenges for social bonds has historically been the relative complexity of defining, measuring and reporting positive impact from underlying projects. To compare with green bonds, it tends to be easier to quantify emissions than the type of outcomes issuers might look to fund with a social bond.

"One of the most important factors for investors is impact, and this is not as easy to measure in the social space," Utermarck acknowledges. "We have done a lot of work in this respect, including updating the SBP to define social issues and providing examples of output, outcome and impact in the harmonised framework for impact reporting for social bonds."

The recent spike in interest in social bonds has coincided with a major update to the SBP, which ICMA published in June this year. A key goal of the update was to ease the path to market for issuers, including in the impact measurement and reporting area, while maintaining the rigour of the asset class (see box on p50). The degree of impact the update will have remains to be seen. But ahead of the update's adoption there can be no doubt that bringing a social bond to market represented more of a challenge to new issuers than the equivalent process in the green space.

NRW.BANK made its social-bond debut at the end of June this year with the print of a €1 billion (US$1.1 billion) 15-year line. The issuer's social-bond programme aligns with five of the UN Sustainable Development Goals (SDGs): no poverty, quality education, decent work and economic growth, reduced inequality, and sustainable cities and communities.

All of these individual SDGs align with NRW.BANK's mission as the development agency for the German state of North Rhine-Westphalia. Even so, its Düsseldorf-based head of investor relations, Frank Richter, notes the additional complexity involved in delivering a security that met investor expectations.

"Social is less straightforward," Richter admits. "Of course ICMA's SBP give a lot of advice and good guidance to identify social loans and the targeted population behind them. Even so, impact reporting is much more challenging than green. Data availability is weak and KPIs are not as sharp as on the green side."

For NRW.BANK, the aim is to start the process then work to refine it over time. The challenges do not disappear with experience, however. IFC has been in the social-bond market since 2017 and had issued nearly US$3 billion equivalent in the format even before COVID-19. But Marcin Bill, senior financial officer – funding at IFC in Washington, says it remains a "much more complex matrix of indicators for social bonds than it is for green bonds".

This has not stalled IFC's ambitions. In the COVID-19 recovery sphere alone, the supranational sees social bonds as a way of funding projects as diverse as vaccine R&D, support for employment in the SME space, adaptation of processes in the manufacturing sector and production of healthcare supplies.

AUSTRALASIAN LEADERSHIP

Australian and New Zealand issuers have a rare opportunity to take leadership in an evolving market. Kāinga Ora is grasping the nettle with its ambitions to be a trailblazer in impact reporting. "We don't want our impact measurement to be a case of producing a report once a year and considering ourselves done," says Sam Direen, treasurer at Kāinga Ora in Wellington. "We see it as a massive opportunity to take a leadership role – to make other issuers want to follow us."

The agency is facing the same central challenge of measuring and reporting impact in the social space as all social-bond issuers. But its commitment goes beyond identifying quantifiable factors that satisfy standards such as the SBP. The easier path to achieving this goal would be to look for outputs. Kāinga Ora, by contrast, is exploring reporting related to outcome.

Jason Bligh, senior treasury manager at Kāinga Ora in Wellington, explains: "An output could be building a target number of social or affordable houses to a certain [New Zealand Green Building Council] Homestar rating whereas a social outcome would be measured over time to assess whether the targeted social benefit has been achieved. This can be complex when considering multilayered projects, programmes and cross benefits."

Appropriate indicators need to be well considered and benefits defined, Bligh adds – for instance how construction contributes to a thriving community, wellbeing and the extent to which this translates to better quality of life.

Kāinga Ora is developing benefits-management processes directly related to its strategy and outcomes framework themes. The process will continue to evolve and become mandatory for all new programmes. It already collects data on customer-service delivery in some areas, for instance whether tenants are in financial hardship and need of assistance, or whether they are well served in response to COVID-19. But Bligh admits developing a deep and quantifiable understanding of outcomes and reporting will take time.

Elsewhere in the Australasian government sector, the growth of the social-bond market appears to be providing a

> "One of the most important factors for investors is impact, and this is not as easy to measure in the social space. We have done a lot of work in this respect, including updating the SBP to define social issues and provididng examples of output, outcome and impact."
>
> **SIMONE UTERMARCK** INTERNATIONAL CAPITAL MARKET ASSOCIATION

BRINGING THE SBP UP TO DATE

Record issuance of social bonds in 2020 has COVID-19 recovery as its most prominent driver. But International Capital Market Association (ICMA)'s social-bond working group has been sharpening guidelines since the Green and Social Bond Principles (GBP SBP) AGM in June 2019.

ICMA's social-bond working group identified five focus areas for the following year that it believed would accelerate growth of the social-bond market.

These were to provide more guidance on impact measurement and reporting, to create case studies to illustrate eligible use of proceeds (UOP), to review and update the mapping of the SBP to the UN Sustainable Development Goals (SDGs), to review the SBP to ensure they keep up with market evolution, and to survey investor views on and requirements for social-bond investments.

The key changes in the updated SBP launched at the June 2020 AGM are a new definition of what constitutes a social issue, expanded examples of project categories used to identify UOP and adding context on target populations.

There is also a focus on impact measurement. The SBP include voluntary guidelines aimed at developing a harmonised framework for impact reporting social projects. These guidelines include templates for the format of impact reporting at project and portfolio level that issuers can adapt to their own circumstances.

One of the goals of the update is to help make social bonds a relevant instrument to a wider group of issuers. Even the product's advocates admit its primary use had been in developing markets and, as such, it was in danger of becoming a niche funding tool of multilateral development banks with work focused in these regions.

Improving social conditions in the developing world is an important goal, of course. But the SBP update aims to broaden social bonds' appeal. "There has been a lot of discussion about why social bonds have made up such a small proportion of the sustainable-finance market," reveals Eliza Mathews, director, sustainable finance at Westpac Institutional Bank and member of the SBP GBP's workstream on fostering the global social-bond market.

She adds: "The goal is to find a way to make the social-bond definitions work not just for developing countries or governments but also, for instance, companies that are doing fantastic things to support the wider population – in a way that serves a social purpose and is also profitable."

Measuring and reporting impact is vital to this goal. Mathews says social-bond impact reporting has historically tended to be "story based" – an approach that might be necessary in a data-poor developing-world environment but will not suffice for a larger, more broadly deployed asset class.

Denise Odaro, member of the GBP SBP executive committee and head of investor relations at International Finance Corporation, also notes the expanded project list available for social-bond financing, which includes components like increasing employment in the wake of a crisis. She says: "We have tried to make the SBP directly applicable to the corporate space. In fact, one of the key goals of the working group is to promote social bonds to the corporate world."

COVID-19 focus

The update process was in train prior to the COVID-19 pandemic. But the onset of the global crisis early in 2020 gave a clearer focus to what might be needed to mobilise the social-bond market as an funding tool for such a cataclysm. Odaro says the COVID-19 pandemic has helped cement in the SBP community the idea that the general populace can be an option for a social-bond target population, rather than needing to identify a population subset.

"While you may have a target population – which could be people living at the base of the pyramid, minorities or marginalised populations – there are instances where you do not need to have a subset of the population because it is an endemic social issue that it affects everyone. While no-one knew it was to come, the COVID-19 pandemic in itself is a testimony to this," Odaro explains.

Social bonds have obvious uses during a pandemic, including funding solutions in areas such as health and sanitation. But the updated SBP extend the instrument's application to the recovery from the crisis as well.

For example, the social-project category of employment generation has expanded to include programmes designed to prevent or alleviate unemployment stemming from socioeconomic crises.

The next phase of work for the SBP working group includes further targets of codifying social-bond impact measurement. Odaro reveals one such goal is mapping the SBP to the SDGs – which she says is "key for investors". Elsewhere, impact reporting will be further refined in order to make it "valuable but concise".

more marginal appeal. New South Wales Treasury Corporation (TCorp) updated its GSS asset pool to include social as well as green projects ahead of the issue of its first sustainability bond, in November last year. But social assets are a minority of the issuer's pool: just A$550 million, compared with a first deal that alone soaked up A$1.8 billion of liquidity.

Treasury Corporation of Victoria is contemplating following TCorp into combined sustainability issuance, while Queensland Treasury Corporation is exploring the possibility of adding a standalone social-bond programme to its green-bond issuance.

PRIVATE-SECTOR QUESTION

There is an even bigger question mark in the private sector. Where green investment looks like an increasingly wise move for financial institutions and corporate borrowers, social projects remain largely the domain of government entities. Put simply, it is hard to align social benefit with the profit motive.

CommBank's Peacock acknowledges there are "a few steps to play out" before corporate interest translates into more social funding. "To get real market growth we would need to see both of issuers rethinking the assets they invest in and the buy side

“To get real market growth we would need to see both of issuers rethinking the assets they invest in and the buy side rethinking how it allocates funds. I’m not sure this is as red hot as has been suggested.”

MARK PEACOCK COMMONWEALTH BANK OF AUSTRALIA

rethinking how it allocates funds. I’m not sure this is as red hot as has been suggested,” he comments.

It may be most accurate to view the spark provided to social-bond issuance through two lenses. For public-sector issuers, the combination of a renewed focus on social outcomes and the reality of fulfilling massively increased issuance tasks is pushing social-bond engagement right up the agenda. Even if social bonds are not yet a fully mainstream funding instrument, it is not hard to envisage substantial issuance growth in the medium term.

For financial institutions and, especially, corporates, the nature of the catalyst is more about adding momentum to an extended process of engaging more deeply with the social impact of their businesses. This could in time feed through to the funding realm but progress will likely be slower.

It should not be impossible, though. ANZ Banking Group already issues SDG bonds, for instance. Francesca Suarez-Villarica, Paris-based sustainability analyst at Natixis Asset Management subsidiary, Mirova, says: “Intrinsically, one might think social bonds can only be issued by MDBs and it is certainly easiest for them. But we have seen some issuance from private companies and we have invested in these deals. It depends on the social strategy of the company and its involvement in relevant areas.”

Suarez-Villarica encourages companies to identify things they do that could be suitable for social-bond issuance because “corporate issuers are needed to promote diversity if the social-bond market is to become as robust as green bonds”. Such projects could include investment in social housing, sustainable agriculture or specific types of R&D including in healthcare.

This should apply to Australian and New Zealand companies. Eliza Mathews, director, sustainable finance at Westpac Institutional Bank in Sydney, comments: “Some sectors could align with social-bond funding already – for instance healthcare and childcare. It is an area where corporations are involved and playing a strong role that also contributes to under-served populations being able to continue working or to live healthier lives.”

Market participants acknowledge it may be hard for bank and corporate issuers to find sufficient ready-made scale in their asset books to support benchmark social-bond issuance. This may be where the sustainability-bond option comes into play, allowing borrowers of all types to follow TCorp’s path by complementing a green asset pool with a smaller batch of social projects.

This will likely not be the only way in which issuers take their lead from the local and global SSA sector. Westpac’s Silver says issuers have to date been “a little tentative” in their engagement with social bonds, perhaps due to concern about reputational risk in a less easily quantifiable space or a greater focus on green finance given the scale and urgency of the environmental task.

But she adds: “There isn’t a shortage of capital out there. Issuers and investors can fund green and social outcomes, the UN SDGs highlight the need and the SBP contemplate and support this. We have to finance all forms of sustainable development and my view is that social and sustainability bonds will develop a bit like the green-bond market in the sense that supranational and government entities were the first movers but financial institutions and corporates will follow.”

ICMA’s Utermarck adds: “We saw the same path in the green-bond market: MDBs were the first issuers, more than a decade ago, but the market needed issuers of all types to develop scale. This includes financial institutions and corporates.”

Converting new thinking into a capital-markets relevant trend will not happen overnight, though. Kāinga Ora’s Bligh tells *KangaNews*: “In the wake of COVID-19, we have got to a nexus point where action can reflect what the talk has been. The drive towards green and social funding is on a best intentions and best endeavours basis, though – and we have to confront the challenge that many ‘shovel-ready’ projects will be based on the old way of doing things. We need to recalibrate, and this may take time.” •

“In the wake of COVID-19, we have got to a nexus point where action can reflect what the talk has been. But we have to confront the challenge that many ‘shovel-ready’ projects will be based on the old way of doing things. We need to recalibrate, and this may take time.”

JASON BLIGH KĀINGA ORA – HOMES AND COMMUNITIES

INSIGHTS FROM THE *CORPORATE FRONT LINE*

Airports around the world have gone quiet as result of COVID-19, bringing corporate liquidity to the fore. **Brisbane Airport Corporation** was able to re-engage the Australian domestic market in late June for a deal it had been looking to execute prior to the crisis. The airport's head of corporate finance, **Warren Briggs**, speaks to *KangaNews* about the deal process and crisis management.

Brisbane Airport's A$850 million (US$590.5 million) deal comprised A$250 million of six-year and A$600 million of 10.5-year notes. Commonwealth Bank of Australia, MUFG Securities and National Australia Bank led.

The last few months have been tumultuous for the travel industry, including airports. What challenges has Brisbane Airport faced from a funding and liquidity perspective?

The process for this deal started in January, when we were targeting pricing some time in March. We have a domestic bond maturing in October and a bank facility maturing in November for which we were looking to source funding.

We had scheduled a roadshow in early March off the back of our annual EMTN programme update and elected to proceed despite the backdrop of an escalating situation with COVID-19. This was done as a combination of physical meetings complemented by telephone and video conference as new social-distancing measures were beginning to be implemented.

We had a good response from investors about the underlying airport credit. However, markets were displaying heightened volatility so we decided to put the process on hold.

The focus then turned to our liquidity position. Both Moody's Investors Service (Moody's) and S&P Global Ratings (S&P) published reviews of the airport sector, and Moody's in particular focused on Brisbane Airport's liquidity position in light of our upcoming maturities.

We had more than A$450 million of undrawn bank lines at the time but there was clearly a level of concern about how we would manage our liquidity requirements over the next 6-12 months.

In response, we went to our existing bank groups and within 2-3 weeks we had put in place a new, A$840 million, 18-month bank facility. This ensured we had a strong liquidity buffer to get through whatever would come out of the pandemic.

In April and May, we saw 95-98 per cent less passenger traffic as international and state borders were closed. This meant collapsing revenues in parking and transport, retail, and duty free.

Responding to the crisis, we took a hard look at costs and cut expenditure wherever we could. We dropped our capital-expenditure plans for financial year 2021 to A$90 million from A$470 million, for example. We also implemented a restructure of our hedge book to realise A$75 million of interest savings over each of the 2021 and 2022 financial years.

Moody's had put us on review for downgrade when the rest of the sector was on negative outlook. But addressing our liquidity position resulted in our rating being moved back into line with our peers. S&P also has the sector on negative credit watch.

What eventually gave you confidence to execute the deal?

We were watching closely for an opportunity to execute a trade ahead of our 30 June year-end. Operationally, we were seeing some positive signs, particularly in relation to domestic traffic. There was also some encouraging news coming out of the Virgin Australia sale process.

We had to update our disclosures, and this gave us the opportunity to re-engage with investors. Our performance has been tracking above our projected base case, which we were able to share with investors. This combined with a positive market backdrop gave us the confidence to push ahead with the deal. The trigger for us to proceed was the release of an S&P report reaffirming our credit rating at triple-B.

In light of the uncertain backdrop, we adopted a more cautious stance in approaching the market. This involved taking a couple of days of additional informal feedback from investors prior to launching an official indications of interest (IOI) process on 22 June. The response to this was very encouraging and we received more than A$1.5 billion of indicative interest.

This gave us the confidence to move forward with a formal transaction launch the next day. We were overwhelmed by the response and a diverse orderbook that reached around A$1.75 billion, providing us with good price leverage while allowing us to print our full volume requirement.

Why did Brisbane Airport opt to stay domestic with this deal? Were other options ever on the table?
We looked at Europe over the last couple of months as there has been a good flow of Australian corporates successfully going to the market and a lot of deals in the region. We had confidence that we could achieve the volume we wanted.

Price discovery was an issue in euros – but it was in Australian dollars as well, so this was not necessarily the deciding factor. What it came down to was execution certainty, which we felt was greater in the Australian market.

How much engagement did you have with domestic and offshore investors in the last couple of months?
We are always active with regular investor engagement and updates but this has ramped up since our February roadshow.

Investors have been very eager to understand the dynamics of the business. For example, one-third of Brisbane Airport's domestic traffic is intrastate, so we have been able to talk about the mining sector in Queensland and how FIFO [fly-in, fly-out] worker flow has been maintained through the crisis. This has sustained a level of traffic at the airport. There are differences between airports, which are important for investors to understand.

There has also been a lot of interest in the actions of various airlines, specifically their ability to scale down and now restart passenger routes. Virgin Australia is obviously a key customer

> "Investors here, and in Asia to an extent, will see more headlines than an investor in Europe or the UK. The story is easier to tell here because the investors are seeing more positive signs every day, notwithstanding what is happening in Victoria in late June."

of ours and investors have been eager to know how we view the voluntary administration process and how we have factored this into our forecasts.

They have also been interested in the additional levers we can pull if the recovery does not continue as expected – if there is a second wave or another unforeseen event and we need to take additional liquidity or expenses measures.

What insights can you share around demand for this deal: by investor type, geography and by tranche?
There was a difference in distribution between the six- and 10.5-year tranches. The six-year tranche had much higher participation from Asia, with around 30 per cent sold regionally and the balance to investors in Australia and New Zealand. The 10.5-year tranche was nearly 90 per cent allocated to Australia.

More than 90 per cent of the long-dated tranche was allocated to asset managers and other real-money accounts. Around three-quarters of the six-year tranche was allocated to these investors with a higher proportion of private banks and other investors.

There has obviously been a lot of pricing movement in the last couple of months. How did you go about re-establishing price guidance for this deal?
We had discussed internally the need to be pragmatic when it came to pricing. Clearly markets have moved wider. We had our April 2025 domestic deal as a pricing point. This has moved materially wider, on small traded volume, in recent months.

This gave some guidance for the six-year tranche, but the big question mark was over the 10.5-year tranche. In early conversations there was a large range, of around 100 basis points, for where investors saw fair value.

This is quite unusual in normal times, but it is where we started and is why we took a more considered approach with the interim step of IOIs to formalise demand and sharpen pricing. We had offshore markets in the back of our minds and were confident that where we would print in Australian dollars would be competitive if not better.

Finally, it was about pushing go and achieving the best pricing outcome. The focus was on execution certainty and getting a strong trade away for the volume we wanted. We always want the best price we can get but this time around it was slightly less of a focus. •

There is a lot of optimism around the domestic travel market, as well as the potential for a trans-Tasman bubble to open. We felt this story resonated more with the domestic investor base than European investors, which would not have as much visibility or understanding of our local circumstances.

Investors here, and in Asia to an extent, will see more headlines than an investor in Europe or the UK. The story is easier to tell here because the investors are seeing more positive signs every day, notwithstanding what is happening in Victoria in late June. The potential for a trans-Tasman bubble is important for us. In normal times, New Zealand provides a good portion of our international traffic so the reopening of these routes would be a positive development.

FEATURE

Corporates find more crisis funding options

The economy-wide impact of COVID-19 has affected Australian corporate borrowers in a host of ways. But access to funds has generally remained in place as issuers navigate a path back to some type of normality – even for those in the most affected sectors.

BY CHRIS RICH

Social-distancing measures, travel restrictions and the enduring potential for outbreaks have wrought havoc across the Australian economy. While the country appeared by the mid-way point of the year to be in a better place than many from a health standpoint, the worst of the economic impact may still be to come.

Unemployment jumped to 7.1 per cent in May from 5.2 per cent in March – when the lockdown restrictions were introduced, toward the end of the month. The increase was kept in check by people dropping out of the labour force altogether: the underutilisation rate, which combines the unemployment and underemployment rates, hit a record high of 20.2 per cent in May.

The federal government's A$70 billion (US$48.6 billion) JobKeeper programme – designed to keep employees attached to their workplace by providing A$1,500 per employee per fortnight – is scheduled to end on 30 September with no transition plan in place, by 1 July, for the estimated 3.5 million employees covered.

There is growing commentary that the end of JobKeeper could represent an economic cliff, where support – and thus the relatively buoyant level of economic activity during the mid-part of the year – falls away vertiginously.

On the other hand, the volatility from the first few weeks of the crisis has seemingly been all but forgotten as equity markets have regained most of their losses since the Q1 sell-off.

Likewise, offshore debt markets were replete with corporate issuance even in the weeks after the immediate shock of COVID-19, as wider spreads and – later – central-bank support for the credit market in key global jurisdictions attracted investors back to the sector. In a 24 June research note, S&P Global Ratings estimates a total of US$1.6 trillion in new debt had been issued in 2020, a rise of 60 per cent over the same period in 2019.

Relatively early in the second quarter, Australian corporates waded back into global bond markets – particularly euros (see p16) – and the bank debt market for their pressing refinancing needs. Meanwhile, an 18 May Westpac Institutional Bank research note says capital raising on the Australian Securities Exchange excluding IPOs topped A$9.2 billion (US$6.4 billion) in April 2020 – the most since May 2009.

QBE Insurance was the first Australian domiciled issuer to access the US 144A market since the escalation of the crisis, executing a US$500 million additional tier-one capital transaction on 5 May. It was later followed by Scentre Group, which issued a senior 144A deal (see p18).

The Australian corporate market took longer to adjust to new valuations and, market sources say, to clear an overhang of paper that was effectively blocking new issuance. With no corporate asset-purchase programme to assist, the market had to clear this backlog itself to prepare the path for new issuance.

However, Australia's corporate deal pipeline was relatively robust in May and June. The number of deals was low but outcomes suggest volume is available to trusted names.

Woolworths Group was the first corporate to execute a transaction in Australian dollars since the COVID-19 crisis commenced, on 13 May (see p20). Investor sentiment had improved by then, with key breakthroughs including a settled sovereign yield curve and liquidity, and successful bank transactions (see p32).

"I think banks are more mature, as a result of the financial crisis, in how they deal with a challenging credit environment. Banks have built relationships and do not want to throw them out the window over something that will ultimately pass."

OSKAR TOMASZEWSKI NEXTDC

The final full week of June saw corporate issuance pick up strongly, with just less than A$1.9 billion printed in transactions from Brisbane Airport Corporation, Optus Finance and WSO Finance. In the end, the second quarter of 2020 actually saw more corporate issuance in Australian dollars than the same period a year earlier (see chart 1).

There should also be plenty of money to be put to work by investors as redemptions reach close to A$9 billion in the second half of the year (see chart 2).

BANK DEBT

Perhaps the biggest trend of the COVID-19 crisis in corporate funding has been the ability of most investment-grade companies to come through the initial maelstrom without major liquidity stress. In this sense, lessons from the last crisis appear to have been learned – assisted by the initial stickiness and relatively quick snap-back of liquidity across debt funding options.

The global financial crisis left many corporate borrowers in a tricky spot as bank liquidity dried up, including some international banks dropping out of the Australian dollar market altogether.

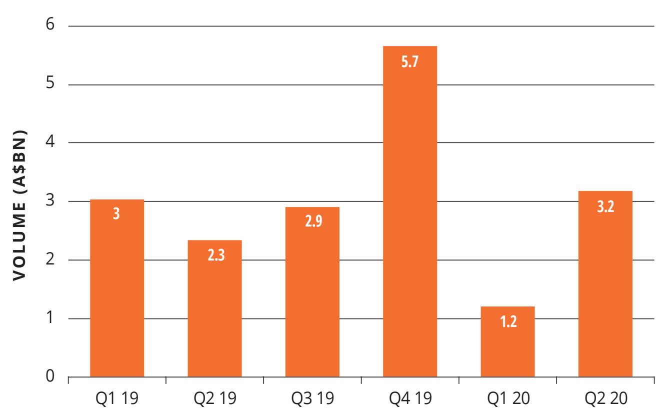
While COVID-19 saw equity capital issuance spike up across corporate Australia, the local loan market has not seen large-scale facility establishment and drawdown announcements akin to the trend among investment-grade corporates in the US and Europe, according to a 29 June Westpac research note.

Companies are refinancing and extending committed facilities, however. The Westpac research suggests sizeable corporate cash balances are available to provide support if needed – “a result of strong balance sheets and relatively limited capex programmes being undertaken by Australian corporates relative to historical levels”.

A flight of bank liquidity does not appear to have eventuated in the latest crisis, either. This is even the case for growth companies. For instance, Oskar Tomaszewski, chief financial officer at NEXTDC in Sydney, is optimistic about the firm’s ability to raise funds in the bank market.

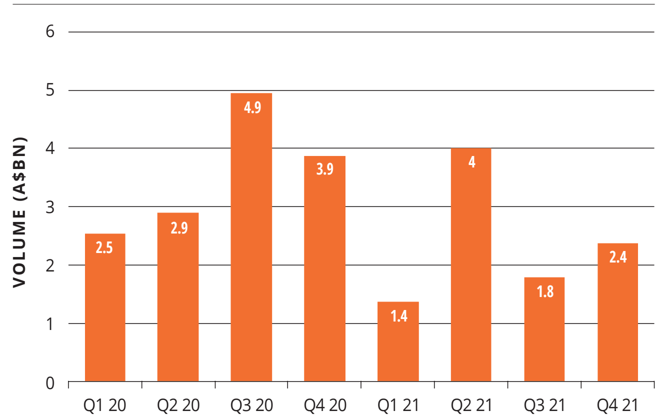
“In part my confidence is because of our strong business, but it is also because I think banks are more mature, as a result of the financial crisis, in how they deal with a challenging credit environment,” Tomaszewski explains. “Banks have built relationships and do not want to throw them out the window over something that will ultimately pass.”

CHART 1. AUSTRALIAN MARKET TRUE CORPORATE ISSUANCE



SOURCE: KANGANEWS 29 JUNE 2020

CHART 2. AUSTRALIAN MARKET TRUE CORPORATE REDEMPTIONS



SOURCE: KANGANEWS 29 JUNE 2020

AIRLINES AND AIRPORTS

The airline and airport industries have faced the brunt of the COVID-19 fallout as international and even domestic travel has been effectively banned under Australia’s lockdown. However, debt has been available to most borrowers even in this most challenged of sectors.

Virgin Australia has to date been the highest-profile casualty of the crisis as it entered voluntary administration on 21 April. Qantas disclosed extensive staff layoffs in late June, demonstrating that Australia’s largest airline is far from out of the woods itself. Even so, Qantas was able to secure A$1.1 billion in additional liquidity in a bank facility issued on 25 March.

> “We are thinking about funding if we don’t return to normality and our real concern is next year rather than this one. While liquidity is tough this year, it could be tougher next year – depending on what happens with borders.”
>
> **LAURENCE ZANELLA** UNIVERSITY OF SYDNEY

Sydney Airport also established A$850 million of new two- and three-year bank debt facilities, on 20 April. This is despite provisional data indicating a 96 per cent decrease in international passenger traffic and a 97 per cent decrease in domestic passenger traffic in the first 16 days of April versus the prior corresponding period.

The company has said it expects to see similar reductions in traffic for as long as restrictions on travel remain in place. Qantas announced on 25 June that it does not expect to fly international routes until mid-2021.

Michael Momdjian, Sydney Airport's group treasurer, tells *KangaNews* accessing liquidity was relatively straightforward as relationship banks remain supportive. He says the competitively priced deal was oversubscribed without onerous terms and conditions given the borrower's strong credit fundamentals.

Brisbane Airport demonstrated that capital markets debt, including in the Australian dollar market, can also be available to airport issuers. The company printed A$850 million of new bonds in late June with a healthy oversubscription (see p52).

Warren Briggs, Brisbane Airport's treasurer, tells *KangaNews* the company had more than A$450 million of undrawn bank lines going into the crisis but "there was clearly a level of concern about how we would manage our liquidity requirements over the next 6-12 months".

Before the bond deal, the airport secured an A$840 million, 18-month bank facility. "This ensured we had a strong liquidity buffer to get through whatever would come out of the pandemic," Briggs adds.

Entering debt capital markets seems to be off the table for Sydney Airport for the time being, despite Brisbane Airport's success. The reason is its relatively secure liquidity position.

At its AGM in May, Sydney Airport revealed it had a current liquidity position of A$2.7 billion comprising A$360 million in cash, A$1.8 billion of undrawn bank facilities, including the A$850 million of two- and three-year debt raised in April, and approximately A$600 million of new US private placement (USPP) bonds priced in February and settled in June.

Trevor Gerber, chairman of Sydney Airport, said after A$1.5 billion of debt maturities the remaining A$1.2 billion of liquidity is "more than enough to sustain operations for an extended period of time, even if the current operating environment were to persist for some time".

Momdjian says Sydney Airport is comfortable with its liquidity position since establishing its additional bank facilities and receiveing the funding from a USPP deal that priced as COVID-19 jitters were intensifying. He explains the additional liquidity buys the airport time to assess bond markets and provides a better story to tell investors.

Momdjian adds: "The uncertainty caused by COVID-19 has seen investors across our sector demand an additional spread on longer-dated bonds for what is expected to be a temporary event."

RETAIL IMPACT

Along with the airline, tourism and hospitality industries, the property sector has been one of the hardest hit. But, again, whatever is happening on the business front does not appear to have radically weakened access to markets or debt funding strategy.

David Rowe, treasurer at Stockland in Sydney, tells *KangaNews* the crisis has not changed the way the borrower thinks about its diversity of funding or its approach to market. Stockland's debt book contains a mixture of USPP, EMTN, AMTN, bank debt and commercial paper. Rowe says COVID-19 highlights the importance of a diversified funding portfolio and access to a range of debt options.

On the other hand, Rowe adds: "Market disruption from COVID-19, and the the potential for further deterioration, compelled us to increase our liquidity position."

As part of a market update on its third quarter results, Stockland announced an increase in available liquidity to around A$1.6 billion from A$850 million in February, after putting in place additional unsecured bank facilities totalling A$600 million and issuing a new 10-year HK$805 million (US$109.7 million) bond in February.

Moody's Investors Service, in a 24 June research note, suggested most Australian real-estate investment trusts (REITs) have sufficient gearing buffers to withstand likely property-value declines during COVID-19, reflecting the sector's overall conservative capital management. Declining property values, which are expected to drive up gearing for REIT portfolios, will largely reflect other credit metrics such as lower earnings and cash flow, the note says.

The retail component has been the most severely affected within the property sector and Stockland has the largest exposure to retail among diversified property companies. Moody's says, though, that Stockland has significant buffers within its covenants and will only approach its rating threshold if its retail property values decline by more than 30 per cent.

"The uncertainty caused by COVID-19 has seen investors across our sector demand an additional spread on longer-dated bonds for what is expected to be a temporary event."

MICHAEL MOMDJIAN SYDNEY AIRPORT

Releasing its third-quarter 2020 results on 13 May, Stockland acknowledged the numbers do not fully reflect the impact of COVID-19 on its business. But it added that there are signs of improvement in its April figures.

Stockland has A$250 million of bonds maturing in the next 12 months and expects to pay them out with its current liquidity. As a frequent issuer in the euro and USPP markets, Rowe says the company will continue to look for opportunities in these jurisdictions as they recover further.

HIGHER EDUCATION

The university sector is another that has been hard hit by COVID-19. Increasing demand from offshore for Australia's highly-regarded tertiary education system has led to a significant proportion of international students enrolling at universities around the country. In 2019, international student enrolments were just shy of a million according to the Department of Education, Skills and Employment. This is a roughly 50 per cent increase from 2009.

The closed national border has staunched this revenue stream. Meanwhile, the government excluded universities from the JobKeeper programme despite the international education sector contributing A$39 billion to the Australian economy in 2019.

Universities Australia, the peak body representing the sector, estimates universities could lose A$16 billion in revenue between 2020 and 2023. Australia's prime minister, Scott Morrison, announed a pilot programme to enable the return of international students, on 12 June, but there has been little other movement on getting international students back into Australia.

Laurence Zanella, treasurer at University of Sydney, says uncertainty around when international students will return has changed debt strategies. "We are thinking about funding if we don't return to normality and our real concern is next year rather than this one. While liquidity is tough this year, it could be tougher next year – depending on what happens with borders."

Consequently, University of Sydney is ensuring it has adequate liquidity via stand-by bank lines. The positive note is that this type of liquidity is available to higher-education borrowers. "We added to our existing bank lines and put additional ones in place just to give us extra liquidity and flexibility for 2021," Zanella tells *KangaNews*.

But he adds: "If you have an existing arrangement, it has been a lot easier to refinance or extend that facility. If you don't have an existing facility it is more difficult to get one in place, even with a relationship bank. There is more credit work required than there was six months ago."

University of Sydney has a A$200 million bond maturing in 2021, and Zanella says it is not looking to refinance it in debt capital markets at this stage.

PLANNING AHEAD

While Australia's public-health outcomes during the COVID-19 crisis have been among the world's best, at least in the first wave of the virus, events in June demonstrate that the path back to an earlier earnings profile is not guaranteed for most companies. A spike in cases of the disease led to a second lockdown in Melbourne at the beginning of July and slowed the process of reopening borders. While the initial phase was a short, sharp shock, companies are now confronting a longer-term change to their business profiles.

On the other hand, the crisis will produce winners. NEXTDC, a data-centre provider, says there has been no noticeable change to its sales pipeline as a result of COVID-19. In fact, the increasing use of online technologies during the pandemic is a tailwind.

NEXTDC raised A$863 million in equity over April and May, consisting of a fully underwritten A$672 million institutional placement of new shares and A$191 million through a non-underwritten share purchase plan.

In a 2 April Australian Securities Exchange announcement, NEXTDC said the funds raised will support its growth agenda, "including the proposed development of a new data centre in Sydney together with balance-sheet flexibility required to accelerate and expand a range of growth initiatives in line with recent and expected material contract wins".

Tomaszewski tells *KangaNews* NEXTDC's plans for expansion could not be serviced by issuing debt due to its capital requirements. It expects the equity raising will meet funding needs for the next two years.

Already, though, NEXTDC has turned its attention to extending its runway by upsizing its debt stack. But as an unrated corporate it faces a more challenging road. "We have seen investment-grade credit improving, and even almost back to pre-COVID-19 levels. The subordinated or noninvestment grade credit markets are starting to show stabilisation and the green shoots of recovery, but they are not yet as robust as where we see investment grade," Tomaszewski says. •

"Market disruption from COVID-19, and the the potential for further deterioration, compelled us to increase our liquidity position."

DAVID ROWE STOCKLAND

WA KEEPS ON ITS TOES AS LOCKDOWN END NEARS

Western Australia (WA) has had among Australia's best outcomes when it comes to the health aspect of the COVID-19 crisis, allowing it to project a target date for the lifting of all remaining social restrictions state-wide. **Ben Wyatt**, WA's Perth-based treasurer, discusses the state's economic response and outlook.

What sort of headroom did the state have coming into the crisis in the sense of capacity to support the local economy without immediately requiring a substantially increased borrowing requirement?
The government's disciplined financial-management and budget-repair efforts over the past three years have put the state in a strong financial position, giving it the financial capacity and flexibility to respond to COVID-19.

Moody's Investors Service confirmed in May that our efforts have put WA in a position of relative strength to respond to the current conditions and prepare for recovery on the other side.

Our responsible fiscal management has resulted in net debt being a massive A$9 billion (US$6.3 billion) less in the March 2020 quarter than forecast when we took office. This improved budget position has enabled us as a government to move quickly to put in place measures to support WA families and businesses as they have been affected by the COVID-19 pandemic.

Can you give highlights of the measures the state government has introduced to support the local economy through this crisis?
The impact of COVID-19 is being felt across the breadth of our economy. The WA government, like all governments in Australia, is looking for ways best to support households, businesses and community groups. We have to date announced more than A$2.3 billion in COVID-19 stimulus and relief measures for Western Australian households and businesses.

Key measures include a freeze on all household fees and charges in 2020/21, targeted energy subsidies for small business, charities and eligible households, payroll-tax reductions for small-to-medium businesses, low-cost liquidity loans for local governments and universities, commercial and residential rent support, assistance for affected sectors like hospitality and tourism, and a housing stimulus package to support the residential construction industry across WA.

Further announcements, including targeted investments in infrastructure, are expected to support the recovery of economic activity after the pandemic. More information can be found at www.mediastatements.wa.gov.au.

How significant is the forecast decline in revenue, and how significant is the state government's own decision to freeze household tariffs, fees and charges?
Although mining royalty collections have remained relatively resilient, this is expected to be outweighed by declines in other sources of revenue, including GST [goods and services tax] grants, payroll tax, transfer duty, land tax, vehicle licence duty and agency own-source revenues.

While a high degree of uncertainty still exists, Treasury modelling indicates total general government revenue over 2019/20 and 2020/21 is expected to be approximately A$1.8 billion lower than previously forecast. The decision to freeze household fees and charges at 2019/20 levels will have a budget impact of A$402 million over the forward-estimates period, but this is an important step in reducing cost pressures on households.

Nevertheless, with WA state government revenue less reliant on the GST and transfer duties than other states, the WA budget is comparatively better placed to weather the impact of the slump in revenues from these sources.

Staying on revenue, what is the WA government seeing in the commodity sector as a consequence of the shock to global demand?
The commodity sector remains a key driver of activity for the local and national economies. The WA government's decision to deem the mining sector an essential workplace in March has enabled this sector to continue to employ, mine and export commodities at a similar rate to pre-COVID-19.

This has allowed the sector to take advantage of strong prices for iron ore and gold in particular, supported by the lower-than-forecast Australian dollar-US dollar exchange rate. Strong export performance flows to the government in the form of royalties and payroll tax, and is essential in underpinning key domestic economic activity through employment, wages, household consumption and business investment.

How can WA exploit its relative good economic performance even as the overall trajectory remains weak?
The Q1 national accounts saw WA real state final demand rise 0.9 per cent in the quarter, which was the strongest of the states. The domestic state economy has grown in three of the past four quarters to be up 3.4 per cent year-on-year, which was also the strongest of all states and the fastest rate of growth since 2012.

Our March 2020 quarterly results – prior to the full impact of the social-distancing measures required to contain COVID-19 – showed that we were on track for our second consecutive budget surplus and a further reduction in net debt. I expect the full-year results to reflect a less positive set of financial and economic data, although there is ongoing uncertainty on the depth and duration of the effects of the pandemic on the global economy and how this will be felt across WA.

However, the results so far reinforce for me that the WA economy is more diversified – between mining, agriculture, services, manufacturing and construction – than some commentators might have appreciated, and we are thankful that not all these sectors have been adversely affected by COVID-19.

The parts of our economy that remain strong during this crisis are essential in providing us the platform to support the rebuilding of those sectors that have been adversely affected by COVID-19.

This platform includes underpinning our revenue base to support the capacity of government to respond to COVID-19, support for employment, and opportunity for the state to leverage the strengths of these industries to rebuild and grow new business opportunities.

WA is taking a conservative approach to reopening state borders even to domestic travel. Can you give an indication of the expected consequences for the state economy, for instance around lost tourism revenue, of a protracted hard state border closure?
Reopening the economy is a key priority for the government but must be balanced with protecting the health outcomes of our community. The whole world needs to find a way to live with COVID-19 while returning to an economy that is growing and supporting strong employment outcomes. It's a tight balancing act.

However, the efforts of Western Australians to adhere to strict social-distancing rules and our hard state border closure has allowed us to fast-track the easing of restrictions and reopen sections of our economy to get businesses back in operation and get people back to work.

How is the state government thinking about the point at the end of Q3 at which many federal support packages are due to expire?
This crisis continues to evolve – given the pace of change since the beginning of March, the end of September seems a long way away. The size and nature of federal and state government support will need to be constantly reassessed over the coming months as the situation unfolds.

To assist this, the WA government has established a State Recovery Advisory Group, with representatives from a wide range of business, industry and community groups to support the development of a state recovery plan. This will guide our efforts over the course of 2020 as we continue to respond to the situation.

It is also the case that both levels of government continue to announce measures targeted at addressing the impact of the pandemic and promoting recovery, with these initiatives set to run for some time.

What makes you confident that a response plotted during the acceleration phase in mid-March remains appropriate?
The initial impact of the COVID-19 pandemic on the Australian economy has been steeper and quicker than the financial crisis. Even if we are fortunate enough to have an equally sharp rebound, parts of our economy and community will still require assistance.

The WA government has consciously targeted relief measures to those areas of our economy most in need. Measures have also complemented those provided by the Commonwealth, which has greater fiscal capacity. The state government has also been mindful to retain sufficient financial capacity to deliver stimulus to return our economy to its pre-COVID-19 growth trajectory.

We are of course still moving through this global health pandemic and the risk is still present. There are also many variables that mean the recovery may move quickly in some sectors but more slowly in others. The focus and value of government support will need to be reassessed constantly over the coming months. Perhaps a silver lining to have come out of this crisis is the collaboration between all levels of government, industry and business to achieve the best outcome for Australians. •

"Perhaps a silver lining to have come out of this crisis is the collaboration between all levels of government, industry and business to achieve the best outcome for Australians."

QUEENSLAND FINDS STRENGTH IN ITS DIVERSITY

Queensland is among Australia's most diverse state economies. The state's treasurer and minister for infrastructure and planning, **Cameron Dick**, speaks to *KangaNews* about how this diversity is helping the state through the COVID-19 crisis.

What impact will the pandemic have on the budget?

Like other jurisdictions in Australia and around the world, COVID-19 has had a significant impact on Queensland's economy. Fortnightly employment and retail-sales data from the Australian Bureau of Statistics indicate Queensland's diversified economy may have spared it from some of the worst impacts. But we know the effects of the last few months may take years to recover from.

As the prime minister and the governor of the Reserve Bank of Australia (RBA) have said, the volatile economic circumstances we face make the normally difficult task of producing accurate forecasts all but impossible.

This is why no Australian jurisdiction will deliver a budget before October. Queensland's parliament will be in caretaker mode by 6 October ahead of an election at the end of that month, so I have committed to deliver a COVID-19 fiscal and economic review in September. This will take the form of the usual mid-year fiscal and economic review.

What measures has the state government taken to support the local economy through the crisis and into recovery?

Queensland was Australia's first jurisdiction to declare a public-health emergency for the "novel coronavirus", in January. Since then, we have committed more than A$7 billion (US$4.9 billion) to protect Queenslanders' health, jobs and businesses.

Measures taken include refunds, deferrals and holidays for payroll tax, refunds for land tax to be passed on to COVID-19-affected tenants, waivers of fees and charges at government-owned ports, grants and 12-month interest-free loans for small businesses, and targeted industry-assistance packages for tourism and aviation.

Our measures have been designed to complement each other and the support offered by other levels of government. For instance, almost 90 per cent of our 12-month interest-free loans has gone to businesses falling under the payroll-tax threshold and therefore would not benefit from that measure.

As restrictions ease and economic activity picks up, the government's focus is to unite and recover for Queensland jobs.

Tourism businesses in far-north Queensland were among the first to be supported by relief measures, in early February, when they were experiencing the downturn caused by a lack of visitors from China around the lunar new year.

Since then, we have implemented more initiatives to support regional tourism, including our bid for a strategic stake in Virgin Australia. The Palaszczuk government has set aside A$200 million and tasked our world-leading investment manager, QIC, to lead our bid to safeguard Queensland's interest in Virgin.

This is not just about retaining head office jobs in Brisbane, but about ensuring regional Queensland continues to have access to reliable, affordable, and competitive commercial air travel.

Given the likely absence of significant international tourism into 2021, tourism markets in regional Queensland need to know they have the commercial air services to bring domestic visitors to them. Aviation is essential to a viable tourism industry and the government has committed A$15 million to airline route support.

International investors may be particularly interested in the strategy behind Australia's state border closures. How are you thinking about the trade-off of economic and health outcomes?

If we look around the world, the economies suffering the most damage are those that locked down too late or lifted restrictions too early – and those that are having to lock down a second time are paying a greater price still.

After speaking to business operators and workers across Queensland, I understand the financial and emotional pain caused by COVID-19 restrictions. But the sacrifices made have saved the lives of potentially tens of thousands of Queenslanders and, as restrictions continue to ease, we are placed as well as anywhere in the world to get on with the task of economic recovery.

Does the COVID-19 crisis mean having to ease back on infrastructure investment plans?

Just as government had a vital role to play in protecting health and jobs through the early months of the pandemic, it has a vital role to play in recovery and rebuilding the economy.

The Queensland government has announced a A$51.8 billion infrastructure pipeline over the next four years, including an accelerated works programme of A$400 million to support our regions.

We have announced a further A$200 million COVID-19 recovery tranche of our Works for Queensland programme, to support local governments in building productive infrastructure.

Our Unite and Recover for Queensland Jobs strategy is well underway, recognising the need to bring forward vital, shovel-ready public infrastructure projects to support the economy as the private sector recovers.

How are demand and activity in Queensland's other major economic sectors, such as agriculture and mining, playing out through the crisis?

Queensland's traditional economic diversification through industries like mining and agriculture has helped cushion it from some of the worst impacts of COVID-19.

Mining and agriculture have responded to the challenges of workforce management and unstable international trading conditions. These industries have once again proved why diversification is a vital element of the Queensland economy.

Total jobs in Queensland's agriculture industry have fallen by less than 3 per cent since mid-March, compared with Australia-wide losses of 9 per cent. Mining and agriculture have posted strong jobs growth in recent weeks, supporting Queensland's recovery and backing our government's commitment to developing more jobs in more industries right across the state.

Economic crises often bring significant opportunities for new industries. Are there any in Queensland that the government is particularly keen to promote?

The disruption to international supply chains has demonstrated why it is important for Australia to increase its advanced manufacturing capacity. Earlier this year, Queensland was recognised as a global advanced manufacturing hub by the World Economic Forum. This designation recognises the ingenuity and global potential of Queensland's A$20 billion sector.

Our jobs plan also recognises and seeks to support the strengths of Queensland's emerging industries, including renewable energy, new-economy minerals, hydrogen, mining equipment, technology and services, biofuels, the screen industry, and biomedical and health services.

How is the state government thinking about life after federal government support is due to run out in Q3?

The federal government has stated it will reveal its intentions for the future of the JobKeeper programme in July. I have written to the federal treasurer to request that the JobKeeper programme is preserved beyond Q3 and extended to other industries. With the RBA governor committing to do whatever it takes until progress is being made towards full employment, it is incumbent upon all policymakers to use the levers available to ensure a comprehensive recovery. •

QTC ADAPTS TO A *CHALLENGING ENVIRONMENT*

Queensland Treasury Corporation (QTC)'s chief executive, Philip Noble, discusses the impact of COVID-19 on the state's borrowing requirement and the status of its green-bond programme.

Prior to COVID-19, we were in a strong funding position, having completed our indicative A$9.9 billion (US$6.9 billion) borrowing programme and having raised an additional A$2.1 billion to pre-fund future years' programmes.

To further strengthen our position ahead of the potential budget impacts of COVID-19, we were active in reverse enquiry particularly in April and May. Between the release of our borrowing programme on 11 June 2019 and the end of June 2020, we raised a total of A$20.5 billion of gross funding.

The Queensland government will publish its COVID-19 fiscal and economic review in September 2020. This will report the impacts of COVID-19 in the 2019/20 financial year and will revise the forecasts for 2020/21 and the forward estimates. Following this, QTC will announce its indicative 2020/21 borrowing programme.

Our environmental, social and governance (ESG) strategy to date has been to increase awareness of the environmental pillar of ESG and the projects and initiatives being undertaken by the government to support the state's transition to a low-carbon economy.

Since its launch in 2017, we have continued to look for ways to enhance our green-bond programme. In 2019, we increased liquidity for investors by becoming a programmatic issuer of Climate Bonds Initiative (CBI)-certified green bonds. This streamlined the issuance of our new line in 2019 and enabled QTC to be the first semi-government issuer to tap a green bond.

We are proud to have been recently recognised in the CBI's fifth annual green-bond pioneer awards as the issuer of the largest subnational deal of 2019.

We have monitored the increase in social-labelled funding because of COVID-19. Our investors are aware of the importance the Queensland government places on its social responsibilities – such as health, education and job security – and of QTC's role in funding these requirements through our traditional bond programme. The current spotlight on social spending has further strengthened their understanding of this.

As the landscape continues to evolve in ESG issuance, QTC will remain adaptive to investor feedback and market developments across a range of factors. This will include whether a standalone social-bond programme would complement our green-bond offering.

VICTORIA CONFRONTS A CRISIS FROM A ROCK-SOLID BASE

Victoria was arguably the best performer among Australia's states going into the COVID-19 crisis. Despite significant local and national challenges, the state's Melbourne-based treasurer, **Tim Pallas**, says its goal is to chart a path back to positive outcomes in future.

Victoria came into the COVID-19 crisis in a strong budget position with plenty of headroom in its debt position. How has the position changed since the onset of the crisis?

Victoria was in a strong financial position before the coronavirus crisis. The state's March quarterly financial report stated that, except for the extraordinary bushfire and pandemic events, the state's budget would have remained in surplus for 2019/20.

The government has responded to the health crisis with investments to secure the survival of businesses and commence economic recovery, as well as support for the health system.

Through the recently passed *Appropriation (Interim) Bill 2020*, the Victorian government secured the authority to spend A$24.5 billion (US$17 billion) in emergency funding to save lives, support jobs and businesses, and set Victoria up to recover from the pandemic over the next two years.

The A$24.5 billion amount was developed to ensure there was adequate capacity ahead of the 2020/21 budget to deal with a health emergency that was uncertain in its size and complexity.

It may not be that the full A$24.5 billion will be required. The economic recovery will require further investment over the coming months and as part of the 2020/21 Victorian budget.

Can the state government maintain its commitmnet to infrastructure investment in the COVID-19 era?

The Victorian government's infrastructure pipeline has always been a cornerstone for Victoria's economy. Now, as we face the biggest economic challenge in generations, the government's A$2.7 billion Building Works package is investing in thousands of additional shovel-ready projects and creating jobs across the state.

While the government is continuing to deliver its multi-billion dollar Big Build transport construction agenda, the Building Works package is orientated towards smaller projects that Victoria needs, which can get going and get thousands of people back to work.

All businesses that contract with the Victorian government to deliver Building Works projects are required to seek new employees through Working for Victoria in the first instance. Working for Victoria assists businesses to employ Victorian jobseekers, including people who have lost their jobs as a result of COVID-19, in roles that support our community and help Victoria's recovery.

Building Works projects include new and upgraded schools, a big boost for public and community housing, resurfacing and patching roads, regional track improvements, railway station repairs, and upgrades at tourism destinations and local sporting facilities.

Together, these projects will create 3,700 direct jobs across a diverse range of skill areas – including construction workers, painters, plasterers, gardeners, engineers, plumbers, electricians, maintenance workers and administrative staff. Thousands more jobs will be created across our supply chains, while also pumping extra dollars back into our economy. The government has also established a A$180 million planning and acceleration fund to ensure it keeps momentum going as we continue to rebuild our economy.

Building and construction are critical to our recovery from this pandemic, to resurrecting our economy and creating the jobs that let families breathe easier, that let young people dream of the future and that allow us all to enjoy life. There is no doubt that these are challenging times. But Victoria is as well placed as it could be to face them, with years of growth and prosperity behind us.

How significant is revenue decline and what is the state government doing to shore up revenue?

There is no doubt that COVID-19 will have a substantial impact on government revenues around the country – including here in Victoria. The government has already announced substantial payroll-tax relief of more than A$550 million to help tens of thousands of businesses get through this crisis.

As a result of coronavirus and the strong measures governments have put in place to slow the spread of the virus and save lives, we have seen a substantial fall in employment – and an even larger fall in the number of hours worked. The combined effect on payroll-tax revenue will be significant.

The Victorian residential property market was improving at the start of the year, but the pandemic has significantly disrupted property-market activity and reduced transaction volume. The impact is negatively affecting land-transfer duty collections.

What the government will have no part of is driving the economy down further by imposing unwarranted austerity measures at the worst possible time, in a vain attempt to hold on to revenue forecasts that no longer reflect the reality we face. Instead, this government will look at the appropriate balance of taxes required to fund the services and infrastructure Victorians expect and deserve, while supporting the economic recovery.

Consistent with our record of tax reform, we will continue to look for opportunities to enhance the state's productivity and competitiveness – and to build a better future for all Victorians.

S&P Global Ratings (S&P) now has Victoria on negative outlook. Other states have managed the loss of triple-A status – how important is keeping it to Victoria?

We're pleased Victoria has retained its triple-A credit rating, which is in line with that of the federal government. S&P put the state on negative outlook because the arrival of the COVID-19 pandemic in Australia and the associated government responses are severely disrupting Victoria's economy and putting pressure on the state's finances.

The triple-A credit rating remains an important financial-management objective of the government. Maintaining a triple-A rating ensures that the state's finances are in a strong position and the state has access to funding at the lowest possible cost

While no jurisdiction will be immune to the economic challenges coronavirus is creating, our strong financial management means we are well placed to rebuild and recover from this pandemic. The government will maintain a responsible budget and debt-management strategy to ensure the state maintains the highest possible credit rating.

A main concern of analysts is what sort of gap might be exposed if the federal government's "bridge" runs out around Q3 this year while the economy is not yet in full recovery mode. How is the state government thinking about this issue?

The governor of the Reserve Bank of Australia (RBA) has suggested the economy will need support from monetary and fiscal policy for some time, noting there are "certain risks" in withdrawing support too early. The RBA has said it will keep monetary support going for a long time and it is hopeful fiscal support will be maintained too, especially if the economic recovery is drawn out.

Here in Victoria, we agree there is a clear case for extending the support being provided to Australians, such as JobKeeper. We will continue to work with the Commonwealth government through the national cabinet and the treasurers' forum, and to advocate for economic support that will help the Victorian and Australian economies recover from this crisis. Additionally, we've long led the call for the Commonwealth to fast-track infrastructure spending.

We are also working hard to attract investment in high-growth and high-value industry sectors like digital technology, advanced manufacturing, clean energy, agri-food, and health and life sciences. Boosting productivity is key to ensuring Australia weathers the current global uncertainty and returns to economic growth over the long term.

To drive economic growth, it is vital Victoria has a committed partner in Canberra.

What makes the state government confident a policy response plotted during the acceleration phase of the pandemic in mid-March remains appropriate to what may be a less significant public health crisis than was first feared?

We remain vigilant and agile in our response, as evidenced by the latest restrictions. Decisions taken in March are constantly being reviewed based on the latest health advice and the best economic advice.

The strong measures governments around Australia took to slow the spread of coronavirus have been very successful by international standards, but we know the pandemic is not over and there is no room for complacency.

We also know that these strong measures have had significant impacts on our economy. While updated forecasts from the Commonwealth government and International Monetary Fund suggest the economic downturn may not be as severe as first feared, Australia is still experiencing its first recession in almost 30 years – with one of the steepest falls in economic activity on record.

The government is determined to do what it can to help Victorian businesses, households and workers survive this crisis. We also want to ensure business can recover in a sustainable way. We want to lift businesses out of this negative economic environment so we can continue to thrive as a state on the other side of the pandemic. •

"What the government will have no part of is driving the economy down further by imposing unwarranted austerity measures at the worst possible time, in a vain attempt to hold on to revenue forecasts that no longer reflect the reality we face."

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

TCORP'S TOOLKIT EXPANDS TO MEET GROWTH IN FUTURE FUNDING NEED

New South Wales Treasury Corporation (TCorp) has managed a growing funding task through the various Australian and international crises of the last year. **Fiona Trigona**, head of funding and balance sheet at TCorp in Sydney, discusses the tools that will enable the state treasury corporation to continue managing a higher call on debt capital markets.

New South Wales (NSW) has been at the forefront of a clutch of crises over the past 12 months, including the drought, summer bushfires and most recently COVID-19. How has this series of events influenced funding conditions for TCorp and how have you responded as an issuer?

At the end of 2019 and start of 2020, the biggest concern was the bushfires. In November 2019, we launched our sustainability bond a day later than planned because there was a catastrophic bushfire warning on the day we intended to launch. There had never been a catastrophic warning in NSW before, so we did not feel it was appropriate to launch the deal on that day.

When we did launch the transaction, however, investor demand was very strong and we were able to issue A$1.8 billion (US$1.3 billion).

The bushfire season worsened after this. We travelled in Europe in January and February 2020 and the first week was dominated by talk of bushfires. Investors were very interested in what the NSW and federal governments were doing in response. Many felt there were mixed messages coming from the federal and state governments.

In the second week of the trip, coronavirus – it was not even named COVID-19 then – came to the fore. This really dominated the conversation. Operationally, we became very aware of where we were in the world at that point and our attention shifted to getting home.

In the week we returned, investors were interested in the future impact of COVID-19 on NSW state revenues, perhaps more than elsewhere, via the tourism and education sectors. Of course, it soon escalated and became a concern worldwide.

Do you have a clearer view of what the eventual impact of COVID-19 will be on state finances, and hence TCorp's funding requirement?

NSW Treasury has released its expectations on the impact of COVID-19, which is for an initial A$9 billion hit to the budget. This is why we sought quickly to raise an extra A$10 billion in April and May while the other states also raised similar amounts. This current financial year we have now raised A$29 billion.

It is difficult to forecast the eventual impact because no-one has had to forecast this type of scenario before. We will not fully know what our ongoing funding requirement is until the release of the state budget in October 2020.

TCorp issued record volume in April and May to meet the immediate requirements of COVID-19. How was such a large volume achieved in a turbulent primary market?

We needed to be flexible and nimble. The RBA [Reserve Bank of Australia] began buying government and semi-government bonds in late March. This improved market sentiment and gave us confidence to issue in primary markets.

We were open-minded to funding opportunities – including choice of format. TCorp had not issued an FRN [floating-rate note] for a few years going into the crisis, for instance. But this is what investors were buying at the time and we believed it was crucial to issue into investor demand.

> "We have been able to meet Japanese demand with Australian dollar transactions at 2037, 2041 and 2042 maturities. These have also lengthened our debt profile, which was important given the majority of our issuance was less than six years in tenor in the early stages of the crisis."

Our new 2023 FRN and 2024 FRN increase were the first syndicated semi-government deals executed in the Australian dollar primary market since the crisis hit. After this, we saw an increase in reverse enquiry. The increased investor engagement allowed further issuance, including a new 2027 FRN.

Pleasingly, we then had long-dated interest from Japanese and European investors. We issued in euros in February, which was the first time we had issued in that market. We have been able to tap this source of funds further to issue around A$300 million equivalent.

We have been able to meet Japanese demand with Australian dollar transactions at 2037, 2041 and 2042 maturities. These have also lengthened our debt profile, which was important given the majority of our issuance was less than six years in tenor in the early stages of the crisis.

Is curve extension and hitting offshore demand going to be an ongoing focus for TCorp as it embarks on a higher funding task going forward? Would you consider issuing more in currencies other than Australian dollars and euros?
Definitely. It all hinges on the swap and whether the swapped-back cost is comparable to our domestic curve. Issuing in euros currently works but we will continue to assess other opportunities as diversity of funding sources is extremely important.

Investor relations is going to be a vital part of managing this task. How is TCorp looking to stay engaged in a world where investor roadshows are presumably impossible?
The investor base is extremely important to us. We were on the road earlier this year visiting investors in Europe, the UK and Dubai. We also went to the US and Japan last year. We now have the difficult task of maintaining contact with overseas investors while not being able to travel.

It is a key challenge to stay in front of investors and we want to work with investors on the approach that works best for them, whether this is through webinars, one-on-one video conferences or calls. We want to be as open as we can. We will use a different medium from what we did previously, but investor relations remain paramount in this new world.

Sustainability-linked financing is a tool TCorp has already established. Will projects being undertaken by the government greatly increase the potential pool of assets that could be used in labelled deals?
TCorp's sustainability-bond programme was established to be as flexible as possible and to cater for both green and social assets. The COVID-19-related projects that form part of the NSW government stimulus package could be included in the asset pool for our next sustainability bond.

We need to ensure our reporting meets the high standards investors require. The integrity of the programme is very important to us.

Can you elaborate a bit more on this reporting and how TCorp ensures the integrity of it?
We have a strong governance structure in place for the programme. It includes an asset-identification group and a reporting group. We meet monthly to discuss potential assets that could be added to the pool before seeking approval from the NSW sustainability committee.

All assets are scrutinised in order to ensure ongoing reporting can be achieved. We released our first annual sustainability-bond programme report last year and the level of detail was well received by investors.

Do you think the importance of sustainability in funding is reaching an inflection point with investors, in the sense that there may soon be tangible funding benefits for institutions that are actively addressing these issues?
I do. This became apparent particularly through meeting investors in Europe and the UK. Some investors we met assign an ESG [environmental, social and governance] rating to issuers that informs the credit work they do.

Some are looking to be compensated if borrowers do not meet a certain ESG standard. Others would just exclude borrowers that did not meet their required standards altogether.

It is not just a matter of NSW having a strong sustainability programme. Investors will look at what NSW is doing more broadly and assign ratings. From investor feedback, our ratings are generally high – and this provides us with a good source of funding.

COVID-19 has been the main concern for investors and issuers in recent months. But are you finding, with market conditions settling, that the message around sustainability is cutting through even more now?
There is a lot more focus and investors are looking at what issuers are doing in this space. We are seeing increased demand from domestic and offshore investors and we will be looking to issue off our sustainability-bond programme again in the new financial year. •

"It is not just a matter of NSW having a strong sustainability programme. Investors will look at what NSW is doing more broadly and assign ratings. From investor feedback, our ratings are generally high – and this provides us with a good source of funding."

COPUBLISHED **ROUNDTABLE**

AUSTRALIAN GOVERNMENT-SECTOR ISSUERS **RIDE THE WAVES OF COVID-19**

In June, **Westpac Institutional Bank** and *KangaNews* brought together the biggest issuers in the Australian government sector to discuss a rollercoaster ride in markets since the end of March. The issuers describe a relatively straight-line improvement since the thrills and spills of the March-April period, with returning investors supporting increasing issuance volume and liquidity at extended tenor.

PARTICIPANTS

■ **Jose Fajardo** Head of Funding and Liquidity QUEENSLAND TREASURY CORPORATION ■ **Kaylene Gulich** Chief Executive WESTERN AUSTRALIAN TREASURY CORPORATION ■ **Andrew Kennedy** Director, Treasury Services SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY ■ **Justin Lofting** General Manager, Treasury TREASURY CORPORATION OF VICTORIA ■ **Rob Nicholl** Chief Executive AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT ■ **Fiona Trigona** Head of Funding and Balance Sheet NEW SOUTH WALES TREASURY CORPORATION

WESTPAC PARTICIPANTS

■ **Andrew Barrelle** Executive Director and Head of Bond, New Zealand and Inflation Trading ■ **William Grice** Head of Institutional Sales ■ **Damien McColough** Head of Australian Dollar Rates Strategy

MODERATOR

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

Davison How would issuers summarise market access and conditions over the course of the COVID-19 crisis?

■ **NICHOLL** In March, during the heat of the dislocation, the only thing we could access was the Treasury notes market. We got a few small bond tenders away but these did not reflect any meaningful access to the market. I think it was the first time the AOFM [Australian Office of Financial Management] had ever faced anything like this – it was totally unprecedented.

It is interesting to think about how quickly the market was cleared once the RBA [Reserve Bank of Australia] commenced its operations. It announced that it would start clearing the market before it actually announced the policy of yield-curve control.

Once the RBA started it took several weeks for the market to begin to return to any sort of normality. As one would expect in circumstances like this, we had disengagement from offshore investors. These are often the last to return to the market.

We also saw a strong aversion to duration risk at this time. Once we regained access to the market it was only in the short end and it was some while before we could work our way out to the 10-12 year part of the curve. I would argue that the very long end of the curve is now trading again and has been for 3-4 weeks, but not yet with sufficient liquidity for us to be active.

There is still some recovery to go. Our lack of access in the long end could be due in part to the fact that the market is expecting us to bring a new 30-year benchmark at some point. This seems to be hanging over the market, unfortunately.

Davison Has the recovery progressed in a reasonably straight line or have there been bumps along the way?

■ **NICHOLL** It has been a fairly straight-line experience. We have done two syndications, for 2024 and 2030 maturities, and both required a new-issue premium beyond what we would have been willing to pay prior to COVID-19. These both came when there was still some turbulence in the market.

As we went through April and May, we began to get more meaningful offshore-investor engagement. This was a gradual process, but I would say it has been all in one direction – improvement – from the commencement of the RBA's bond purchases to now.

Davison How do the state borrowers assess market conditions over the last couple of months?

■ **FAJARDO** Our experience was similar. Diversity of funding access was heavily affected after the emergence of COVID-19. The demand for our bonds was reduced to a relatively small number of investors – including bank balance sheets focused on short-dated issuance.

The domestic real-money accounts that were major supporters prior to COVID-19 became focused on liquidity, as we all were. They were forecasting redemption profiles and superannuation withdrawals while offshore investors localised their investments, similar to what happened during the financial crisis.

While the investor base in March and April was shallow there was an enormous amount of issuance during this time – close to A$30 billion (US$20.8 billion) across the semi-government sector. This was done at wider spreads to ACGB [Australian Commonwealth government bond] and with greater new-issue concessions than we had seen previously.

Since late April, we have seen broad-based investor demand come back across the semi-government sector. This has increased our ability to access the market and vastly improved issuance conditions, including for semi-governments in the 20-year part of the curve.

QTC [Queensland Treasury Corporation] was in a fortunate position entering the crisis as we had completed our indicative borrowing programme and raised approximately A$2 billion in additional funding. As a result, we did not have any large liquidity requirements going into the crisis.

■ **KENNEDY** SAFA [South Australian Government Financing Authority] completed its 2019/20 financial year funding programme in February so we did not need to be an aggressive issuer. We only have a small programme at the best of times, anyway, so we have some flexibility around market access.

Conditions were very constrained but this has eased substantially with the support provided by the RBA. As conditions have improved we have seen the states with the largest funding requirements able to meet their needs including via points further out on the curve, in larger volumes. This is a welcome development.

In early April, when we accessed markets via a public transaction, we were focused on building a trade with the investors that came to us with requirements. Our recent public

> "As we went through April and May, we began to get more meaningful offshore-investor engagement. This was a gradual process, but I would say it has been all in one direction – improvement – from the commencement of the RBA's bond purchases to now."
>
> **ROB NICHOLL** AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT

FOREIGN-CURRENCY OPTIONS

Larger funding tasks in the wake of the COVID-19 crisis make foreign-currency issuance a more plausible prospect for semi-government issuers. But it is still not likely to emerge in benchmark format.

DAVISON At the start of this discussion, Jose Fajardo alluded to the availability of foreign-currency markets as a fallback liquidity source for semi-governments. How close are issuers to being willing to do benchmark-sized foreign-currency issuance?

FAJARDO Our position hasn't really changed – it comes down to whether there is a capacity issue for Queensland Treasury Corporation's issuance in Australian dollars. I don't see one right now.

We also look at relative value compared with our domestic curve. The 3-10 year part of the curve in US dollars is still well away from domestic pricing and we would have to see this move substantially to look at benchmark offshore issuance.

However, I think it is fair to say the pricing hurdle to undertake offshore benchmark issuance has gone down a little since the COVID-19 crisis. When you see a period where only short-dated funding is available in Australian dollars while the US market is still open, be it at a price, you may be more comfortable to pay a slightly higher price than before to have a foothold in those markets.

TRIGONA It is worth mentioning that we can achieve very long-dated funding in offshore currencies that we still don't get access to in the Australian market. Our new euro bond is a case in point – it has a 30-year tenor. Being able to issue in foreign currencies adds to our funding mix but, most importantly, it gives us the duration we are looking for. Since the crisis, we have been able to issue in the longer end – we have issued A$1.6 billion (US$1.1 billion) in 17 years or longer, including the equivalent of around A$300 million in euros.

We will do more of this issuance if we can because, at current rates, we are able to swap this into very good funding levels for our borrowing clients. It won't be benchmark per se – it's about using another tool to extend our duration.

LOFTING We have been doing a little in the euro market. Our view has always been that offshore funding would need to provide a volume, duration or pricing benefit we can't get at home. In recent times that has been available in 30-year euro deals. I think Jose Fajardo describes it well when he says the hurdle to offshore issuance is now lower – as long as it provides a duration benefit and it swaps back attractively to our Australian dollar curve we will look at it.

GULICH Western Australian Treasury Corporation is very similar to the others – we keep options open through running EMTN and ECP programmes, and we monitor offshore opportunities closely. To date they haven't made sense relative to Australian dollar opportunities. A lot more components would have to move in the right direction for it to stack up relative to other options. We are expecting more market challenges over the coming period, though, and we reserve all rights!

transaction was centred around further development of risk-free-rate issuance into longer tenor, again based off specific investor demand.

With the RBA's support remaining in place and rates – especially short-end rates – remaining low, a lot of confidence has built around the rates market for issuers and investors alike.

LOFTING We were similar to some others in that we had completed our funding requirement for the 2020 financial year before COVID-19 hit. We then began getting early information from our Treasury on the possible expenditure requirements as the government had to scale up the health system potentially to deal with thousands of COVID-19 cases.

We realised pretty quickly that we needed to stay ahead of the game with our funding. We were quite aggressive with our issuance early on, but only via private placements. We never felt comfortable enough that a public transaction would be well supported so we went with what we deemed to be the less risky option.

As Jose Fajardo says, early on the pool of investors was very shallow. But there were still some deep pockets we could tap.

Our first deal was a floating-rate note (FRN). After this, we progressively moved to longer-dated, fixed-rate issuance. We ended up issuing more in a two-month period than we have ever issued in a year, so it was very significant scale for us. We were getting volume and a maturity profile we were comfortable with so we did not feel it was necessary to issue in the public market.

TRIGONA The crucial turning point was when the RBA stepped in. Its support in buying government and semi-government bonds brought back investor confidence and allowed us all to access markets, which was critical given the volume we all needed to issue at the time.

The reason we felt comfortable entering the public market when we issued our 2023 FRN and 2024 benchmark increase was because of the support the RBA had provided in freeing up markets and the proactive engagement of some larger ADIs [authorised deposit-taking institutions]. Clear communication with our panel banks was especially important during this period.

GULICH The market was incredibly dysfunctional for a few weeks. We could access short-dated liquidity but relying on this is not ideal in the longer term. We saw the RBA come in with size which stabilised market sentiment. Towards the end of May, the market had returned to the point where we were comfortable to raise longer-dated funds.

It has been a rollercoaster. But it is good to be where we are now after what was a painful, if relatively short, period of time.

Davison What is the state of demand for Australian high-grade bonds in late June?

GRICE It has felt like a long 3-4 months. Going back to March, the emerging crisis was compounded by the fact that there was yet to be any guidance on monetary and fiscal policy, and that we were heading into the futures roll.

We were beginning to see what we have experienced in other crises: offshore investors returning to their core markets. There was significant liquidation and deleveraging from offshore real money and hedge funds. This was exacerbated locally by the fact that domestic fund managers were concerned about asset reallocations that were pending on the collapse of the equity market.

Later, the retreat of investor liquidity was compounded by the government decision to allow early access to superannuation, which also meant local funds needed liquidity. This continued until the RBA gave some guidance around its plans to buy bonds in the secondary market as the marginal investor and to cut the cash rate to 25 basis points.

The relative value of Australian dollars for global investors has changed. First, the currency collapsed – which was exacerbated by domestic superannuation funds re-hedging offshore asset exposures.

Then 10-year yield differential to the US went to 35 basis points over from 75 basis points under very quickly. This led to re-engagement from offshore investors in April and May. We were seeing this in nominal and inflation-linked bonds as Australia's nominal and real yields looked attractive again globally, as did the currency. The RBA had also stepped in to buy enough of the slack on trading books that we could better facilitate customer risk locally and offshore.

By late March and early April, all the issuers had access to markets and there was capital to be deployed. ADIs were some of the first movers stepping in to buy semi-government bonds. Looking at our high-level flows, there was good buying in January and February, an aggressive switch to net selling in March, and then we have seen buying slowly return in the last couple of months.

BARRELLE It is worth emphasising the package of measures in the RBA's QE programme. It really was a package, and was well advised. The cash-rate target, yield-curve control and bond buying have all worked in the same direction. This gave issuers, investors and market makers confidence to come back.

From the trading desk, having repo volume and price guaranteed was important to provide surety of funding. This allowed us and other market makers to take on excess selling.

RBA ROLE

Davison The RBA has been able to taper its bond purchases quite quickly. Are market participants confident central-bank intervention will not need to become a permanent fixture in the market?

MCCOLOUGH The RBA has two reasons for implementing its asset-purchase programme: to target three-year ACGB yield of around 0.25 per cent and to restore market function. It gets two ticks for these.

Will Grice mentioned shifting relative value globally in favour of Australian dollars. I think this has meant more marginal investors coming in – so we should not need the RBA to continue to access its own balance sheet.

A big part of the success so far is that there was not a volume target for bond purchases but a level target. The market is very comfortable that the RBA will do what it needs to achieve its goals. This is not jawboning but the messaging is strong and it means going forward the RBA should need to do less rather than more.

Davison Several issuers have already mentioned the importance of the RBA's intervention. How did the reserve bank's role assist the return to benchmark issuance?

KENNEDY When we went to the market in April it was a day-by-day proposition as to whether we could issue and get the traction required to print a transaction that would not be detrimental to the sector at that point.

We had to pick the right time to show there was enough confidence to facilitate access to public markets – and this was based on external factors in markets and, more importantly, the direct policy action from the RBA. We felt the time was right by the end of March and we issued in early April.

GULICH It was always our intention to bring a new 2031 benchmark bond to the market – this was originally planned for March as part of our refinancing plans for our July 2020 maturity. Very early in March, though, we realised this would not be a good outcome for anyone.

We kept a very close eye on the market and we saw the impact of the RBA activities in soaking up excess supply. There was widespread sentiment that the RBA had supported the market early in size and with the stated intention to keep being

"If excessive pressures on our health system had emerged there is no question all our health departments would have required immediate access to funding to upgrade their day-to-day operations to deal with a pandemic. I think we all accredited ourselves well in being able to provide this."

ANDREW KENNEDY SOUTH AUSTRALIAN GOVERNMENT FINANCING AUTHORITY

THE ROLE OF *GSS BONDS*

Australia's government-sector issuers do not expect radically to increase their issuance of green, social and sustainability (GSS) bonds. At the margin, though, there may be room for a greater social component of existing and new programmes.

DAVISON One of the constraints on the issuance of labelled GSS bonds has been the perception by some issuers that this type of issuance would come at the cost of liquidity in their mainstream benchmark programmes. To what extent could GSS issuance provide additional capacity to larger funding tasks?

■ **FAJARDO** We have approximately A$6 billion (US$4.2 billion) in our green-bond project pool and we have close to A$2.5 billion of green bonds on issue. So we certainly have capacity for further issuance.

We are seeing a lot of interest and enquiry from domestic and offshore investors for our green bonds so it's more likely to become a supply issue than one of demand. We continuously review and evaluate projects for inclusion but it's uncertain whether the expansion of the pool will meet future demand.

We have been working hard on how we as an issuer can increase the liquidity of the product. What we've done, as a programmatic issuer, is enable investors to access existing bonds through reverse enquiry. We have also provided stock-lending facilities to our dealers and have done four taps of our 2029 green bond.

Labelled social funding is something we have taken an interest in as government initiatives resulting from COVID-19 have focused on the social side. I think our investors are well aware of the importance the Queensland government places on social aspects such as health, education and job security, and our role in funding these requirements via our benchmark bond programme. The increasing awareness and visibility of social spending has further strengthened investors' understanding in this area.

Our green-bond programme was established to engage investors on the environmental side of environmental, social and governance (ESG) issues happening in the state. Having Climate Bonds Initiative certification for the programme is only made possible by maintaining a separate green-labelled product. We believe this provides investors with a greater level of assurance when investing in our green bonds.

As the landscape continues to evolve in the GSS space, we remain adaptive to investor feedback and market developments in a number of areas – including whether a standalone social-bond programme would complement our green-bond offering.

DAVISON Could the social component of New South Wales Treasury Corporation (TCorp)'s sustainability-bond programme grow as a result of COVID-19?

■ **TRIGONA** Yes. Our sustainability-bond programme already incorporates social assets – currently we have about A$550 million of social assets in the pool. But the majority of the pool still comprises green assets.

Some of the increased funding required during the crisis will be used to fund the COVID-19 stimulus package announced by the New South Wales (NSW) government. As the funding will be used to meet social outcomes, we have the ability to increase the asset pool.

We are working with the asset identification group and the NSW Sustainability Committee to identify assets. The key consideration is reporting requirements. We want to make sure that we can report on the assets in the pool for the duration of a bond.

DAVISON How much harder is the reporting of social assets relative to green?

■ **TRIGONA** We are engaging with Sustainalytics to ensure the social assets we are considering meet with the revised International Capital Market Association Social Bond Principles. Maintaining the high standards and the integrity of our sustainability-bond programme is paramount.

DAVISON What is the outlook for GSS bond issuance from Treasury Corporation of Victoria?

"IF WE STARTED TODAY, I THINK THERE'S A GOOD CHANCE WE WOULD HAVE A PROGRAMME LIKE TCORP'S, WHICH CAN INCLUDE ASSETS ACROSS GREEN AND SOCIAL. WE WILL COME BACK TO THE MARKET, BUT IT WILL BE A WHILE BEFORE WE IDENTIFY THE ADDITIONAL ASSETS TO GO INTO THE POOL."

JUSTIN LOFTING TREASURY CORPORATION OF VICTORIA

active as required. These were all really important messages. When the RBA began to taper it was on the back of market confidence that it would step back in again if needed.

By May, bid-offer spreads returned to reasonable levels and we were seeing increased secondary activity. The RBA had been out of the market for about three weeks at this point, which gave us a further indication conditions had settled.

We scheduled our deal for the third week in May. There was a bit of disruption just before this with spreads moving a bit wider. This highlighted some ongoing fragility from sell-side pressure, but also represented value to investors.

We decided to pursue the deal because it was more about access, though outright pricing was comparable to pre-COVID-19 levels and remained at a historic low. The feedback

LOFTING It has been a while since we issued our green bond. If we started today, I think there's a good chance we would have a programme like TCorp's, which can include assets across green and social.

We will come back to the market, but it will be a while before we identify the additional assets to go into the pool. We have loans to housing associations, for instance, which would probably be suitable for a social bond. We need to do the work behind the scenes to update both our programme and our asset pool.

It will probably be the second half of the coming financial year before we return to the market.

DAVISON Does having a larger funding task make those that have not previously issued in GSS format more likely to consider it?

NICHOLL We have our hands full trying to meet our current financing task, as well as other programmes such as the one we are implementing to support SME lending through nonbank and smaller bank lenders. We are following developments in the market, but responding would require policy direction from government.

GULICH We have a larger programme than anticipated but it is still not very large. There are points on the curve that are a more immediate priority for us. We have more work to do on GSS issuance. It has been on the back-burner for the last few months, which was when we were hoping to progress it.

However, it is something for which we want to put the groundwork in, by building relationships with the agencies and establishing the criteria for asset identification, reporting and issuance.

We want to have the option to issue in this format, whether it is green, social or a combination. But that point is still a while away.

KENNEDY I have voiced the reasons why we have not rushed to do a green bond in the past and our path remains the same. When we do something we want to do it right including ensuring it encompasses our whole programme. We do not want to isolate the best assets of the state to achieve a short-term, suboptimal outcome.

We are doing substantial investigative work across government to gather enough evidence so our whole programme will meet the UN Sustainable Development Goals. This will cover everything we do as a state and an issuer, not just a little bit.

Governments should be – and are – socially and environmentally responsible in everything they do, with strong governance and regulatory overlay. So it is about how we best articulate this and put it into a programme to achieve an optimal outcome for the state. Ultimately, investors will understand this approach.

we had from our panel banks was that investors were interested in semi-governments and in our name. With the tenor being beyond 10 years, we expected some offshore participation as well.

LOFTING The semi-governments have been meeting with the RBA every week to provide feedback on market conditions. The reserve bank has been very open and listened to us on what parts of the market needed support. This gave me a lot of comfort that it was willing to do whatever was necessary to ensure the semi market remained operational.

This was true all the way through the crisis. The RBA's focus has been on ensuring markets are operating effectively. I feel confident that if there are further problems, which I hope there will not be, RBA support will be there.

ISSUANCE OUTLOOK

Davison How has the supply story played out over the last few months?

FAJARDO We need to take the demand in the context of a reduction in supply from semi-governments in May and June. We will probably get a clearer picture of demand once we are all active issuers, in the new financial year. So far, signs are positive that capacity can be absorbed in Australian dollars – but we need to start going back to being more regular issuers.

We also have feedback from our marketing offshore that investors would like to see issuance from QTC in US dollars or euros to diversify their credit risk. If capacity in the domestic market ever becomes an issue, we are capable of pulling that trigger as we have current USMTN and EMTN programmes.

MCCOLOUGH We have already talked about the surge in supply early on and, as Jose Fajardo says, this has slowed down recently. Price action has followed – we saw a big widening in semi spreads to ACGBs but they have now come all the way back in again.

The next big move or potential driver of price action will be when we get clarity on what supply will be for the upcoming financial year. That won't be until October or November for most issuers, or September for QTC because of the timing of the state election.

Whether it's the Commonwealth or the semi sector as a whole, I believe the announcement from Victoria of a A$24 billion programme recalibrated expectations – in a positive way. There were estimates being thrown around like A$150 billion of extra supply from semis through the latter half of the 2019/20 financial year and into 2020/21 financial year. This got wound back to more like A$100 billion across the sector, and now it's about A$60 billion more for the upcoming fiscal year.

I think the market will be comfortable with this. There may be individual surprises state by state. But the market should be comfortable with something like an extra A$60 billion of semi-government supply and Commonwealth outstandings of A$800-850 billion by June 2021.

Davison The fact that issuance volume is set to increase quite dramatically is well known. But, with budget rounds largely postponed, the market does not yet know exactly what volume is coming. What has issuers' dialogue with investors and dealers been like?

Westpac Institutional Bank participants


ANDREW BARRELLE


WILLIAM GRICE


DAMIEN MCCOLOUGH

GULICH We put out an estimated 2021 borrowing programme in late May. This followed an update our treasurer gave parliament reflecting some estimates of the COVID-19 impact on revenue and key economic conditions in the state.

We are all aware this estimate will change somewhat, though – not least because the length of the lockdown and the return to economic activity is quite different even now compared with what we were anticipating six weeks ago. There is a lot of water to run under this bridge.

At the end of May, we had an estimated new-money programme of A$1-3 billion. That's a step-up – we were anticipating a zero new-funding requirement for the state in our previous update. We also have the maturity of the July 2020 bond and an FRN early next year.

Between our prefunding and where we are at with the run rate this year, our programme next year is likely to be A$2.6-4.5 billion. This is probably on the lower side of what the market might have been anticipating and it covers quite a range. We also expect to be making inroads into the July 2021 maturity during the course of next year – so our actual activity may be a bit higher than that range.

LOFTING Initially, we were unsure of the scale of the COVID-19 impact on expenditure and revenue as the budget process has been delayed until October.

Treasury came up with a range of A$20-24 billion for the 2020/21 financial year, which is about an additional A$14 billion on the original TCV borrowing forecast for 2020/21 of about A$10.5 billion.

At this stage, we expect the borrowing requirement to be at the lower end of the range as the impact on the health sector has not been as significant as expected and we have not seen the full revenue impacts yet. Things like GST [goods and services tax] revenue are only starting to flow through and will continue to do so over the next few months.

At 30 June, we had completed around A$7 billion of the 2020/21 funding requirement.

TRIGONA We are also not in a position to say what the funding task is for next year – we will get more clarity in October. Having said this, the state government has already forecast a A$9 billion hit to the budget. This is why we embarked on a funding task in March and April. We are in a similar position to other semis in that we acquired a lot of funds at that time that haven't yet been used.

Governments haven't had to forecast for a pandemic before, so they looked at worst-case scenario options. Initially, too, the health impacts were expected to be far greater than originally forecast.

The better-than-expected outcomes should result in less deterioration in revenue. But we are yet to see the impact on payroll-tax revenue and stamp duty, or even GST.

The pertinent fact is that we are in a very liquid position going into the new financial year. We won't have the pressure on us that we thought in March might be there.

FAJARDO Like the other states, Queensland deferred its budget. We will be publishing a COVID-19 fiscal and economic review in September 2020. We have continued to keep investors informed of all the latest publicly available information, and we have found them to be very understanding of the situation. It's a significant global event and governments around the world are still assessing and managing the impacts.

The sector has already undertaken a large amount of issuance, which may mean investors are broadly more comfortable with the issuers' funding positions ahead of state budgets.

QTC is in a very strong position having raised an additional A$9.2 billion in net issuance above our indicative borrowing programme.

KENNEDY South Australia's revised funding task at the mid-year budget review in December 2019 was that we needed to raise A$3 billion of term funding. Through to 30 June, we have raised just more than A$5.25 billion.

There has been no formal update from the government on the current budget position. My understanding from Treasury

"The first part of the crisis was about trying to access funds at the most cost-effective rate we could achieve while meeting investor demand, which meant shorter-term funding. We've been able to extend our debt profiles as the market has improved."

FIONA TRIGONA NEW SOUTH WALES TREASURY CORPORATION is that we will not be provided with an interim financial position report so we will be unable to provide investors with any update until we get our budget in late October. This includes future-year funding forecasts.

While this makes things a bit frustrating in the sense of how best to communicate our funding requirements to investors, they are also understanding of the situation given its unprecedented nature.

We had forecast our 2021 borrowing programme to be A$3.6 billion at the 2019/20 mid-year budget review. Obviously it will be bigger than this, but it's impossible to put a quantum on it. I'm not sure we have seen the immediate impact on revenue we might have expected back in March – which is probably why we are all in a better-than-expected funding position at this point in time.

I think all the states acted prudently in ensuring they had sufficient liquidity against a worst-case scenario. When we look back on this situation in a couple of years, I hope we will be able to say we did a really good job of ensuring, in difficult conditions, that we were able to maintain the funding and liquidity position for the states.

■ **LOFTING** I'd add that I don't think we've ever been in a situation where our ability to finance governments could materially affect the ability of governments to invest in the health infrastructure they needed to keep people alive. There was no choice: we needed to ensure there was enough liquidity around to fund, for instance, a state order for ventilators as quickly as possible.

■ **KENNEDY** That's 100 per cent correct. If excessive pressures on our health system had emerged there is no question all our health departments would have required immediate access to funding so they could upgrade their day-to-day operations to deal with a pandemic. I think we all accredited ourselves well in being able to provide this should the emergency event have arisen.

■ **FAJARDO** We also really had to think about the initial chase for liquidity while trying to minimise the impact on our funding costs. We looked, for example, at liquidity initially through T-note issuance and then waited for the market to improve to undertake term funding.

■ **TRIGONA** This is a good point. The need for most of the semis to get access to liquidity, especially in March and April, meant the majority of issuance was less than six years in tenor. Subsequently, we are seeing a lot more issuance in the very long end and even ultra long. For example, we have issued close to A$2 billion in tenor longer than 17 years in the last month or so. I know the other semis have also issued in the long end.

The first part of the crisis was about trying to access funds at the most cost-effective rate we could achieve while meeting investor demand, which meant shorter-term funding. We've been able to extend our debt profiles as the market has improved in the last six weeks.

Davison What has been the AOFM's experience of communicating the supply picture in this environment of uncertainty?

■ **NICHOLL** We found that investors were very forgiving of the absence of a gross programme number for the year. We have been in daily contact with Treasury for months and there have been many revisions to the outlook for financing tasks during this time. Each iteration has less volatility and variation than the one before. I think we're getting very close to having a good understanding of the underlying budget impact.

One thing we said to investors was that the government's fiscal response had been costed and there was a relatively high degree of confidence about those figures, putting to one side the adjustment that was made to the JobKeeper programme. What we didn't know – and what nobody knew at the time – was what was happening to the underlying budget position. That's what made things very difficult – and still does, given the uncertainty of the recovery outlook.

We have provided the market with periodic guidance on issuance rates rather than giving specific programme numbers. Every investor I have spoken to has appreciated this and said it's more than sufficient for their needs for the time being.

Another thing we've done is make a deliberate attempt, in all our investor updates through April and May, to describe what investors could expect as a pattern of issuance behaviour from us – broadly speaking. This complemented the issuance-rate guidance.

Also, as soon as we could we got out and made clear where we would be introducing new maturities via syndication. Then, in late May, we said we wouldn't be doing anything more until providing updated guidance to the market in early-to-mid July.

We are now thinking about the next round of guidance we're going to give, and we're also in the position that the treasurer is going to make a statement on 23 July. We have taken every reasonable opportunity to use whatever information

"The accuracy of funding projections we would normally rely on isn't there. It's about being honest about this but also about not getting ahead of what your premier or treasurer is in a position to say."

KAYLENE GULICH WESTERN AUSTRALIAN TREASURY CORPORATION

LONG-DATED DYNAMICS

After a patch of short-dated issuance driven by market dynamics, issuers are keen to take advantage of returning demand at the long end.

DAVISON What does the Reserve Bank of Australia (RBA)'s emphasis on the short end mean for longer-dated issuance?

■ **NICHOLL** There is a combination of factors here. The RBA's participation in the market featured heavily in the investor updates we did during April and May. We took the opportunity to reinforce what we thought the view was from the RBA's actions at the time: that it did not see structural support across the curve as key to achieving its monetary-policy objectives.

In addition, the bulk of market-clearing activity required was bonds from the belly of the curve that had quickly accumulated on trading accounts.

These were bonds sitting on investors' books that are in a part of the curve where we are not normally very active as an issuer. They are bond lines that don't tend to attract a lot of interest until they roll towards the three-year futures contract.

I think investors were first looking to sell liquid bonds followed by those that they were less likely to buy again quickly. I do not think a huge volume of ultra-long-end stock changed hands, because of the duration risk.

All the signals we have seem positive for long-end interest, including the return of Japanese investors, the steepness of our curve relative to other sovereigns and the RBA's clear signal that it will not be buying in the long end – which some investors may appreciate because the RBA will not be creating distortions. These factors are making investors happier to look for opportunities in the long end. Don't forget, some volatility is a good thing.

The Australian market stands out in a global context because we have not had to go down the path of other jurisdictions, where it has become difficult for investors to interpret market signals because of the scale of central-bank activity.

We will benefit from this and we are beginning to see it in the long end. I am not surprised it has taken a relatively long time for conditions at this point of the curve to recover, though. Volatility is still in place due to other factors and while it remains high it no doubt brings with it some aversion to duration risk.

■ **TRIGONA** I see the RBA's role as being to stabilise markets, not to buy across the yield curve. With the steepness of the yield curve there is a pickup for investors at the long end. This is what is happening now, with Japanese investors coming into this space. We are also seeing demand from Europe.

■ **LOFTING** The other point to make is that the RBA's objective in buying was about making markets more efficient by clearing excess positions on bank balance sheets rather than funding semi-government borrowers.

Clearing out risk in shorter maturities frees up the banks to take on risk at the back end of the curve. I don't think there was a lot of 10-15 year semi-government stock sitting on bank balance sheets – more was with end investors.

■ **FAJARDO** The RBA could have targeted longer bonds but it may have crowded out investors in the longer end by setting artificially low yields and a flatter yield curve. As Rob Nicholl mentioned, the steepness of the curve and attractiveness of long-dated Australian dollar bonds compared with other bond markets are an important driver of the demand we are seeing.

■ **GRICE** The Australian market is trying to find an equilibrium level for the whole term structure of the bond curve and then the relative spread to semi-governments. The 10-30 year curve in Australia is around 10 basis points steeper than in the US and it feels like we are at a level that is bringing in the marginal investor from offshore. The ultra long end of the Australian curve has always been a little bit tricky but it is continuing to normalise and see increased activity.

It is hard to quantify the expected concession for a new 30-year sovereign bond. But it feels like the current mid-80s basis points on 10-30 years is about the right equilibrium level for now.

■ **BARRELLE** The RBA has avoided nominal bonds with maturity greater than 10 years, and inflation-linked bonds altogether, in its bond-buying programme. This has allowed these markets to be somewhat free trading and find their equilibrium levels. In the long run this can be good for these sectors as it provides volatility and trading opportunities for investors.

we have and to provide the market with the kind of guidance we could give on a 'no-regrets' basis. By this I mean not giving as much detail as we usually would but as much as we can, and then making clear when we think we will be in a position to update investors again.

All this has required us to step aside from the normal process we follow because of the absence of official budget updates. It has been a question of balancing what we need to say to give the market some guidance with what we can't say until an official update is forthcoming. I think we've managed to find our feet pretty well through this, which the market has appreciated.

Davison Is there any risk to the approach Justin Lofting mentions, in other words of starting with the biggest possible number for future funding requirement and potentially revising it down if outcomes come out better than expected?

■ **NICHOLL** We have taken the approach, to date, of giving guidance we can hold to for the periods we give it – like the weekly issuance rates we publish. Where we are using syndication this gives us flexibility around volume, so markets aren't focused on trying to reverse engineer a particular deficit or budget outcome for the year from our guidance.

If we go out and say to the market we're going to do something for a particular period, we will have thought about all the possibilities around the volume being higher or lower and what we might do in those circumstances. But being able to hold to our guidance has seemed important to us.

> "We had to really think about the initial chase for liquidity while trying to minimise the impact on our funding costs. We looked, for example, at liquidity initially through T-note issuance and then waited for the market to improve to undertake term funding."
>
> **JOSE FAJARDO** QUEENSLAND TREASURY CORPORATION

It's easy for anyone who is not in our shoes to think they can take numbers from Treasury and convert them into issuance programmes. But the basis on which our programmes are formulated makes us the last step in a process the foundation of which is what's going on in underlying budget positions. This has been very difficult to read for outsiders, and I would argue it remains so.

I think we're a long way from having what we would normally think of as clarity on the way forward. My understanding is that on 23 July the treasurer will focus on 2019/20 and 2020/21 with detailed mention of out years to wait until October when the actual budget is handed down. This should be more than sufficient for the ACGB market until the budget, though.

As long as we are transparent with the market – and, if things change, we adjust our advice to the market pretty quickly in recognition of the change as opposed to just ignoring it – the information we are able to provide should be welcomed by investors.

GULICH I agree with all this – it's about transparency. Everyone is in a very similar situation at the moment and certainly the accuracy of funding projections we would normally rely on isn't there. It's about being honest about this but also about not getting ahead of what your premier or treasurer is in a position to say.

It has helped that the approach across all the jurisdictions – including the Commonwealth – has been consistent. We all have a good feel for what we can say and how we can best say it to position ourselves amid this degree of uncertainty. For the most part, what I'm hearing from investors and panel banks is that there have been no real surprises or outliers so far.

What we are saying is resonating relative to the economic and health situation. This has been a real positive and it gives support to our market more broadly. •

BRIGHTER FUTURES

The perilous trading conditions of late March allowed the Australian government-bond futures market, operated by the **Australian Securities Exchange** (ASX), to prove its worth as a source of price discovery and liquidity even in the most stressed conditions. ASX has plans to grow and improve the futures suite even further.

BY LAURENCE DAVISON

It is easy to forget, in the wake of massive Reserve Bank of Australia (RBA) support and the relative calm of markets at the mid-way point of 2020, just how challenged trading conditions were as the world woke up to the threat of COVID-19 and global economies went into shutdown mode.

On 19 March, RBA governor Philip Lowe noted that "the functioning of major government bond markets has been impaired" – to an extent that necessitated the introduction of extraordinary support measures.

The impairment was clearly acute. Speaking at a *KangaNews*-Westpac Institutional Bank roundtable in late June (see p66), Rob Nicholl, chief executive at the Australian Office of Financial Management (AOFM) in Canberra, revealed that at the height of the crisis even the sovereign borrower only had access to short-term liquidity while its Australian Commonwealth government bond (ACGB) tender outcomes "did not reflect any meaningful access to the market".

He added: "I think it was the first time the AOFM had ever faced anything like this – it was totally unprecedented."

FUTURES LIQUIDITY

Users restricted to participation in physical markets would have experienced similar conditions. By contrast, the ASX futures platform continued to offer liquidity and tight bid-offer spreads throughout this most tumultuous period.

The three-year government bond futures contract recorded average daily volume of 236,474 in the period 16-20 March, compared with 213,157 for full-year 2019. Average trading volume during the same period of maximum stress was 189,655 in the 10-year bond contract, compared with 174,053 last year.

Futures also provided a highly tradeable option. According to ASX data, bond futures contracts consistently offered half-tick bid-offer spreads even in a period when cash bond spreads were observed to be at 15 basis points and even wider at times.

"It was really noticeable during the March period of turbulence that the futures market continued to perform even as some OTC markets struggled," says Helen Lofthouse, executive general manager, derivatives and OTC markets at ASX in Sydney. "It was clear that the futures market was the primary point of price discovery for multiple reference markets."

The futures complex provided an avenue for market participants to hedge risk and manage positions at a time when many were undertaking an urgent hunt for liquidity. When even the most liquid physical asset was struggling to find a competitive bid, users could come to ASX and find a deep and liquid market even beyond the on-screen trading of the benchmark three and 10-year ACGB futures.

For instance, Lofthouse says ASX also observed the importance of exchange for physicals (EFPs) during the March-April period. These transactions price a bond or swap trade as a spread to futures. Executing an EFP enables both parties to get better pricing in a risk-neutral trade.

"In a market where a lot of investors were selling bonds to realise cash, this was a crucial way to get tight pricing on their asset sales and subsequently access futures-market liquidity to reduce positions in a flexible and cost-effective way," Lofthouse explains.

Average daily EFP volume was approximately 114,000 lots in March this year, compared with 78,000 in March 2019. Lofthouse says the EFP market demonstrates the value of the futures complex to physical traders and asset managers.

The March period saw some cash-market transactions move to the futures environment, though in many cases the cash transaction still had to be completed – selling physical bonds, for instance. In this case, futures provided a better price by allowing holders to sell bonds in EFP format and buy futures. The futures market also allowed bond price-makers to transact with much less risk by allowing them to hedge simultaneously with cash execution.

Lofthouse tells *KangaNews*: "In a really difficult set of circumstances, market makers were able to be much more confident about making prices by using EFPs. On the other side, asset sellers were able to get EFP prices that were much tighter than outright sales. They were left with futures positions to unwind but those in turn were much easier to exit because of the liquidity of the futures market."

The reason liquidity is able to hold up in the futures complex even when it falls away in the OTC market is the scale of participation in the exchange-traded product. This does not just mean the number of users but their varying reasons for being involved.

"The fact that all these global users, with different types of businesses, come together in the same place is what makes futures such a critical source of liquidity and is what allows futures to provide this liquidity even in the most challenging times. Not everyone is doing the same thing at the same time," Lofthouse explains.

The breadth of users also applies geographically. The ASX bond futures suite is a liquid market throughout the day including active trading throughout London and US trading hours as well as in the Asia-Pacific time zone. In fact, the exchange sees nearly a third of its volume through the night session.

NEW CONTRACTS

Increased issuance from the AOFM, targeting 3-5 and 10-12 year maturities, along with the RBA's intervention in the Treasury bond market, has accelerated ASX thinking about a new contract in the bond suite. On 26 June, the exchange disclosed plans to introduce a new five-year Treasury bond futures contract to complement the existing three-, 10- and 20-year futures.

The RBA has committed to anchoring Australia's three-year sovereign-bond yield at 0.25 per cent for the foreseeable future, which has had the effect of greatly suppressing volatility at this point on the curve.

With around A$175 billion (US$121.6 billion) of ACGBs already on issue between the three- and 10-year futures buckets and the expectation of plenty more to come, hedging in the mid-curve was already an important requirement for many market participants. This has become harder to do using the existing futures contracts alone.

Lofthouse explains: "In the past, users might have hedged 'in-between' exposures using a mixture of three- and 10-year bond futures contracts. But there is a question about whether this approach will create the right hedge when the three-year is stable while the 10-year is still moving."

The substantial pickup in AOFM issuance in conjunction with RBA intervention has brought consideration of a new contract to the top of the agenda for ASX. "We think it makes sense to have a five-year point on the curve anyway and it is something our customers were asking for even before yield-curve control," Lofthouse comments. "What's different now is that we believe market conditions will help generate early liquidity at the five-year point."

ASX says the contract listing is expected to come late this calendar year, subject to regulatory approval and market readiness. The first expiry month is likely to be March 2021. The exchange also plans to complement the five-year contract with new spread products, including a 3-5 year and a 5-10 year, to add to the existing 3-10 year and 10-20 year spreads.

ASX is currently engaging with users – including trading and clearing participants and their vendors – as well as regulators and other stakeholders in preparation for the launch.

Market participants seem to support the rationale behind the new listing. Anthony Morriss, Sydney-based head of Australian and New Zealand economics at BofA Securities, says the RBA's success in controlling three-year ACGB yield has made the five-year part of the curve more attractive for investors. He expects the forthcoming ASX five-year futures contract further to increase demand in this part of the curve and says it should also facilitate issuance.

FUTURE SUITE

Once introduced, the new five-year contract will remain part of the ASX suite on an ongoing basis – regardless of whether or when the RBA lets the three-year bond yield float freely again at some future point.

Lofthouse tells *KangaNews*: "Our expectation is that there will be enough issuance in the physical market to support liquidity between the three- and 10-year points on an ongoing basis. In fact such liquidity already exists, even without the AOFM's issuance profile changing very much."

An expanded physical Treasury bond market should also give a boost to activity in the 20-year futures contract. This has been less actively traded than the three- and 10-year futures. Lofthouse says this is not a surprise given the lower level of issuance at the long end, the inherent risk profile of the contract and the focus of a greater proportion of market participants on the shorter-dated part of the curve.

She continues: "We don't expect the 20-year futures to have the sort of volume we see in the 10-year – it's a riskier contract. But it is an important point on the curve that we remain committed to, and in the current environment more significant interest in the long end is also bringing opportunity back to 20-year activity. Breadth of access and liquidity both have a chance to step up." •

"The fact that all these global users, with different types of businesses, come together in the same place is what makes futures such a critical source of liquidity and is what allows futures to provide this liquidity even in the most challenging times. Not everyone is doing the same thing at the same time."

HELEN LOFTHOUSE AUSTRALIAN SECURITIES EXCHANGE

AUSTRALIA'S SOVEREIGN: STRENGTH BUT GROWING RISKS

Australia's sovereign rating will be tested in the coming months as the ramifications of the COVID-19 crisis play out through the economy, according to **Fitch Ratings**. A newly placed negative outlook on Australia's AAA rating relates to significant downside risks in the domestic economy as well as global factors.

BY MATT ZAUNMAYR

In a 25 May webinar focusing on the macroeconomic and sovereign outlook, James McCormack, global head of sovereigns and supranationals at Fitch in Hong Kong, revealed the rating agency does not expect global income to return to pre-crisis levels until at least 2022 or 2023. "We are not expecting a V-shaped recovery," he adds.

The COVID-19 crisis has sparked a record level of downgrades and negative outlooks on sovereign ratings (see chart 1). Fitch affirmed Australia's sovereign rating but revised it to a negative outlook on 22 May.

Jeremy Zook, Hong Kong-based director, Asia-Pacific sovereigns and primary sovereign analyst for Australia at Fitch, says the deterioration in public finances will be material. This is despite Australia's federal Treasury revealing, on the same day as the Fitch briefing, the cost of the JobKeeper scheme had been overestimated by A$60 billion (US$41.7 billion).

The Treasury's revision led Fitch to reduce its 2021 forecast for gross government debt-to-GDP to around 55 per cent from 58.2 per cent. Nevertheless, the rating agency expects the deterioration in public finances will add to downward pressure on Australia's sovereign rating.

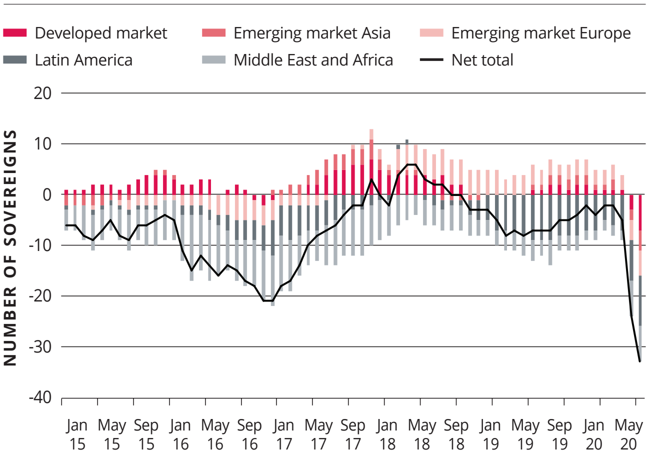
GLOBAL CONTEXT

The COVID-19 crisis precipitated unprecedented fiscal stimulus from countries around the world as they grapple with the impact of an imposed economic hiatus.

The factors that correlate with rating downgrades have all been moving in the same direction. In particular, the number of Fitch-rated sovereigns that are improving their debt position relative to those with rising debt has fallen off a cliff (see chart 2).

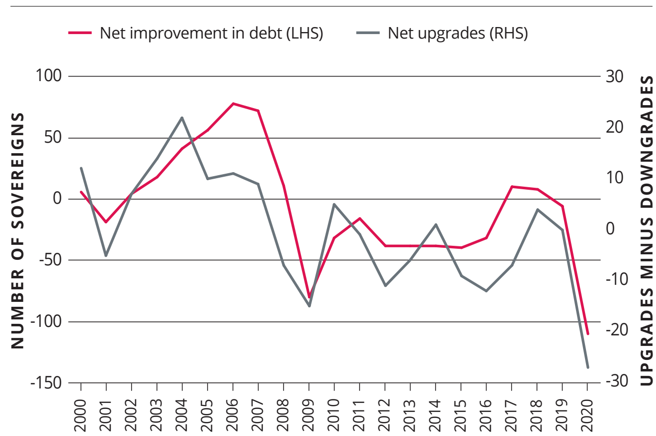
With deteriorating debt positions essentially locked in, Fitch is making sovereign rating decisions based on expected fiscal consolidation after the crisis. "Our expectations on sovereigns' ability to consolidate debt depends in large part on their track record since the financial crisis, as well as their respective starting points for deficits relative to rating peers," says McCormack.

CHART 1. FITCH NET POSITIVE RATING OUTLOOKS



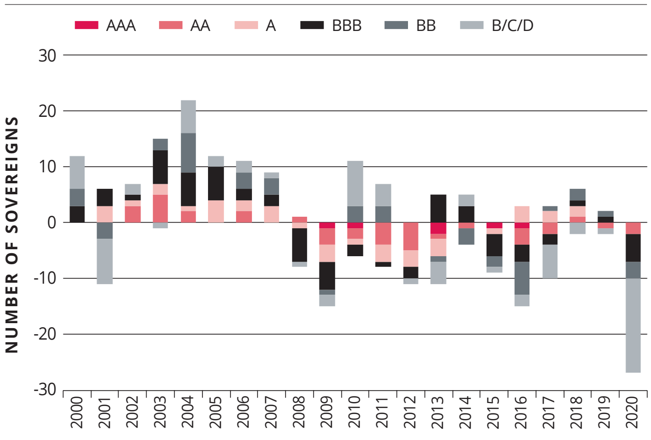
SOURCE: FITCH RATINGS 25 MAY 2020

CHART 2. FITCH NET IMPROVEMENT IN SOVEREIGN DEBT AND NET SOVEREIGN UPGRADES



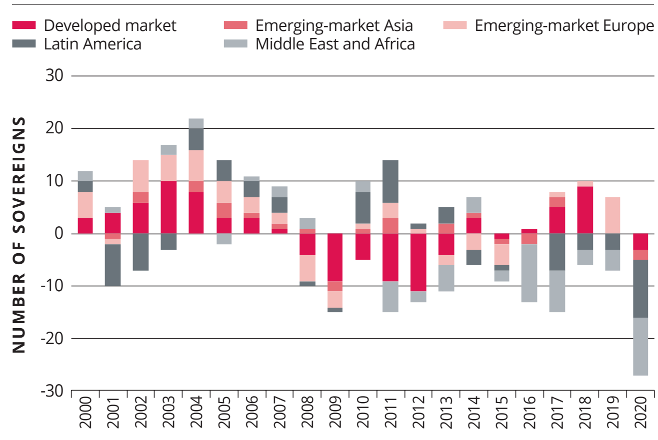
SOURCE: FITCH RATINGS 25 MAY 2020

CHART 3. FITCH NET RATING CHANGES BY CATEGORY



SOURCE: FITCH RATINGS 25 MAY 2020

CHART 4. FITCH NET RATING CHANGES BY REGION



SOURCE: FITCH RATINGS 25 MAY 2020

This approach is likely to stand Australia in good stead given its improved budget position in the years since the global financial crisis. By contrast, McCormack adds that the track record of many global sovereigns has been poor in the last decade leading to weak starting points at the onset of COVID-19. Indeed, sovereign ratings were declining on average even before the crisis. This is particularly true for emerging-market sovereigns, which now have an average rating below double-B for the first time.

Fitch's sovereign rating actions to date have primarily affected emerging-market countries (see charts 3 and 4). As a result, McCormack says the aggregate value of downgraded debt in the COVID-19 crisis is, so far, low compared with other crises.

AUSTRALIA'S POSITION

The Australian government's response to COVID-19 has been in line with other developed countries, but several factors place its rating in a relatively favourable position.

Zook confirms Fitch's view that the Australian federal government has a strong track record on fiscal consolidation and a good starting point with a budget close to balance before the COVID-19 crisis. "The Australian government has been very focused on surpluses, and prudent fiscal management has in the past been key to electoral success," Zook explains.

The rating agency still expects a significant widening in Australia's fiscal deficit and a deterioration of public finances, however. Zook says a rising debt-to-GDP ratio has already eroded Australia's position relative to the triple-A mean. Slippage in this ratio has been ongoing since Fitch upgraded Australia's sovereign rating in 2011.

"Pressure will come onto Australia's sovereign rating if we do not see sufficient plans to roll back the stimulus measures that have been implemented. A lot of the programmes are temporary so the rollback should happen naturally to an extent. But some of the stimulus measures will be difficult to take away," Zook comments.

Fitch also expects Australia to be able relatively easily to attract the level of investment required to finance its record fiscal stimulus, given it has maintained interest rates above those of other triple-A sovereigns. McCormack adds that the purchase of government securities by the Reserve Bank of Australia, while supportive of demand, does not change sovereign fundamentals.

Australia's health and economic position during the COVID-19 crisis is strong on a relative basis. Nonetheless, Fitch sees significant downside risk for the local macroeconomic outlook and, consequently, the sovereign rating.

In particular, Australia's high household debt was manageable largely in the absence of a labour-market shock. Such a shock has occurred and, if unemployment remains elevated, households' ability to meet debt repayments could be reduced once fiscal support is rolled back. A substantial decline in house prices would have a similar impact with further negative consequences for the Australian economy and sovereign rating.

Fitch is also mindful of the Australian economy's exposure to China. Stephen Schwartz, Hong Kong-based head of Asia-Pacific sovereign ratings, expects China's economic growth to be 0.7 per cent in 2020. "This is shockingly low for what we have come to expect in China. But it is positive growth – which is in contrast to many emerging markets, where we are lowering growth expectations to negative," Schwartz explains.

Chinese fiscal stimulus measures could prove a boon for some Australian exports but others, such as beef and barley, have come into the political firing line. Zook says it is too early to tell what the effect of trade restrictions will be on Australian GDP, though they may be limited if Australian exporters can find alternative markets.

On the other hand, he adds that Australia's economy could be particularly vulnerable if political tensions with China continue to escalate. For instance, if China restricts the flow of international students it would not only have a large effect on Australia's tertiary-education sector but would also spill over into consumer spending and the rental-property market.

Declining immigration as a result of border closure represents a risk for developed economies, says McCormack. Fitch modelling suggests, if immigration slows, most developed markets would begin to exhibit the low-growth characteristics and demographic challenges of Germany and Japan. •

Ticket to the ghost train

Investors are adjusting to a new normal in the Australian high-grade market as conditions settle after March's turmoil. Reserve Bank of Australia (RBA) bond purchases slowed to a halt by the mid-way point of the year, but investors say its presence is still bringing stability and creating opportunities.

BY MATT ZAUNMAYR

The RBA stepped into the Australian government bond market in late March to ease trading conditions, which had deteriorated to the point of dysfunction (see p66). Between 20 March and 6 May, the RBA bought A$51.4 billion (US$35.7 billion) of Australian government and semi-government bonds.

Since early May, the central bank has ceased purchasing as it deems its two key objectives for unconventional monetary policy – a three-year Australian Commonwealth government bond (ACGB) yield of 0.25 per cent and general functioning of capital markets – are being met.

The Australian Office of Financial Management (AOFM) executed two record syndications in April and May, for an aggregate of A$32.5 billion, and regularly tendered around A$5 billion of government bonds each week from April to the end of H1. Semi-government borrowers have also issued record volume, indicating to the RBA that the market is functioning.

While government and semi-government bond yields were the first to react to the RBA's purchases, in Q2 yield in other high-grade and credit asset classes progressively moved to levels lower even than before the pandemic (see chart 1).

The RBA will intervene if necessary. Its June monetary policy statement says: "The government bond market is operating effectively and the yield on three-year Australian government securities is at the target of around 25 basis points… The [RBA] is prepared to scale up its bond purchases again and will do whatever is necessary to ensure bond markets remain functional."

Now the dislocation and spread widening of March-April has passed – at least for the time being – the Australian buy side is adapting to what is widely expected to be a protracted period of ultra-low rates. The challenge investors face is finding a positive return with an acceptable risk profile.

OPPORTUNITY SET

There is still at least some juice even in the ACGB market. The RBA's approach is to keep its intervention to a minimum but to make clear its willingness to be as active as necessary to meet its goals. This approach has facilitated stability but allowed market forces to dictate spreads outside the three-year ACGB. Investors say a relatively free-floating long end has opened up opportunities.

Anthony Kirkham, Melbourne-based head of investment management and Australia and New Zealand operations at Western Asset Management, says: "We know the three-year rate is locked down but the RBA has not really bought past 10 years. This makes the market fluid and susceptible to different outcomes, which we need when taking positions."

The RBA's actions have caused a steepening of the ACGB yield curve (see chart 2). Tamar Hamlyn, principal at Ardea Investment Management in Sydney, says: "The RBA's yield target for three-year government bonds creates a point on the curve that is more or less fixed. As a result, the forward interest rates implied by government-bond yield are steep beyond three years. This can present some attractive relative-value opportunities."

This opportunity extends into the semi-government sector, says Darren Langer, senior portfolio manager at Nikko Asset Management in Sydney. He expects semi-government yields to stay on a tightening path as issuers have now dealt with a large portion of their borrowing requirement while banks' high-quality liquid asset requirements are likely to ramp up – and with them demand for semi-government bonds.

On the other hand, an expected massive increase in Australian dollar government and semi-government issuance may also be opening the door for investors to see value in supranational, sovereign and agency (SSA) issuance. Australian dollar SSA

"The second ride on the ghost train is not as scary as the first. A lot of measures to support the market are now in place so, while there could be pockets of volatility, the outcome is unlikely to be as severe as it was in March."

SONIA BAILLIE AMP CAPITAL

volume in 2020 pales in comparison with government and semi-government syndicated deals. However, Langer says recent mid-curve deals have been relatively attractive in the secondary market.

Limited SSA supply may continue to support the sector's relative value in Australian dollars. Kirkham tells *KangaNews* the recent performance of semi-government spreads, and the tightening of bank spreads on the back of limited issuance expectations, has made SSAs a valuable alternative.

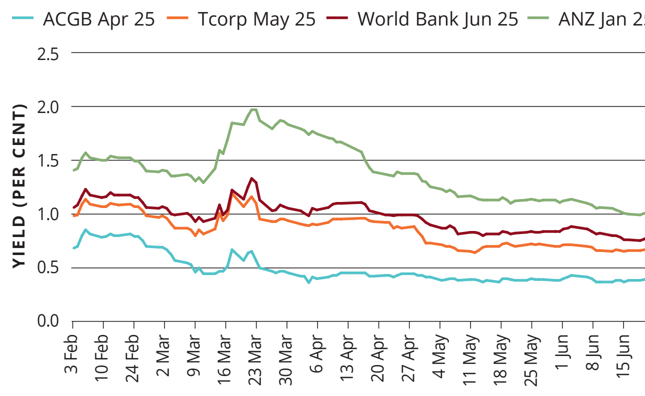
At the same time, credit-market conditions also significantly improved during Q2. Sonia Baillie, head of credit at AMP Capital in Sydney, says the weight of supply from the high-grade sector provides an impetus to weight toward rates, but the technical factors supporting credit spreads make financials and some corporates an attractive option too.

Primary credit deal flow was slower to return to Australia than Europe and the US, where central banks took an active role in markets by buying financial-institution and corporate bonds. However, by late June there had been a flurry of Australian dollar action from overseas and domestic financial institutions and even a handful of corporate deals, including one from Brisbane Airport Corporation (see p52), that showed the market's ability to see through the crisis to greener pastures.

However, investors have little expectation that corporate deal flow in H2 will make up for the expected absence of the market's largest credit issuers, the big four banks, from wholesale issuance in the near term at least.

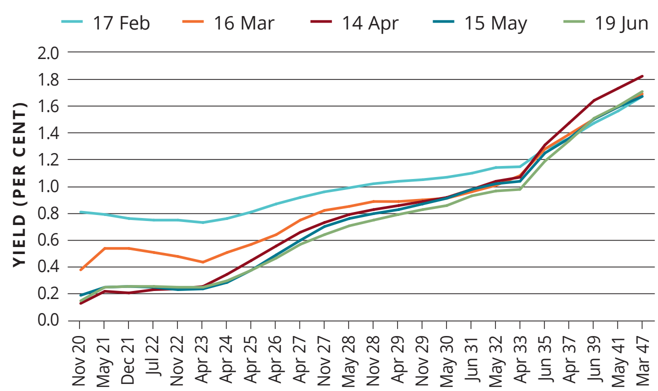
"We do not anticipate major banks or many corporates needing to come to the Australian dollar market, meaning there is technical support for spreads despite the uncertain outlook. Investment-grade corporates are attractive and we think downgrade risk is reflected in spread. We think it makes sense at the moment to add credit," Baillie explains.

CHART 1. SELECTED AUSTRALIAN DOLLAR BOND LINES



SOURCE: YIELDBROKER 25 JUNE 2020

CHART 2. ACGB YIELD CURVE



SOURCE: YIELDBROKER 24 JUNE 2020

FAITH IN THE SYSTEM

Fund managers appear to have a good degree of trust in the RBA's promise to help maintain market function and liquidity. Record high-grade issuance volume has been absorbed since April, despite the economic hit from COVID-19 still looming especially as government stimulus measures are due to expire at the end of Q3.

The Australian economy had largely reopened by the end of H1 but, at the same time, economic data for growth and unemployment have begun to reflect the grim reality of COVID-19 lockdown measures. The income hit many consumers face is potentially only going to be known once the two main planks of government stimulus – JobSeeker and JobKeeper – are unwound. Meanwhile, in early July a spike in COVID-19 infections in Melbourne spurred a second city-wide lockdown.

Markets appear unsure about the likely course of action – or at least different asset classes are projecting different outcomes. After a brief period of volatility in March, equity and debt markets have continued the recent-year trend of telling market watchers divergent stories by both rallying at the same time.

"Market sentiment has been dislocated from reality for many years now. The recent market moves are merely another chapter in the book. But the commitment and capacity of the RBA

> "The commitment and capacity of the RBA and other central banks has been put beyond all doubt for now, which suggests market sentiment can remain elevated relative to fundamentals for a long time yet."
>
> **TAMAR HAMLYN** ARDEA INVESTMENT MANAGEMENT

LIQUIDITY FROM ALL ANGLES

At the peak of financial-markets turbulence in March, liquidity across the spectrum of risk assets evaporated. Fund managers say the Reserve Bank of Australia's measures have largely reversed this and liquidity has returned in primary and secondary markets as well as in client flows.

Liquidity problems began in March and snowballed when the federal government announced plans to allow early access to superannuation, leading to large redemption calls on domestic fund managers. However, by late June fund managers say these issues have largely played out and even reversed.

Investors say secondary-market liquidity has greatly improved from March, to the point where they can execute typical sector rotations between semi-government and supranational, sovereign and agency (SSA) bonds.

Darren Langer, senior portfolio manager at Nikko Asset Management, says liquidity is only part of the contemporary equation, however. He explains that investors and banks are driving spreads in quickly, but not evenly. Volatility between sectors is higher than usual and this creates switching opportunities.

The SSA sector has often been perceived as relatively illiquid compared with semi-government bonds in Australian dollars. Sonia Baillie, head of credit at AMP Capital, says this led AMP to be underweight in SSAs prior to the crisis due to the perception that a stress event may be on the horizon. "No-one anticipated COVID-19, but we were cautious on the macroeconomic outlook and were running severe stress and liquidity tests on our books," she reveals.

Investors report it was as difficult to sell a triple-A semi-government bond in March as it was to sell a lower-rated SSA. However, the stress event does not appear to have changed perceptions of liquidity to the extent that investors would prefer to hold the higher-yielding SSA paper purely for the compensation of extra spread.

Tamar Hamlyn, principal at Ardea Investment Management, tells *KangaNews* fixed-income securities performed in line with expectations aside from a brief period in March. He says governments and central banks have taken sufficient measures to make this experience unlikely to repeat. Rather than shifting assumptions on fixed income, Hamlyn says the crisis has validated them.

"Our experience of investing in Australian dollar fixed income is that relativities change over time. Sometimes semi-government bonds may be cheap and at other times it may be SSAs. If we can switch between asset classes, it is a natural function of markets and an attractive source of return," he explains.

Client flows

Fixed-income funds faced intense pressure from client redemptions in March and April, as individuals took advantage of early superannuation access at the same time as a reallocation of funds into the bottomed-out equity market was occurring.

The market has moved past this phase, though. The superannuation call ultimately was not as large as initially expected and the rebound in fixed-income spread and liquidity has led to cash being redeployed in the sector.

Hamlyn says: "Yields now offer less outright value but many people are still concerned about the outlook while returns in other asset classes are uncertain. In this environment, the role of fixed income as a safe and secure store of capital for people with low risk appetite is clear."

Australian dollar sovereign-bond yield is low but has gone back above that of the US. All else being equal, these dynamics could be expected to attract more international flows into Australian fixed-income funds.

Anthony Kirkham, head of investment management and Australia and New Zealand operations at Western Asset Management, says the pace at which allocations are flowing out of Australian fixed income and into the US has slowed.

However, the Australian dollar has also strengthened relative to yen and US dollars. This means the factors drawing international funds into Australian fixed income are offset to some extent by those prompting existing international investors to take profit on their Australian dollar exposure.

and other central banks has been put beyond all doubt for now, which suggests market sentiment can remain elevated relative to fundamentals for a long time yet," Hamlyn tells *KangaNews*.

Investors say they are not ignoring the obvious risks on the horizon. However, faith in central banks' commitment to being the buyer of last resort is currently sufficient to assuage any doubts around borrowers' ability to repay debt.

Hamlyn continues: "It is an unusual situation where there is an enormous increase in debt issuance and a very weak outlook for the economy and tax collection, but at the same time government bond yields are at all-time lows. This indicates very little doubt about the ability of governments to service even an elevated level of debt. At the end of the day, the ability to repay debt is the essence of fixed income and at the moment there does not appear to be any concern."

Australian investors also have the sense that, even though a lot of the economic pain is still to come, there was at least some clarity on the outlook by the end of the first half and fewer unknowns than was the case in March.

Baillie tells *KangaNews* the sharp spread revision in March factored in a lot of downside risk as well as liquidity premia. Furthermore, she says rating agencies have been quick to respond, meaning deteriorating credit profiles are also largely factored into pricing.

"There is of course still a lot of uncertainty around the risk of a second wave of COVID-19 and the need potentially to go back into lockdown. But the second ride on the ghost train is not as scary as the first. A lot of measures to support the market are now in place so, while there could be pockets of volatility, the outcome is unlikely to be as severe as it was in March," Baillie says.

“Issuance has been consistent and it has all been swallowed by investors. Borrowers are issuing into demand, which means there is limited scope for a blowout in high-grade or credit spreads.”

ANTHONY KIRKHAM WESTERN ASSET MANAGEMENT

ECONOMIC OUTLOOK

A ghost train may end up being an apt analogy for the Commonwealth and state economies in the wake of COVID-19. Massive increases in government spending with the potential support of central-bank purchases have proven effective in putting a floor under economic growth in the short term. But a major question mark remains over the prospects for a long-term growth recovery driven by private-sector investment and productivity gains.

The various QE programmes implemented around the world in the wake of the 2008 financial crisis have proved difficult to unwind. This point may be some way off for global central banks, but if it does happen the Australian market could be exposed due to its emphasis on supporting front-end yields.

Hamlyn explains: “By providing explicit support for short-end bonds and more discretionary support for long-end bonds, the RBA is effectively borrowing the capacity of other central banks that are willing buyers across the yield curve. This approach works well when central banks are delivering maximum stimulus, but when this support is unwound support for the Australian market will be unwound too.”

The Australian implementation of unconventional monetary policy has so far been very different from other jurisdictions. In particular, the RBA has only had to buy a relatively small volume of bonds to facilitate lower yields and successful issuance by federal and state government entities.

Between late March and early May, the AOFM issued A$36.1 billion of ACGBs by tender or syndication. In the same period the RBA took a little more than A$40 billion off investors’ books. Since early May the AOFM has been able to issue A$50.5 billion of ACGBs without the RBA purchasing any bonds in the secondary market.

This pace of issuance is set to continue for the near term at least, and semi-government requirements will likely be elevated for some time to come as well. The RBA’s explicit messaging around its intention to intervene to whatever degree is necessary for as long as is necessary has put investor concerns around a supply deluge at ease, though.

“Issuance has been consistent and it has all been swallowed by investors. Borrowers are issuing into demand, which means there is limited scope for a blowout in high-grade or credit spreads,” Kirkham argues.

The rise in issuance is also being facilitated by a return of liquidity to local asset managers. Investors universally report a stabilisation in the drawdowns that occurred during March (see box on facing page).

There has also been a notable increase in global investor demand for Australian dollar high-grade product, says Hamlyn. This has occurred due to other central banks intervening more in their government bond markets than the RBA has, leading to Australian dollar yield becoming attractive compared with global options.

“Rising supply has been well met by demand so far, so we continue to see opportunities in holding government bonds. A large ramp up in supply would, in isolation, be a cause for concern for investors. But it is not occurring in a vacuum,” Hamlyn explains.

In fact, the increase in debt issuance from the Australian federal and state governments may actually be beneficial for ratings in the long term, if the economic support provides a sufficient boost to offset the long-term debt burden. Australia’s relative position remains strong, too, despite the rapid weakening of the budget and fiscal position.

Langer explains: “If it was just Australia at risk of downgrade it would be an issue. But at the moment all countries are in the same boat and, relatively, Australia is in a better position than many. Australia’s level of debt is still going to be magnitudes lower than most other developed economies.” •

“If it was just Australia at risk of downgrade it would be an issue. But at the moment all countries are in the same boat and, relatively, Australia is in a better position than many. Australia’s level of debt is still going to be magnitudes lower than most other developed economies.”

DARREN LANGER NIKKO ASSET MANAGEMENT

KIM MARTIN ACTING DIRECTOR, CAPITAL MARKETS
NEW ZEALAND DEBT MANAGEMENT

PLENTY MORE ISSUANCE BUT ***STRONG STARTING POSITION*** FOR NZDM

New Zealand Debt Management (NZDM) is facing a funding task in the coming years multiples higher than even its most active historical programmes. **Kim Martin**, New Zealand Treasury's Wellington-based acting director, capital markets, discusses the solid starting position and execution plans for the coming issuance requirement.

New Zealand came into the COVID-19 crisis with good capacity to expand the Crown balance sheet in response. What was the debt position and how it has been affected by stimulus measures so far?
Successive New Zealand governments have had a focus on fiscal sustainability and reducing debt relative to GDP. This is particularly pertinent as New Zealand is a small, open economy that is subject to natural disasters. Further, this has ensured a significant fiscal buffer in the event of a shock.

Before the onset of the COVID-19 pandemic, net core Crown debt was just less than 20 per cent of GDP. To date, fiscal stimulus measures, alongside the expected softer tax take, have led to an additional NZ$19 billion (US$12.3 billion) of New Zealand government bond (NZGB) issuance, or about 6 per cent of GDP, relative to what was expected in February.

What is Treasury's modelling on the trajectory of sovereign debt to GDP?
Based on the May 2020 budget economic and fiscal update (BEFU), sovereign debt is expected to increase substantially over the period from the end of June 2019 to the end of June 2024. Forecast gross NZGB issuance is about NZ$150 billion higher than forecast at the 2019 half-year economic and fiscal update (HYEFU).

The increased issuance is weighted towards the early part of the forecast period. This is due to the timing of the government's response to the COVID-19 shock and, as NZDM increases the forecast cash buffer, to manage funding and liquidity risks at a time of heightened uncertainty.

As a proportion of GDP, net debt is forecast to increase to just less than 55 per cent in June 2023 from 19 per cent in June 2019, before stabilising at that level. Over the longer-term projection period – June 2024 to June 2034 – net debt as a share of GDP is modelled to be on a gradually declining trend.

New Zealand lifted its lockdown on 8 June and, as of 15 June, is considered to have eliminated community transmission of COVID-19. How does this rapid emergence from the domestic economic lockdown affect forecasts for sovereign funding?
With no known community transmission in New Zealand, the economy is essentially reopening and operating close to business as usual, with the exception being international borders remaining largely closed.

The 2020 BEFU forecasts assumed the economy will be operating at alert level one – the current situation – or alert level two – meaning slightly stricter rules regarding hospitality, group sizes, and contact tracing – until March 2021, when the borders are assumed to reopen.

While this assumption remains reasonable it will be reviewed, alongside the sovereign funding plans, at the pre-election economic and fiscal update in August. The general election is scheduled for 19 September 2020.

NZDM increased the NZGB programme to NZ$60 billion for the 2020/21 financial year, NZ$50 billion more than than forecast at the 2019 HYEFU. How has the funding strategy changed given the volume of issuance required?
Forecast annual issuance of NZ$60 billion will be a record, surpassing the previous high of NZ$20 billion in 2011 that came following the Canterbury earthquakes.

We have made material changes to the funding strategy but our core principles of transparency, consistency and even-handedness remain unchanged. We continue to provide investors with as much certainty as possible while allowing ourselves additional flexibility to respond to economic and market developments.

We now release full tender schedules ahead of each month, rather than each quarter, and we offer multiple bonds at each tender rather than just one. We continue to announce expected syndications at economic and fiscal updates with further information, such as the maturity date, disclosed preceding deals and alongside tender schedules.

Syndication will play a key role in meeting our funding requirements. We are now undertaking them on a more frequent basis. There were two in the June 2020 quarter and we expect a further two in the current quarter.

In addition, we have increased individual nominal bond-line caps to NZ$18 billion from NZ$12 billion. This provides further flexibility within the existing nominal NZGB portfolio.

How have syndications gone in the COVID-19 era?
In April, we undertook a tap syndication, for the first time, of the May 2031 nominal bond. We chose a tap syndication targeting the new 10-year benchmark so as to issue a sizeable volume prior to the maturity of the April 2020 nominal NZGB. Overall, we issued NZ$3.5 billion out of a total book size of more than NZ$5 billion.

In June, we syndicated a new May 2024 nominal bond. Market dynamics and feedback indicated there was appetite for a shorter-dated issue. The total book was more than NZ$14 billion – significantly more than any previous NZGB deal. We ultimately issued NZ$7 billion.

We were very pleased with participation in both deals, which had a good mix of investors across geographic regions and by type. It was also encouraging to see the breadth of names, some of which we had not seen participate in previous syndications.

Has the larger borrowing programme caused NZDM to look into alternative instruments?
Our primary funding instrument remains the nominal NZGB, which accounts for NZ$58-59 billion of the 2020/21 forecast issuance. Treasury bills on issue at end-June 2021 are also forecast to be higher, at NZ$10 billion relative to the NZ$4 billion forecast at HYEFU 2019.

Inflation-indexed bonds (IIB) remain an important part of the borrowing programme. We intend to issue around NZ$1-2 billion of IIBs in 2020/21, up from around NZ$400 million in 2019/20. The proportion of IIBs in the total NZGB portfolio is forecast to decline to less than 15 per cent by end-June 2021, but it intentionally remains high relative to many sovereign peers.

We continue to focus on New Zealand dollar denominated issuance to maximise liquidity in existing securities. New Zealand dollar funding instruments also continue to be more cost-effective than foreign-currency issuance. However, we now have a small volume of short-dated foreign-currency euro commercial paper on issue, which we plan to maintain. Documentation for a long-dated euro MTN programme is also up to date, should it be required.

Offshore holdings had been trending downwards, which has presumably been exacerbated by the COVID-19 crisis. How does NZDM view this?
The downward trend over recent years has coincided with the narrowing of NZGB spreads to many peers, such as US Treasuries. However, in recent months the proportion of NZGBs held offshore has stabilised at around 50 per cent. Since May, NZGB yields have increased relative to key peers such as US Treasuries and Australian Commonwealth government bonds.

> "We hear from offshore investors that any decrease in holdings of NZGBs is not a reflection of concerns regarding the New Zealand sovereign credit."

Investors will always make their own relative-value judgements. However, anecdotally we hear from offshore investors that any decrease in holdings of NZGBs is not a reflection of concerns regarding the New Zealand sovereign credit.

Consistent with this view, New Zealand is one of the few countries to have the positive outlook on its credit ratings affirmed since the onset of the COVID-19 crisis. S&P Global Ratings and Moody's Investors Service reaffirmed New Zealand's long-term local credit ratings, at AA+ with a positive outlook and Aaa with a stable outlook.

How have your investor-engagement plans changed as a result of COVID-19?
We undertake frequent interaction with our global investor base as part of our structured investor-engagement strategy. While the current environment means some of the usual engagement methods have been restricted, we have been impressed by how effective engagements via virtual platforms have been.

Has COVID-19 changed NZDM's strategy when it comes to environmental, social and governance (ESG)-themed issuance?
In BEFU 2020, much of the government's new spending was targeted at those most affected by COVID-19. The aim of the measures is to prioritise the wellbeing of current and future generations of New Zealanders, consistent with the government's wellbeing objectives.

New Zealand is among the most highly rated sovereigns in the world on various independent sustainability and ESG metrics. These include a 2020 UN Sustainable Development Goals rank of 16 out of 193 countries.

In this context, we have no imminent plans to issue bonds in a specific ESG format, though we continue to investigate the contribution NZDM can make to supporting ESG outcomes. We continue to pursue a holistic approach and are aware of the contribution efficient debt funding can make to support the government in achieving ESG objectives. •

KĀINGA ORA'S FUNDING JOURNEY SO FAR

It has been two years since **Kāinga Ora – Homes and Communities** re-entered debt capital markets, in which time the agency's funding requirement and market footprint have grown significantly. **Sam Direen**, treasurer at Kāinga Ora in Wellington, discusses the development of the funding programme including the emphasis on sustainable debt and the impact of the COVID-19 crisis.

Can you give an overview of the highlights of the programme's development?
The three key highlights of the journey so far have been our re-entry to markets, establishing our sustainability framework and, more recently, getting ahead of our issuance task for the first time since coming to market.

Our re-entry to markets came through a commercial-paper tender in February 2018, then we executed a five- and seven-year transaction in June 2018 with good books for a debut deal.

On sustainability, we stuck with our gut feeling and rolled out a sustainability-financing framework rather than a green-bond framework. There is nothing wrong with green bonds, but sustainability is the perfect fit for our business. This area is evolving rapidly and the progress we have had as an organisation – and the engagement this has allowed with investors – has been a highlight.

Recognising the importance of sustainability, earlier this year we created a new position in our team primarily to look at sustainability and further developing our framework. We want to remain at the forefront of this market in New Zealand and tell the compelling story we know exists with our wellbeing bonds.

Recently, it has been good to get ahead of the issuance curve. We had intense financing pressure even before COVID-19. To deal with this we negotiated a Crown standby facility and brought in two new primary dealers.

This put us in a good position once COVID-19 hit. We were able to put questions around offshore investor appetite and the size of our financing task to rest, at least for the time being, with a couple of game-changing transactions in April 2020 – which was incredibly satisfying. It was amazing how quickly our financing requirement and liquidity position changed.

Measuring impact is a huge topic in the sustainable-debt space. What can you tell investors about the positive outcomes of investment in Kāinga Ora bonds?
There are the big things, like the 200 homes we already have certified 6 Homestar by the New Zealand Green Building Council and the 3,000 homes currently under construction we expect to achieve this certification. This is something we did not have when we launched our sustainability programme in March 2019.

But it's the real-life stories that matter. As an example, a tenant was recently placed into a new home in Christchurch – where it gets really cold in winter. The house is of such good quality that the tenant did not need to turn the heaters on. They were saving on electricity, but not only that: after just a week in their new home they no longer needed to take medication for a respiratory illness.

This is exactly the kind of outcome we want to see and hear about. It is also what the government is trying to achieve with its focus on wellbeing. It is not about departments and entities just having budgets to do their own thing. It is about achieving outcomes across government that cover all the different parts of people's lives.

Are you happy with the extent to which liquidity in the Kāinga Ora programme has developed?
Liquidity has many components. Turnover was always going to be a challenge for Kāinga Ora while we were looking to establish lines in volume via syndicated issuance.

Spreads to swap and other comps largely reflect our supply dynamic. This can be broken down into two periods: the first year, when our bonds were in limited supply, and then the second year, when our financing task increased and supply concerns waned.

Moving forward, tenders will be a key focus for us to generate more liquidity in the secondary market. We intend to launch the tender programme in the second half of the calendar year.

The last nominal bond Kāinga Ora executed, amid the COVID-19 crisis, had a noticeable uptick in offshore participation. What factors contributed to this result?
The timing was key. It was after New Zealand Debt Management reopened

the market with its syndicated deal the week prior. The Reserve Bank of New Zealand (RBNZ) had slashed interest rates and implemented its large-scale asset purchase programme, which brought a lot of confidence to the market. We heard there was a lot of cash that needed to be put back to work once markets began to settle and we wanted to take advantage of this opportunity.

We were prepared to offer a new-issue concession to ensure we achieved our volume and diversification objectives, and this certainly helped. It is tempting to focus on every last basis point as an issuer, but we need to put this in perspective. As the most recent addition to the universe of high-grade issuers, we need to offer a value proposition to investors. Our goal is to lower the cost and risk of financing over the long term.

The COVID-19 crisis has changed the way borrowers manage their international investor relations. How are you adapting your strategy to keep investors engaged?
We are organising a virtual investor day with KangaNews on 19 August 2020. This is an opportunity to showcase all facets of the business and operations, and for investors in any jurisdiction to engage directly with senior Kāinga Ora personnel.

Moving forward, our primary dealers tell us some investors are comfortable meeting online – particularly if they have met us before – so perhaps some travel can be substituted. However, investors are the customers in debt issuance and we will do our best to accommodate individual preferences.

We are always open and happy to be contacted directly by investors. We find this mutually beneficial because it helps us work out where we need to improve our market communication. We do not want investors to be shy but equally we do not want to be hassling investors, because we know they are also very busy.

There was some speculation in the market about Kāinga Ora bonds being added to the RBNZ's purchase programme. This has not come to pass – has this affected Kāinga Ora?
It would obviously have been good to be included, but we understand why the RBNZ made this decision. At the time we had no more than a fifth of the amount of bonds on issue as others in the programme so we can see why the line was drawn where it was, particularly given the fact our bonds have been moving in line with other high-grade issuers.

We have not had much feedback on this, and we are not dwelling on it either. We have a job to do, as does the RBNZ – and we respect the role it plays. It is possible that some investors find a compelling case to purchase our bonds over competitors given the yield pick-up. Kāinga Ora's triple-A rating from Moody's Investors Service is also worth emphasising, we think.

The New Zealand government's budgets going forward are clearly going to be radically different from what they were in the recent past. Has there been much change to the expectations of funding requirement for Kāinga Ora?
The latest New Zealand government budget had an announcement of 8,000 new public homes on top of those previously announced in the 2018 budget. Kāinga Ora's role in this is to be confirmed, but typically around 70 per cent of public homes are built by Kāinga Ora.

The government has flagged an increase in our borrowing protocol of around NZ$5 billion to make this happen, bringing our total borrowing protocol to around NZ$12 billion. This is yet to be formalised, but we expect our bond programmes to be around NZ$2 billion per year for the foreseeable future.

Our preference is for any amount above this to be sourced away from debt capital markets, such as through Crown loans. This will help to ensure ongoing consistent supply but provide a release valve should build programmes change significantly.

What role do you see inflation-indexed bonds (IIBs) playing in the Kāinga Ora funding programme? Do you have ambitions to build larger, liquid lines and what are your volume aspirations more generally?
There are three key benefits for Kāinga Ora in issuing IIBs. They provide better matching to our housing assets, a natural hedge to housing rental income and investor diversification. So we are keen to continue exploring this option.

The deal we priced in April this year was in play since January. We decided to execute when we did given the strategic nature of our issuance and our desire to have the ability to print more in future.

We see IIBs accounting for up to 20 per cent of our portfolio over time. However, building liquidity in IIBs has different challenges from nominal bonds. Our preference is to work with intermediaries and investors towards an issuance approach that works for all parties. We will remain tactical in our approach to the market for this product, but we are keen to issue more. •

"As the most recent addition to the universe of high-grade issuers, we need to offer a value proposition to investors. Our goal is to lower the cost and risk of financing over the long term."

COPUBLISHED
ROUNDTABLE

OPEN ECONOMY, CLOSED BORDER: OPPORTUNITIES AND CHALLENGES IN NEW ZEALAND

New Zealand's government-sector issuers experienced market upheaval as severe as their neighbours in Australia during the height of the COVID-19 crisis in March and April. Intervention from the Reserve Bank of New Zealand (RBNZ) and an enviable pace of economic reopening have improved the outlook, but issuers at a *KangaNews*-**Westpac** roundtable in June say plenty of challenges remain to be faced.

PARTICIPANTS

- **John Bishop** Group Treasurer AUCKLAND COUNCIL
- **Mark Butcher** Chief Executive NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY
- **Sam Direen** Treasurer KĀINGA ORA – HOMES AND COMMUNITIES
- **Kim Martin** Acting Director, Capital Markets NEW ZEALAND DEBT MANAGEMENT
- **Vanessa Rayner** Head of Financial Markets RESERVE BANK OF NEW ZEALAND

WESTPAC PARTICIPANTS

- **David Austin** Head of Institutional Sales
- **Mat Carter** Director, Debt Capital Markets and Syndicate
- **Joanna Silver** Head of Sustainable Finance
- **Imre Speizer** New Zealand Financial Markets Strategist
- **Matt Wilsher** Associate Director, Debt Capital Markets and Syndicate

MODERATOR

- **Matt Zaunmayr** Deputy Editor KANGANEWS

Zaunmayr How would issuers summarise market access and conditions in New Zealand since the start of the COVID-19 crisis?

■ **MARTIN** It was clearly very volatile in March and the feedback was that liquidity was very poor. However, it appears now that things have normalised. Looking at our usual metrics for market conditions, tenders are well covered averaging around 2.5 times subscription. This is with the backdrop of increasing weekly tender volume, to around NZ$1 billion (US$648.3 million) per week from NZ$150-250 million per week before the crisis.

During this period, we have also had two record syndications, which we used to really test market access. The most recent was by far our largest-ever volume, at NZ$7 billion, with a good range of investors by geography and type. We cannot discount the volatility we all experienced in March but we are pleased with the market conditions we have been seeing more recently.

■ **DIREEN** Once we saw some normalisation we took the opportunity to return to primary issuance – and we are glad we did as we were able to diversify the pool of investors that buy our paper as well as reduce funding risk. We have not needed to access the market since late April and are still some way away from our next transaction.

■ **BUTCHER** We have been fortunate. We got through some pretty dark times where the primary and secondary markets were actually failing. It was horrendous in March and early April. There were days when the bid-offer spread on our bonds in the secondary market was 50 basis points, where it would normally be five.

This was partly because bid-offer spreads on government bonds were also widening a lot. This was not unique to New Zealand – it was similar in the Australian semi-government market and other government bond markets around the world.

The positive aspect is that we have been able to issue NZ$1.8 billion over the last six months. There have been times when this came with wider new-issue premia and overall pricing was wide compared with prior years. However, we have been able to access the market – and for record volume.

There have been dark times but, with the assistance of the reserve bank, market confidence has returned quickly. Where we are now relative to last year seems okay. It has been an interesting time and no doubt another chapter in the book on the history of markets.

■ **BISHOP** We have not been active in public markets but have had a similar experience. We raised a fair amount through private placements in March and April. This was expensive and the maturities on offer tapped out at around three years, but we did get more than NZ$500 million away.

The market has returned to a sort of normality now. Our next major issuance is likely still a couple of months away, though.

Zaunmayr What is the view on market conditions from an intermediary perspective – and in particular what has Westpac seen when it comes to investor capacity to absorb new issuance?

■ **CARTER** As the borrowers have said, there was a sentiment of market dislocation coupled with material volatility in March. This led to a 'cash is king' ethos that was a theme we had not seen for a while.

The end of March and start of April was very concerning. But kudos to the RBNZ and other global central banks, which efficiently implemented measures to enhance market functionality. These were desperately needed.

One can't help but compare the 2008 financial crisis with the current period. However, that crisis played out over 2-3 years, whereas the COVID-19 crisis played out in only a matter of weeks. It has been a sprint rather than a marathon – hopefully this remains the case and volatility can remain somewhat in check going forward.

Regarding market capacity, we have seen strong execution outcomes from the local high-grade borrowers, together with Kauri issuance.

A huge amount of liquidity needs to be put to work and trading books are now also short of paper. The NZ$7 billion deal from NZDM [New Zealand Debt Management] had an orderbook of NZ$14 billion, which is a highlight when talking about market capacity. The LSAP [large-scale asset purchase] programme has also been a real positive for the secondary backdrop – we have seen a significant contraction in credit spreads across many sectors and the market is keen to see more primary supply further down the credit curve.

■ **AUSTIN** In times of stress, investors in particular focus predominantly on shoring up liquidity. A lot of domestic

"We need efficient price discovery to achieve monetary-policy effectiveness. A good amount of two-way activity has returned to high-grade fixed-income markets and bid-offer spreads have come back in. Bond-swap spread levels have also returned to the levels of early 2020."

VANESSA RAYNER RESERVE BANK OF NEW ZEALAND

Westpac participants


DAVID AUSTIN


MAT CARTER


JOANNA SILVER


IMRE SPEIZER


MATT WILSHER

investors looked to their experience in the 2008 financial crisis to assess what measures they would take this time around.

This saw funds looking to convert a meaningful portion of their portfolios into cash or near-cash instruments. Offshore investors were also liquidating New Zealand dollar assets as they sought to revert to core markets. In New Zealand, pretty much all enquiry was coming from the sell side.

Trading books needed a release valve, which the RBNZ provided with its LSAP programme. This cleared the way for the market to resume some normality.

Now, cash levels remain extremely high. There is close to NZ$30 billion of cash in the system compared with around NZ$7.5 billion typically. There is a lot of cash sitting on bank balance sheets looking for a home, while fund managers and retail investors have also accumulated additional cash from maturing assets.

RBNZ ROLE

Zaunmayr What is the RBNZ's view on market conditions and domestic high-grade issuance over the couple of months since it began its QE programme?

■ **RAYNER** I agree with what has been said on market conditions. We observed severe dysfunction in mid-March as the market responded to uncertainty in the economic outlook. As Mark Butcher mentioned, this was not unique to New Zealand. But the increasing uncertainty resulted in increasing demand for liquidity.

Domestically, we saw a spike in short-term interest rates and widespread sales of high-grade bonds to raise cash. We also observed that internal balance-sheet constraints were hampering the ability of financial intermediaries to manage the large volume of sales. On some days there just were no buyers of New Zealand high-grade bonds. We were very concerned about what we were seeing throughout this period.

Prior to establishing the LSAP programme, we also implemented other measures to try to provide confidence and liquidity to the market. We began by injecting an unprecedented amount of liquidity via the FX swap market and did some small-scale purchases of government and LGFA [New Zealand Local Government Funding Agency] bonds.

We also established a term auction facility to provide banks with liquidity out to 12 months if they needed it. And we started corporate open-market operations so banks could support their corporate clients.

These measures were all introduced in the lead up to the announcement of the LSAP programme. While our markets team was doing all it could to restore market function, our economics colleagues and the Monetary Policy Committee (MPC) were assessing the economic impact of the pandemic.

It quickly became clear we would need to provide more stimulus through lowering the overnight cash rate, providing forward guidance and launching the LSAP programme.

The primary objectives of our LSAP programme have been to lower interest rates across the economy and to support market function. On the market-function piece, we are pleased to see confidence has been restored to New Zealand financial markets. Inevitably we will go through periods of ups and downs but it is pleasing to see some stability relative to March and April.

We need efficient price discovery to achieve monetary-policy effectiveness. A good amount of two-way activity has returned to high-grade fixed-income markets and bid-offer spreads have come back in. Bond-swap spread levels have also returned to the levels of early 2020.

Another sign of success has been the large volume of high-grade issuance absorbed by the market in the last couple of months. It will be positive to see more issuance beyond the high-grade sector in the coming months to show continuing improvement to market function.

By helping to restore market function we have been able to achieve monetary stimulus. The sovereign yield curve is lower and flatter, which is being passed through to lower interest rates in the financial system and economy. This happened quickly with wholesale rates but recently we have seen it pass through into retail rates as well. This is what we want to see.

Zaunmayr What was the thinking behind the types of securities and tenors targeted by the LSAP programme, and by the volume of regular purchases?

■ **RAYNER** The asset composition of the programme is determined by the MPC. It has a range of principles in mind around the effectiveness of particular securities for achieving monetary-policy objectives, the efficiency of the market, financial-system soundness and the risk to the RBNZ's balance sheet.

Once the decision is made around the size, duration and composition of the programme, implementation is delegated to staff in the financial-markets department. Our strategy has been to buy bonds across the curve in a balanced manner, because we think there are multiple channels through which monetary-policy stimulus occurs. This is across price and quantity channels.

We have seen a notable impact on yield across the curve. This will ultimately reduce borrowing costs for government, businesses and households. The capital-gains channel is also part of the transmission mechanism. Investors that already own these bonds will see some wealth-channel effect.

There is also the volume of purchases. Buying at the long end of the curve will reduce the term premium, encouraging investors to rebalance portfolios into riskier asset classes and reduce credit spreads.

We may also see offshore investors sell out of New Zealand dollar assets, which will result in a lower exchange rate – all else being equal.

We do not want market participants to read too much into the weekly purchase schedule because ultimately the stance of monetary policy is decided by the MPC and we have varied our purchases operationally from week to week based on market conditions. We ramped up purchases significantly in the early stages of the programme to support market function and clear inventory. We have slowly reduced our purchase volume as market conditions have improved.

■ **SPEIZER** The market's perception of the LSAP programme so far is that it has been highly effective. It has cured a briefly dysfunctional government bond market and had a lot of other benefits including bringing rates down across the curve.

Vanessa Rayner is right about the market being fixated on the weekly pace of purchases. Tweaks to this pace have sometimes been met with modest reactions. In time, the market should learn that the RBNZ recalibrating its approach on an ongoing basis is not that significant.

One thing I'd be interested to know is whether the RBNZ foresees a time when it will potentially sell securities that it has acquired during QE and, if so, what pre-conditions would need to be met to do so?

■ **RAYNER** Future decisions around the size, duration and exit strategy from the LSAP programme will be determined by the MPC and will depend on the outlook for economic activity, unemployment and inflation.

The indemnity letter for the LSAP programme says it is our intention that these bonds will be held to maturity. We are a long way away from contemplating what an exit strategy for the programme looks like, though. The statement from the June MPC meeting was that there are still downside risks to the outlook and the RBNZ is ready to provide additional stimulus if necessary. At this stage, we expect monetary policy to remain stimulatory for a long period.

Zaunmayr We have heard the RBNZ say it is is keen to see corporate issuance to indicate ongoing market recovery. What is the outlook for corporate issuance in H2?

■ **CARTER** The corporate sector has focused on immediate liquidity needs, which have been satisfied through the bank loan market. Thus far, the COVID-19 crisis has been short, sharp and violent, so debt capital markets issuance has not been on the immediate radar for most corporates.

Now that we have seen a stabilisation of markets and we have had time to digest the new environment, we expect to see corporate supply in the second half of 2020.

Another important point to note is that many corporates will want to wait until after the release of their annual results in mid-August. If we stay on the current trajectory, there will definitely be opportunities for strong execution and the supply will be welcomed by wholesale and retail accounts.

For retail-driven transactions, issuance will be at lower coupon hurdles compared with last year due to the compression in term-deposit rates and the lower-for-longer yield environment.

Zaunmayr There does not appear to have been much dislocation in pricing between issuers that are part of the LSAP and those that are not. Why do borrowers think this is the case?

■ **DIREEN** The LSAP programme has clearly helped us even though we have not been a direct target of RBNZ purchases. We had never really been ahead of our issuance run rate in the 2.5 years since our market return. Having settled conditions

> "It was clearly very volatile in March and the feedback was that liquidity was very poor. However, it appears now that things have normalised. Looking at our usual metrics for market conditions, tenders are well covered and averaging around 2.5 times subscription."
>
> **KIM MARTIN** NEW ZEALAND DEBT MANAGEMENT

NEW ZEALAND'S *ECONOMIC UPSIDE*

New Zealand became the envy of the world in June when it was able to lift all domestic social-distancing restrictions. The economic challenges are not over, though – especially while the national border remains closed.

ZAUNMAYR The New Zealand economy has been able to open earlier than expected – at least domestically. Is there any possibility of the economic hit from COVID-19 not being as severe as expected and, as a result, of funding tasks surprising on the down side?

■ **SPEIZER** We have already seen a positive surprise in the recent high-frequency data. This caused us to upgrade our economic outlook slightly compared with the depths of the crisis. For example, we are expecting unemployment to peak at around 8 per cent this year rather than 10 per cent.

This is still not a great situation, but it is not as bad as we had thought. If this faster rebound has durability we will continue to tweak our forecasts.

However, there are some big risks out there. The big one is obviously a second wave of COVID-19 infections, which we are already seeing in the US and elsewhere. This would slow the economy and, for New Zealand, may push out the timing of the travel bubbles we were expecting later this year.

We are also unsure of what the labour market will look like when the wage-subsidy schemes expire. It is too early to draw conclusions.

■ **RAYNER** Some aspects of the outlook have surprised to the upside as we outlined in the June monetary policy review. This included the move to level-one restrictions and a higher level of fiscal spending than we had expected in the May monetary policy statement. We have also seen some trading partners relax restrictions, which has provided some confidence on the outlook for export demand.

Downside risks remain. We are in a fragile world with many countries struggling to contain the virus. Until that happens there are significant risks to us as a small, open economy.

ZAUNMAYR What are issuers doing to position for ongoing volatility whether geopolitical, economic or directly related to a second wave of COVID-19?

■ **BUTCHER** It is important to remember that six months ago we were not talking about COVID-19 – we did not even know what it was. We have been through a dramatic three-month period and I think we just need to keep pre-funding because it is not that expensive to do so.

If things turn around, fantastic. But if they do not the benefits from being cautious are well worthwhile. We were slightly ahead of the curve going into COVID-19, but not that far ahead. This has been a lesson for us.

We are not trying to pinpoint a moment in the future where the recovery might take place. It is such a moveable, volatile situation that is hard to plan for or predict.

■ **DIREEN** I agree on the point around getting ahead of the curve as we simply don't know how the next year or so will play out in health, economics or geopolitics.

When it comes to our drivers, demand for housing was at an unprecedented level even before COVID-19 and there was a significant state-housing shortage. The demand will only be greater as the underlying economic impact is felt in coming months.

■ **BISHOP** We have done a fair bit of pre-funding and we are holding more cash than we typically would. We are expecting a large drop off in our revenue next year through people not using public transport as much and less demand for events at our stadiums. We will need to fund some of this revenue shortfall through debt.

Our initial forecasts were possibly a bit pessimistic. But, as others have pointed

allowed us to bring a nominal bond transaction of NZ$1 billion, which was a game-changer for us – so we strongly support the work the RBNZ has done.

We have not seen much pricing dislocation and I think this is because there is not much credit difference between those that are in the programme and those that are not. The market appreciates this and prices it in.

There may have been some speculation from investors on whether we would be included in the LSAP programme. But not being included did not stop us from achieving a great outcome in our last deal. We are happy with the point we have reached.

■ **BISHOP** The moves by the RBNZ have brought confidence back. Although we still have not seen a lot of trading in our bonds, pricing has largely followed the LGFA.

To be fair, the LGFA has probably performed a bit better. This means it is likely relatively more attractive for us to raise funds via the LGFA at the moment than through our own name – though this in turn may in part be down to the RBNZ programme.

■ **BUTCHER** We had record council borrowing in the March and June quarters. In fact, it has been helpful that the bulk has come through the LGFA as opposed to being scattered too far around the marketplace. A lot of councils began hoarding cash at the start of the crisis and, by contrast, this did not help with our issuance task in the first half of the year.

I also want to touch on the RBNZ's role. It is important for the market not to be completely reliant on the reserve bank. I think the RBNZ should be the buyer of last resort.

In the early days of LSAP, New Zealand dollar yields went well through Australian dollar and US dollar yields. This was concerning because it meant there would potentially be a flood of bonds coming back from offshore. The role of LSAP to me should be to keep the market at an equilibrium with a clearing price with which investors are engaged and borrowers can get issuance done.

out, if things get worse again this can change quickly.

■ **MARTIN** We have taken a similar approach by front-loading our funding task and increasing our funding by more than the forecast underlying cash requirement. This means our forecast programme of NZ$60 billion (US$38.9 billion) for this fiscal year is forecast to leave us with a larger cash buffer than we would ordinarily forecast. This will allow us to manage any short-term funding or liquidity risks.

We also have flexibility in our short-term Treasury bills programme and have reinvigorated the foreign-currency ECP programme. We also have a limited overdraft facility with the reserve bank.

Recent times have shown us we need to have all options available. Hopefully we will not require them, but it is good to know they are there.

WILSHER We did some investor-relations work recently where every offshore investor mentioned and applauded New Zealand's response to the COVID-19 crisis and the subsequent health and economic benefits.

How positive is sentiment around 'New Zealand Inc.' at the moment and are borrowers seeing this come through in their own investor-relations work?

■ **MARTIN** We took the opportunity between the budget and our upcoming debt transactions to do a series of domestic and global investor engagements. This covered investors in almost 30 cities, over two weeks. There are definitely some benefits to doing investor engagements virtually.

How well New Zealand has done in mitigating the health risks of COVID-19 is widely acknowledged. However, there is also a lot of conversation around the long-term impact on the economy and specific industries, particularly from the closure of our international border.

We heard few concerns around New Zealand's sovereign credit risk or indeed any concern about our increased funding task. There is recognition that New Zealand came into this on a strong platform, and ultimately we are likely still to be in a strong position, relatively, on measures such as net debt.

As Vanessa Rayner says, who knows when LSAP will end. At LGFA, we are already thinking about how and when it might end and how we will extricate ourselves from the support. We do not really want to go down the path of Europe or Japan where the market has been totally reliant on the central bank for almost a decade. The more reliant the market becomes, the more difficult it is to return to normality.

■ **RAYNER** It is important that we do not suppress market signals too much because it could lead to inefficient allocation of capital. There needs to be active participation in the New Zealand market so it can flourish. The RBNZ does not want its presence to impede market function and we need to balance this when considering the speed and size of the programme.

FUNDING TASKS

Zaunmayr The New Zealand government released its budget in May. Has this been helpful for NZDM's communication with market participants?

■ **MARTIN** We recently did a series of virtual engagements with our domestic and offshore investors. There was an acknowledgement of the achievement of presenting the budget on schedule. Investors recognised the challenges posed by the uncertainty and also the operational limitations of doing this during a strict lockdown.

Because of the inherent uncertainty, along with the main economic forecast the Treasury included three other scenarios in the budget. Investors welcomed our five-year forecast for the bond programme. They also appreciated the clarity provided by our practice of pre-announcing our full tender schedules, even if these are now quarterly.

Because of the New Zealand election this year, we are required to provide a pre-election update. At this time, investors will receive an update of all economic and fiscal forecasts and our borrowing programme, rather than having to wait for the half-year economic and fiscal update in December.

Zaunmayr What guidance have other borrowers been able to give to the market?

■ **BISHOP** In the long term our borrowing requirement will remain roughly the same as it has been previously, at around NZ$1-1.5 billion per year of new and refinanced debt. We have had calls with domestic investors and our banks. We have not formally engaged our offshore investors since COVID-19 began but we will look at the best approach for doing so over the coming months.

■ **DIREEN** The government has announced the delivery of an additional 8,000 houses over the next four years. Kāinga Ora's borrowing protocol limit is still being worked on through the Ministry of Housing and Urban Development. But it will likely be around NZ$12 billion, up from NZ$7 billion currently.

We have always wanted to give as much certainty as possible to investors but it can be challenging when decisions around the quantum of both building and financing are not ours to make. We are involved in a government workstream on financial sustainability and continue to make the case to other agencies that bond programmes need to be predictable and not swing from year to year based on build requirements.

We have gauged changes in sentiment based on just NZ$500 million variation in our bond programme so we are advocating for a cap on our New Zealand dollar market issuance and to divorce the bill programme from the bond programme. From our perspective, we would prefer to have an alternative form of financing for any amount over a certain threshold.

We have a programme of NZ$2 billion this year and expect it to remain similar for the next few years – but it could change.

■ **BUTCHER** Investors always ask us about issuance intentions and timing. In April, we increased our projected funding requirement for each of the next three years by around NZ$250 million, which is around 10 per cent for each year. We had sampled our council borrowers for this – though it is difficult to get certainty as we are a funding conduit.

Council borrowers are now beginning to think about the future. Most have spent the last couple of months focused on addressing short-term issues around potential revenue shortfalls and maintaining services.

Councils have a lot of debt servicing capability. We are about to relax some of our financial covenants to allow greater borrowing and this should allow further investment in infrastructure and other projects for COVID-19 recovery.

We still think our funding projection for the coming years is about right, though. This allows for an extra NZ$500 million to NZ$1 billion of new borrowing by councils each year.

We have concerns, though, on councils' ability to deliver capex due to capacity constraints and a history of a lot of capex being promoted and publicised by central and local government but then delayed. If projects cannot be started, council borrowing requirements could be lower.

Zaunmayr How have borrowers adapted their funding strategies to allow for a large increase in overall volume, for instance via curve extension?

■ **MARTIN** We have had an active policy to extend the weighted-average maturity of the portfolio for a while. We have had a 20-year bond in the past and returning to this point is a strategic objective we will achieve with the new 2041 line we plan to issue in July.

We receive demand for deals with even longer tenor but we are wary of creating orphan bonds and like to have relatively even spacing between bonds on our curve. We also want to be able to issue into bond lines and keep them liquid through their lifetime. This is harder to achieve if we issue a lot further out.

However, we are giving ourselves as much freedom as possible within our funding task. For example, we recently issued a short-dated infill bond, the new 2024 line, and have undertaken syndicated taps for the first time, to add volume to existing lines.

We have also had an increase to the cap on each of our nominal bond lines, to NZ$18 billion from NZ$12 billion, to give us greater flexibility. There may be times when markets are again more volatile and issuing long-end bonds may not be the right approach at such times.

Zaunmayr How deep is New Zealand dollar demand for long-end bonds and does it extend across the full spectrum of high-grade borrowers?

■ **WILSHER** The long-end market is in its infancy in New Zealand but, with yield at an all-time low, there will be some natural movement from investors further out on the curve to find more attractive yield. I think we will see this in NZDM's 2041 transaction.

How relative value stacks up compared with offshore markets will be a key aspect of demand, particularly given the RBNZ is participating in the long end of the market much more than other central banks.

Zaunmayr Is curve extension a big focus for the other borrowers – and how easy will it be to achieve?

■ **DIREEN** Our nominal curve goes out to 10 years and we have also issued a 20-year inflation-indexed bond. We have been interested in issuing long-dated debt since early 2018, even before we came to the market for the first time.

We saw little bits of interest over this time but nothing material that presented a compelling opportunity for us to issue a long-dated transaction. We were presented with reverse enquiry for an inflation-indexed bond in January and worked on this transaction for several months. This issuance makes sense for us because of the nature of our asset base – long-lived housing – and our rental-income-based revenue stream. The diversification it provides for us, as a developing issuer, is also important.

We would like to issue up to 20 per cent of our debt in long-dated funding if the demand is there and the opportunities make sense for our portfolio.

■ **BUTCHER** In general we are probably a little disappointed with the local government market for not extending the tenor of its debt. The only thing holding LGFA back from issuing longer bonds is that we already have a much longer average tenor of issuance versus average tenor of lending.

Councils had an initial surge of debt extension when we first came along. But this seemed to cap out at around the seven-year maturity mark. Until this process of extension resumes, any bond issuance we do in the long end is the LGFA largely taking funding onto its book. This is a lot more expensive at the back end of the curve. But we will entertain

"Once we saw some normalisation we took the opportunity to return to primary issuance – and we are glad we did as we were able to diversify the pool of investors that buy our paper as well as reduce funding risk."

SAM DIREEN KĀINGA ORA – HOMES AND COMMUNITIES some long-dated funding in order to develop the market and extend average tenor.

Carter The long-dated market is typically a function of offshore currencies. We haven't seen many New Zealand dollar placements at the long end but we have seen some offshore peers undertake long-dated funding in euros. Are any of the borrowers looking at foreign-currency funding more closely now than before the latest crisis?

■ **BUTCHER** Our view is unchanged. We continue to monitor offshore funding markets for pricing but we need to be very price sensitive. The councils do not need to borrow through LGFA so if we start landing offshore funding back into New Zealand dollars at levels far wider than they could issue domestically in their own names they are unlikely to fund through LGFA.

■ **DIREEN** How we view the opportunity versus financing in New Zealand dollars is similar. Our appetite for foreign-currency funding is low – we have legacy loans with the Crown and we think this mechanism could be used for any residual financing needs, should they arise. This could tie into our work on financial sustainability. Diversification and tenor are appealing but ultimately it comes down to cost.

■ **BISHOP** Euro deals are still on the agenda for us. We have completed three euro benchmark deals so we have a nice curve. We have always mixed our funding between domestic issuance in our own name, offshore funding and borrowing through the LGFA – and this will remain consistent going forward. We have nothing planned offshore at present, though.

GSS ISSUANCE

Zaunmayr Could labelled green, social and sustainability (GSS) issuance become more prominent as issuers seek additional capacity for larger funding tasks?

■ **CARTER** We are seeing demand from domestic and offshore accounts for GSS bonds from New Zealand issuers. The depth of domestic New Zealand dollar environmental, social and governance (ESG)-specific demand is still gathering pace. While it is obviously not as deep as it is in offshore markets, it is clear that appetite is increasing.

It is also important to note that investors are putting a critical ESG lens over nominal issuance. Going forward, in an environment where funding needs have dramatically increased for some issuers, discovering additional pockets of demand such as in GSS bonds should have greater focus.

Zaunmayr Globally, we are seeing transactions aligned with financing requirements linked to COVID-19-related needs from supranational, sovereign and agency names, and also from a handful of corporates. How has COVID-19 changed the shape of the sustainable-finance market? Might this evolution extend into New Zealand?

■ **SILVER** Fundamentally, the pandemic has driven a much greater focus on the need to understand and mitigate more severe and sustained societal risks. One of the ways we have seen this play out is in the social-bond market – which has quadrupled in volume this year, accelerated by the response to COVID-19 in the public and private sectors.

Social bonds have to date been a much smaller market and one that is more difficult to understand, track and scale up than green bonds. Despite this, these bonds have emerged as an important part of the toolbox for borrowers financing their post-COVID-19 strategies and relief packages.

In offshore transactions, we have seen real benefits for a handful of market participants – largely supranationals. It was the same in the early days of the green-bond market and we expect eventually that corporates, insurers and banks will follow suit in the social-bond space. Public-sector issuers generally have a wider social mandate, though, so it is likely these will remain the biggest social-bond issuers.

The types of things that could be financed through social bonds in New Zealand include wage subsidies, supply-chain management and preservation, operations disruption and the funding of essential services.

Zaunmayr Do any borrowers see more scope to use the social side of what they are funding to promote issuance tasks?

■ **DIREEN** We have been intrigued by the issuance of COVID-19 bonds and, while we focus on sustainability and our wellbeing agenda, this highlights that there is demand in the space.

> "We got through some pretty dark times where the primary and secondary markets were actually failing. It was horrendous in March and early April. There were days when the bid-offer spread on our bonds in the secondary market was 50 basis points, where it would normally be five."
>
> **MARK BUTCHER** NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY

NEGATIVE RATES LOOM IN NEW ZEALAND

The possibility of a negative official cash rate in New Zealand at some point in 2021 is a major discussion point locally. If it comes to pass it could reshape the local bond market – though perhaps without seriously disrupting demand.

ZAUNMAYR The Reserve Bank of New Zealand (RBNZ) has not ruled out negative interest rates domestically but has said such a monetary measure is not immediately implementable. What would the desired outcome of negative cash rates be?

■ **RAYNER** We would be considering the ability of negative interest rates to stimulate economic activity and return inflation and unemployment to our stated policy objectives. We have signalled that it is a tool we are considering but it is among a suite of tools we have at our disposal.

We have found the ability to implement negative rates requires banks to be operationally prepared. We sent a letter to banks to ensure they are ready to implement negative rates if the Monetary Policy Committee (MPC) decides to use this tool.

We are doing work internally to assess the relative effectiveness of various tools and, depending on the economic outlook, the MPC will look at the best way to respond.

ZAUNMAYR What have investors been saying about the possibility of negative rates and the likely impact on demand?

■ **AUSTIN** When contemplating a negative cash rate one should not lose sight of the fact that there are domestic funds that are required to hold domestic securities and bank balance sheets that need to hold liquid assets. These investors will not go away. They could move further out along the yield curve to get a higher return. One would also expect these investors potentially to move slightly down the credit spectrum to increase returns.

The other dynamic at play is that high-grade issuance is growing sharply in an environment where corporate issuance has slowed. The changing composition of the local composite fixed-income index means some investors are compelled to rebalance into high-grade from corporate debt, which should also support high-grade issuance even in a negative cash-rate environment.

For offshore investors, it would become a question of relative value. This all hangs on where New Zealand bonds sit relative to offshore bonds.

■ **CARTER** The fact that the RBNZ has mentioned the possibility of using this tool has cemented the lower-for-longer rates expectation with investors. COVID-19 is a new paradigm and will likely result in even lower yields for government and corporate bonds in the medium term, and a hunt for any yield.

■ **SPEIZER** The Westpac view has been that New Zealand will see a lower – negative – official cash rate early next year. We are in a small minority of analysts calling this, though, and there is a long way to go before we are at that point.

If we do get there and other central banks do not move, the risk is that the yield spread could ripple along the curve and affect appetite for longer-term New Zealand government bonds.
We would not entirely rule out the possibility of the Reserve Bank of Australia, US Federal Reserve and other central banks also having to go down this route if things become dire enough, though.

When we talked with European investors in November 2019, sustainability came up in every meeting – even the ones where our briefing note said the topic was unlikely to be of interest. This train is not slowing down despite COVID-19 and we are doing our best to evolve our practices to stay at the forefront.

As an issuer, it is quite tricky to keep track of all the different threads that relate to sustainable finance and it takes a lot of work to do it properly. We are not interested in doing a half job on this.

For us to honour the badge of a wellbeing bond is a multi-year journey. We are making good progress on this and the fact that the *Kāinga Ora – Homes and Communities Act* has sustainability as a core focus and outcome means we have board support to continue this.

■ **BISHOP** Prior to COVID-19, we were looking to increase our issuance of green bonds in New Zealand dollars and in offshore markets. We had a long-term objective of doing most, if not all, of our issuance in green-bond format.

This has been put on hold because of COVID-19. But we expect these plans to ramp up again once we return to more normal markets. It is still very much front of mind to be a leader in the green and sustainable space.

■ **BUTCHER** We remain intellectually curious and we are still putting in place our internal GSS framework for lending to councils. This would allow us to build an asset that we could put into a GSS issuance framework.

The question I have is whether there has been GSS issuance in Australia by semi-government and other high-grade borrowers during the crisis. I am an avid reader of *KangaNews* but have not seen any issuance of GSS bonds highlighted recently. Instead I think the focus has been more on getting funding in the door and, in this case, borrowers tend to default to their vanilla funding.

■ **ZAUNMAYR** National Housing Finance and Investment Corporation issued a social bond at the end of June but you are right that none of the state treasury corporations have issued in GSS format this year.

It seems to be the case that programmatic GSS bond issuers now have access to incremental demand from specialist investors. On the other hand, other issuers' focus has been on getting the funding they need and the work to issue in GSS

“We had a long-term objective of doing most, if not all, of our issuance in green-bond format. This has been put on hold because of COVID-19 but we expect these plans to ramp up again once we return to more normal markets.”

JOHN BISHOP AUCKLAND COUNCIL

format under recent circumstances has probably been too much.

■ **CARTER** The base case for dealing with this economic crisis has been for issuers immediately to resort to either or both of bank debt and their nominal bond programmes, unless they are already a regular GSS issuer. It will be interesting to see how quickly the dial turns back to focus on specific GSS issuance again.

■ **SILVER** We see real parallels between COVID-19 and climate change – they both affect economies and societies, and threaten the wellbeing of the global population. The only difference is the timeframe available to respond, although the climate-change window is perhaps not as large as many think.

There have been calls across a lot of channels to keep this front of mind in New Zealand. This is probably partly due to the structure of the current coalition government, but also to New Zealand having a long-term, stable climate-policy framework.

My sense is that the understanding of the need to finance the transition to a net-zero carbon economy and adjust to the transition has not gone away. The intention to align funding with wider goals has also not changed in the minds of a lot of large institutions.

Zaunmayr What insights can market participants offer on the secondary-market performance of GSS bonds compared with conventional bonds?

■ **SILVER** We have heard from fund managers that when they have vanilla and green bonds in a portfolio they will lose the former before the latter – based on their view on value.

It is worth mentioning that a lot of GSS bonds overseas have been very well oversubscribed, often by more than two times. There has been meaningful participation from the socially responsible investment community.

In New Zealand, a lot of fund managers are waking up to the realisation that having a strong and authentic ESG mandate is important. Green and social ‘washing’ still occurs but investors and stakeholders are becoming more savvy. Social bonds can help ESG fund managers with their mandates and provide a way to engage and support financing the transition we need with a degree of urgency.

■ **AUSTIN** The government recently announced that default KiwiSaver providers appointed next year will be required to exclude fossil-fuel investments from their funds. The detail around how this protocol will be applied is not yet clear, but it has raised the fund-management community’s urgency in regard to ESG investments and clarifying how they fit within investment portfolios.

■ **RAYNER** We have talked about the challenging circumstances we are in. From the RBNZ’s point of view, this is an opportunity for issuers and investors to take a long-term, sustainable view of the recovery. We are in a world where borrowing costs are low and there is significant investment required for our country to achieve its task of climate-risk reduction and adaptation.

The RBNZ has a climate-change strategy and we are thinking about this in terms of the long-run economic and environmental outcomes for New Zealand. There is an opportunity here to provide leadership during difficult times and ensure capital is going towards a more sustainable and climate-resilient economy.

■ **DIREEN** It is a long-term game for us. We do not have a huge market in New Zealand and a lot of our issuance goes to domestic investors. Not many investors in New Zealand have specific ESG mandates, but if we can pick up incremental investors in each bond issue over time we think it will help support pricing in the long term.

The driver for us has always been aligning our financing with organisation and government commitments and objectives, and the discipline it instils within our programmes and practices.

■ **MARTIN** In our most recent round of global investor engagement, ESG conversations were generally notable by their absence compared with February – when there was not a meeting where they did not come up. The most recent meetings were, understandably, more about getting information on the here and now.

More broadly, we have been responding to feedback from investors that they want us to take a holistic approach as an issuer. We hear that they consider New Zealand’s sovereign ESG credentials more broadly rather than necessarily wanting a specific labelled product.

We are doing work to raise awareness on relevant issues, such as New Zealand being ranked 19th out of 193 countries on the SDG [UN Sustainable Development Goals]. Investors also want to hear about momentum and progress, so we are working to make this information available. •

Fintech lenders try not to slip through the cracks

COVID-19 has thrown up challenges even for the most established capital-markets borrowers. The situation is particularly acute for newer financial institutions with shorter track records and smaller asset books. Government support should help, but a protracted downturn could make survival of the fittest a best-case scenario.

BY MATT ZAUNMAYR

In recent years, the fintech lending sector has been championed for its technological innovation and for the competitive challenge its advocates claim it will bring to the lending market. Unencumbered by legacy systems and with the ability to focus on niche subsectors, fintech lenders have started to make market-share gains – albeit at the margin of the overall market.

Operating in a challenging environment will not be new to fintech lenders, all of which have come into being in a period of low growth across Australian business and personal credit (see chart).

Having competitive provision of credit, especially in the SME space, may be helpful to Australia's recovery from the COVID-19 crisis. Fintech lenders have created competition in their respective sectors and arguably improved the range of financing options available to small businesses, consumers and households. If many fail during or after the crisis period, the Australian lending landscape could lose competitive challengers before they have a chance to make their mark.

The timing of the crisis poses specific challenges for many new lenders. Few are cashflow positive and even fewer have the scale or track record to access a diverse range of funding options, even in a more conducive market. Relatively narrow sources of funding potentially mean less ability to withstand negative changes to operating conditions.

"The fintech lending sector in Australia is developed but relatively immature," says Daniel Teper, Sydney-based partner, corporate finance advisory at KPMG. "Owners and shareholders have historically been hesitant to dilute themselves too early so many only have capital to last 6-12 months. Meanwhile, their cash burn rate has likely increased."

Several government stimulus programmes have been designed to help lenders bridge the gap between the onset of the crisis and the economic recovery. Lenders welcome these measures but say eligibility problems may hinder their efficacy (see box on p100).

Some observers believe any winnowing of the fintech field may be no more than the acceleration of a natural-selection process that would likely have happened anyway. But others say the survival of a healthy group of new lenders is important for the future state of competition in Australian lending.

PRESSURE POINTS

Fintechs have emerged in every sector of lending in Australia. Some seek to fill gaps left by major banks in personal and SME lending. Others are challenging the banks by lending in the prime residential mortgage space.

Australian fintech lenders have mostly adopted a similar approach to funding that evolves and broadens in line with loan-book growth. This approach starts with venture capital, then adds bank warehouse funding – potentially including specialist debt investor mezzanine funds – and eventually progresses to public securitisation.

Firms are at different points in the funding journey, though. Some – such as Zip Co – have already issued public asset-backed securities deals. Others are yet to reach even the warehouse phase.

"The question for many [fintech lenders] will be how long they can continue to operate when their capital does not stretch as far and the credit quality of their loan books, both new and existing, is under pressure."

DANIEL TEPER KPMG

There are also contrasting strategies when it comes to seeking authorised deposit-taking institution (ADI) status. A clutch of 'neobanks' believe access to deposit funding, among other benefits, makes entering the regulated arena a worthwhile step. Most fintechs operate as more conventional nonbank entities.

Whatever funding strategy new lenders have adopted, access to funds is clearly harder now than it was before COVID-19. Those that have taken the ADI route have access to deposits, but market participants say this space has become much more competitive and is especially challenging for banks without an established lending product on the other side.

For those that have begun lending, the same operational uncertainties exist as for most businesses during the COVID-19 crisis. A massive and sudden rise in unemployment is likely to affect their customers and their asset quality, and therefore their balance sheets.

Funding is naturally harder for entities with a less well-established track record of credit quality. The concern with many fintechs is less about access to funds in the immediate future but how well ballasted they are to withstand a more protracted – or wholly diverted – route to profitability.

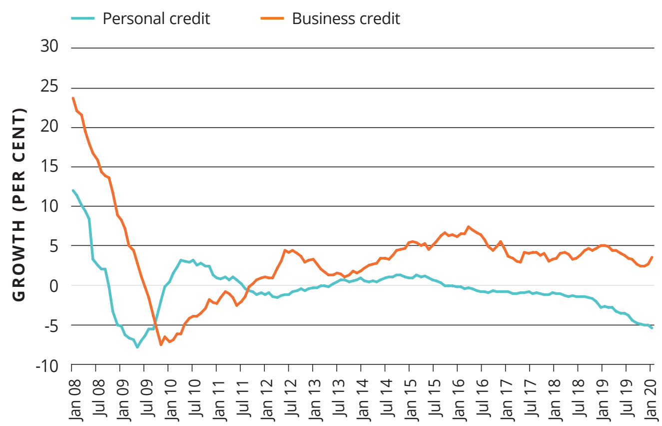
"The capacity for any lender to lend is diminished at the moment and net-interest margin, revenue and profitability are all likely to be down. For some this will mean an extended time period to break even. This is a big issue and the question for many will be how long they can continue to operate when their capital does not stretch as far and the credit quality of their loan books, both new and existing, is under pressure," Teper tells *KangaNews*.

Being on the right side of the scale chart is likely to be crucial. Cameron Rae, Melbourne-based managing director at Laminar Capital, says lenders that have found a niche and begun building a book of high-margin loans will likely be coming into the crisis in better state.

The type of lending a fintech is targeting may also have an impact on its resilience. Rae adds, for instance, that lenders trying to compete with the major banks in prime mortgage lending may have to contemplate diversifying their business models. With low overall demand for home loans, the path to profitability for lenders taking this route has likely become much longer.

On the other hand, sector advocates say the credit quality of the prime space could make it a better place to be. Michael Starkey is co-founder and chief operating officer at Athena Home Loans in Sydney, which has quickly built a book of super-prime mortgages in the last 24 months. He says Athena's focus on

AUSTRALIAN CREDIT GROWTH, 12-MONTH MOVING AVERAGE



SOURCE: RESERVE BANK OF AUSTRALIA 29 APRIL 2020

high-quality borrowers, strict credit criteria and a low-cost digital offering allow it to maintain pricing relevance and credit quality even in a weaker operating environment.

Exactly how challenging the operating environment proves to be for fintech lenders in specific sectors remains to be seen. Sarah Samson, head of securitisation origination at National Australia Bank (NAB) in Melbourne, says early hardship trends are starting to emerge. It appears that buy now, pay later is faring better than traditional personal lending and home loans. This is mainly, Samson says, because the repayment amounts are very low. In fact, NAB is beginning to see more hardships in nonconforming residential mortgages than in prime lending.

The real impact on credit books is yet to play out, though. Samson adds: "It is what happens at the end of the hardship period, when repayments either return to normal or go into default, that will be the real test for the whole lending industry."

TRADITIONAL AVENUES

This sums up the nature of the fintech funding challenge. The cloud looming over Australian consumer credit makes access to funds, including in capital markets, especially challenging and costly for lenders with smaller books and limited track record of navigating downturns – doubly so if they are not consistently generating capital through profitable operations.

Options outside government support channels still exist for fintech lenders, says Teper, though capital raising and debt funding

> "Our customer acquisition has always been more focused on customers refinancing rather than new lending, so we are also insulated from a downturn in new home-loan demand."
>
> **MICHAEL STARKEY** ATHENA HOME LOANS

GOVERNMENT SUPPORT LAUDED BUT NOT THE WHOLE SOLUTION

The Australian government has moved to provide support for businesses and borrowers – both of which could assist the fintech lender sector. Market users welcome the government programmes but say they cannot be the whole answer.

The government stimulus includes measures designed to protect consumers – JobSeeker and JobKeeper. These should help put a ceiling on the eventual peak in arrears and are potentially available to fintechs themselves to bolster cash flow. Regulators have also moved to shield the creditworthiness of lenders from arrears related to COVID-19 hardship.

Meanwhile, Australia's securitisation market has flickered with the help of Australian Office of Financial Management (AOFM)'s Structured Finance Support Fund (SFSF). But it is unclear how much support this will bring for newer lenders. Nonbanks reliant on warehouse funding may be at the mercy of their banks to extend or expand these.

David Hornery, co-chief executive at Judo Bank, a specialist SME lender, says: "The government's response has been substantial, decisive and targeted. It has done a lot to provide support for the financiers of small business and should be congratulated for this."

There are fears, though, that many fintech lenders will fall through the cracks of government stimulus. This is particularly the case for entities that have not yet built scale in their books.

"Many nascent fintech companies are either pre-revenue or are in the early stages where growth is very strong but coming from a low base. This makes it difficult for many to qualify for JobKeeper stimulus," says Daniel Teper, partner, corporate finance advisory at KPMG.

Peter Gray, founder and chief operating officer at Zip Co, agrees that fintech lenders are at risk of missing out. "From businesses that do not qualify for JobKeeper to those that cannot access the same low-cost funding as the big banks, there are gaps that could lead to a significant loss of competition as the economy recovers."

For instance, all authorised deposit-taking institutions (ADIs) should qualify for the Reserve Bank of Australia's A$90 billion (US$62.5 billion) term funding facility (TFF). ADIs can call on the RBA to provide credit – initially worth 3 per cent of outstanding lending – and can then attain further funding for lending to businesses.

However, most of Australia's neobanks are yet to launch their lending products or have only recently done so. Even those with relatively large lending books may not meet eligible counterparty criteria, market sources say.

AOFM support

The purpose of the SFSF is to provide funding support for smaller bank and nonbank lenders, via public securitisation and funding warehouses. Judo is an early example. Hornery tells *KangaNews* Judo's focus on SME lending has allowed it to grow its loan book to A$1.5 billion from A$100 million since it received its ADI license in April 2019. He adds there is a further A$1 billion of loans in the pipeline and the bank's plans to open further offices around the country are unchanged.

A diverse and relatively advanced funding base facilitated this expansion. Hornery says Judo has taken more than A$1.5 billion in deposits since it became a bank. SMEs are generally expected to be hit hard by the COVID-19 economic shutdown and its lasting effect on consumers, but margins in SME lending allow for a greater capacity to fund term deposits at a relatively high interest rate.

Judo also has A$350 million warehouses with Credit Suisse and Citi. These facilities paved

"The government's response has been substantial, decisive and targeted. It has done a lot to provide support for the financiers of small business and should be congratulated for this."

DAVID HORNERY JUDO BANK

will need to be undertaken with revised volume and pricing ambitions. A few neobanks completed capital raising just prior to or while the crisis has been unfolding: 86 400 raised A$34 million (US$23.6 million) in April, Xinja raised more than A$400 million in March and Volt Bank brought in A$70 million in January.

Investor risk appetite is likely fundamentally altered. Anecdotally, *KangaNews* has heard that some institutional investors that have held mezzanine notes in warehouses have sought exits and are willing to take a haircut to achieve them.

Starkey tells *KangaNews* there was a short period at the beginning of the crisis when wholesale funding was unavailable and Athena slowed its pace of loan origination in this period. However, he says increasing market confidence and the support of the Structured Finance Support Fund means funding in these lines is opening up again. As a result, he says Athena is looking to pick up its lending once more.

According to Samson, NAB is in general seeing good support for fintech lenders from warehouse providers. She adds the way for Judo to receive an aggregate of A$500 million in support through the AOFM's SFSF and the same agency's Australian Business Securitisation Fund.

The SFSF is targeted specifically at smaller bank and nonbank lenders. It is able to provide support for primary transactions, in the secondary market and potentially through a forbearance special-purpose vehicle to assist in structures that have been adversely affected by volume of loans on payment holidays or other forbearance.

The SFSF has no constraints by asset class so many of Australia's fintechs that have warehouse funding are eligible. Gray says for Zip – which debuted a world-first buy-now, pay-later-backed public securitisation in 2019 – the AOFM is its first port of call for funding relief given public markets will be challenging for the foreseeable future.

Athena Home Loans' cofounder and chief operating officer, Michael Starkey, tells *KangaNews* the SFSF is explicit recognition from the government of the importance of competition – and maintaining the competitive challenge from emerging lenders – in Australian lending.

"This is a key differentiating feature of the current crisis from the 2008 financial crisis and reduces the danger of banks consolidating the market," he adds. "The work the AOFM has done so far has instilled confidence in the nonbank lending market."

The extent to which A$15 billion can maintain competitors to the majors – how many and for how long – is unknown. Securitisation is a primary source of funding for nonbanks, with A$19-24 billion of supply coming to the public market in each of the last three years.

The intention of the SFSF is to provide liquidity support and not crowd out third-party investors. But with additional support needed in existing term and warehouse structures the fund could be soaked up just by the established nonbank players, potentially leaving little for emerging fintechs.

The government's SME guarantee scheme is an area where fintech lenders are finding some joy. The scheme guarantees 50 per cent of new loans issued by eligible lenders to SMEs until 30 September.

Along with many of Australia's biggest banks, fintech lenders Get Capital, Judo, Lumi, Moula Money, On Deck, Prospa and Tyro Payments have been approved as lenders for the scheme.

Teper says the ability of fintech lenders quickly to approve and distribute loans gives them an advantage in using this scheme, as established banks can sometimes still take weeks or months for approvals.

that positive signalling from the Australian Office of Financial Management around warehouse support for fintech lenders is contributing to a willingness to maintain lines of credit to the industry.

Many fintechs with existing warehouses should have diminished need for new funding at the moment, Samson continues, given origination volume is likely to be down. "There is funding out there, but it will come at a risk-adjusted price. All lenders at the moment need to make decisions on how much they are willing to pay to expand their lending and should only be writing the loans that fit a credit appetite that has been revised for the current environment."

COMPETITION CONSOLIDATION

While some funding appears to be available, market participants agree that not all fintech lenders will emerge on the other side of the bridge. This will likely create opportunities for established market players to acquire fintechs.

This may always have eventuated and for some it has likely been the end goal all along – although founders stand to sell for much less now than they might have done absent the COVID-19 crisis. Teper tells *KangaNews* acquisitions are probably not imminent but he reports that some players are getting their ducks in a row in case of opportunities.

An outright failure of a neobank would be noteworthy. No Australian ADI has technically failed since Australian Prudential Regulation Authority (APRA) was formed in 1998. There have been mergers large and small to avoid such a catastrophe, but COVID-19 is an unprecedented crisis and the neobanks, as new market entrants, are especially vulnerable.

Capital raisings will insulate neobanks in the near term but they will need to get lending products off the ground and into the market as soon as possible to minimise cash burn. In the meantime, their number will not increase any time soon. APRA has ceased granting ADI licences for at least six months from April.

Those fintechs that have established a presence in the Australian lending landscape are backing themselves to get through the crisis and even to attract new business. David Hornery, co-chief executive at Judo Bank in Melbourne, says the bank is well capitalised and liquid so the current environment actually presents a growth opportunity.

He tells *KangaNews*: "It is times like these that true relationship banking really comes to the fore. One thing that is absolutely central to supporting customers is being available and being proactive, which – because of our high banker-to-customer ratios – we can consistently be. We want to set the bar for what the true relationship banking of small businesses looks like in this country."

At the consumer end, Zip is confident its technology platform stands it in good stead. Peter Gray, Sydney-based co-founder and chief operating officer at Zip, says the investments it has made in its credit and decision-making platforms have led to just 1 per cent of its customers being late with payments – a rate he says is substantially lower than for most credit-card receivables.

In prime mortgages, Athena expects to continue to build a strong loan book. Starkey says: "We are set up for digital distribution so we are mitigated from the physical restrictions that might affect lenders dependent on brokers. Our customer acquisition has always been more focused on customers refinancing rather than new lending, so we are also insulated from a downturn in new home-loan demand." •

GLOBAL CREDIT OUTLOOK AS *ARES LAUNCHES IN AUSTRALIA*

Ares Australia Management launched its first local product, the Ares Global Credit Income Fund, on 12 May. The firm is a joint venture between Fidante Partners and Ares Management Corporation – a global alternative asset manager with US$149 billion under management. Teiki Benveniste, head of Ares Australia Management in Sydney, explains how the fund aims to achieve 3-4 per cent absolute return in an ever-lower rates environment.

How do you see a global credit fund fitting into the Australian investment universe?

Australia has entered the low-yield world in a dramatic way in the last three or four years. The outcome is that Australian investors are lacking options for dependable sources of higher income – and this is what our product is trying to address as a first issue. We want to offer a method of targeting income of 3-4 per cent per year in a way that doesn't add to the risks currently in people's portfolios, in other words also creating diversification.

There has to be a focus on generating higher income in a way that does not have to sacrifice capital preservation. This is what we are trying to do, and how we do it is by leveraging Ares' leading investment capability in credit. We are talking about investing in corporate bonds, syndicated loans and alternative credit for this first fund we are launching. It is also global, not Australian. This means there is limited overlap with what investors are likely already to have in their portfolios.

It's also important to note that as the focus is on securities with higher current income we are generally not reliant on capital gains in the fund to distribute the income. The fund's objective in distribution terms is 3-4 per cent per year and we are currently generating 4.1 per cent from interest only. On the other hand, while we select securities with higher coupons, most of our investments for this fund are still in the investment-grade space.

To be able to invest in securities that earn higher income, we need to be able to conduct appropriate analysis. That is, focusing on selecting great underlying investments – the right companies that have the track record to perform through the cycle.

Ares has a demonstrated track record of doing so and outperforming the market, especially in times of stress. At the riskier part of the market, where credit-selection skills are most needed, default rates during the global financial crisis were 15 per cent in the high-yield market and close to 10 per cent in syndicated loans. Ares' investment strategies that focus on investing in those markets only had a maximum 2-3 per cent of defaults during that time.

The Australian investment market has historically struggled with credit in that end-investors want to have credit-type returns but with the liquidity of the rates market. How do you confront the liquidity issue when looking at assets that may not be able to be exited on a daily basis?

Liquidity risk is what gets managers into trouble – if there is a mismatch between the liquidity they are offering investors and the liquidity in the underlying investment. This is clearly a very big focus for us. We are going to adapt the liquidity we offer investors, depending on the underlying investment.

What we are doing in this fund is only accessing what we think are the most liquid markets we can offer in the investment universe Ares covers. It will not have private equity, private direct lending or any of the illiquid investments we could be investing in. The unit trust is focused on securities we believe can provide the daily liquidity investors need and want.

Ares has a huge array of other investments to offer and what we will do is adapt the liquidity we are offering investors through different products. It could be a quarterly liquid product if we had a significant amount of private direct lending or asset-backed lending, for example.

This fund is predominantly invested in the US and Europe. This is a US$4 trillion investable universe across corporate bonds, bank loans and alternative credit markets. The market size also shows the level of liquidity in those markets, with most of these securities traded on a daily basis.

It must be a challenge to launch a fund with an absolute return target in a declining rates environment.

Theoretically, with rates falling, future expected returns become challenged for all asset classes. But the reality is many things are happening at the same time, including credit-spread widening – which offers the potential for better returns or new features making their way into certain instruments.

In any case, we believe we have a diverse enough investment universe of higher-yielding assets to feel confident we can meet our return targets.

For example, within floating-rate credit instruments like loans, we are looking to have LIBOR floors in the assets we invest in. This protects the current income we can generate when rates fall while still exposing our investment to limited interest-rate duration if rates were to start rising. We can also access corporate bonds, which typically have a fixed rate.

In both cases, we will look to find the best relative value on offer to achieve our return targets in the most risk-efficient way. At this stage I think it's important to highlight that this fund is not going to be focused on generating returns from interest-rate movements – so we will not go from having one-year to five-year duration or go short. The fund will generally hold instruments with 1.5-2.5 years of duration and our allocation will be dictated by the best value on offer between corporate bonds, bank loans and alternative credit investments.

The idea of negative rates appears to be on the cards again in the US and elsewhere. For a credit manager, does the move from low to sub-zero mean anything more than any other headline change in the cash rate?

The clear impact of negative rates is that they push investors further out the risk spectrum. They push investors out of cash and government bonds and into the credit world, where they can still find the level of yield they need to achieve their investment objectives. If anything, we think credit is going to benefit from the investment flows generated by negative rates.

What is Ares' current view on the risk environment and on pricing for risk?

We think the environment is one in which investors need to exercise caution. On the other hand, we are focused on looking for attractive investments and companies with strong fundamentals as it is possible to find great companies and investments at any point in the cycle. There are price points in the credit market we have seen as an attractive opportunity to invest, where credits have been oversold.

We are cautious about the market more broadly. The action of central banks has helped markets significantly, so we think we are not stretched on risk and are avoiding sectors that have been most affected by the COVID-19 pandemic. We are remaining highly selective in supporting companies with strong liquidity and the opportunity to outperform when the cycle turns.

During the great financial crisis period, defaults continued to rise after the immediate credit crunch. This is a risk we are aware of. But it is usually during these times that our fundamental and capital-preservation focus help us outperform.

> "During the great financial crisis period, defaults continued to rise after the immediate credit crunch. This is a risk we are aware of but it is usually during these times that our fundamental and capital-preservation focus help us outperform."

What is Ares' environmental, social and governance (ESG) approach?

Ares sees ESG as core to its strategy and this is evident in a number of ways, starting with where Ares' head of ESG, Adam Heltzer, sits within the overall organisation. With a direct reporting line to Ares' CEO, Mike Arougheti, Adam receives full backing from the top in defining and executing Ares' ESG strategy across the platform.

At Ares, ESG is considered at two levels: responsible investment and corporate sustainability. Responsible investment takes into account the ways in which Ares integrates its ESG principles into the investment process. Corporate sustainability encompasses how Ares manages material ESG factors in day-to-day operations. In both areas, Ares has an established track record of action and impact.

Ares follows seven key principles as outlined in its responsible-investment policy and that guide its approach. Further, Ares is continually seeking to evolve and improve upon these.

The principles include a systematic implementation of ESG factors throughout Ares' investment process and a tailored approach of adapting platform-wide Ares ESG objectives to the specific dynamics and levels of influence in each investment strategy.

Importantly, Ares is always striving to improve and continually seeking to push the frontier of best practice in ESG integration. This is particularly relevant given Ares' leadership role in US and European direct lending to small- and medium-size companies.

For Ares Australia Management's Global Credit Income Fund specifically, we use our research team's proprietary analysis and third-party ESG ratings to research companies to identify and discuss existing and emerging ESG risks, generate trade ideas using positive and negative outliers on specific ESG issues, and monitor ESG developments affecting key industry drivers. •


www.rentenbank.de