NZDM's short-term borrowing strategy

Introduction

The primary objective of New Zealand Debt Management (NZDM) is to minimise the Crown's borrowing costs over the long-term with due consideration to risk, while ensuring ongoing access to debt funding markets.

Short-term borrowing is an important part of the core Crown borrowing programme. It provides a base level of funding and flexibility to address short-term liquidity requirements. A key aspect of meeting NZDM's primary objective involves balancing cost and risk of the Crown's short-term borrowing activities.

NZDM has reviewed its short-term borrowing strategy, as part of its ongoing development of its funding strategy. It now expects to maintain higher short-term borrowings on an ongoing basis. This note explores the rationale for increasing the volumes on issue.

Background

NZDM's short-term borrowings consist of two instruments, Treasury Bills (T-Bills) and Euro-Commercial Paper (ECP).

T-Bills: short-dated NZD securities, were historically the Crown's primary source of short-term borrowing. They are typically issued with terms of 3, 6 and 12 months and are purchased by investors seeking a secure, short-term, investment. T-Bills can represent a 'safe haven' for investors in times of market stress.

T-Bills are issued via weekly tenders, under a predictable schedule and, generally, at stable volumes, which allows the market to adapt by adjusting price and, subsequently, demand.

That said, NZDM is somewhat price sensitive for T-Bill issuance and, should pricing not meet NZDM requirements, T-Bill tenders may not be fully allocated.

ECP: short-dated foreign currency securities. Prior to April 2020 the ECP programme had not been utilised since 2015. ECP provided a useful additional funding source in 2020 when the market outlook was highly uncertain. However, ECP initially made up a relatively small proportion of NZDM's short-term funding strategy. The programme involves the use of a bank dealer panel with transactions performed on a 'reverse enquiry' basis. Issuance timing and volume fluctuate depending on investor demand. Issuance may occur via multiple transactions a day.

NZDM's ECP programme is highly rated[1] and repo-eligible with the European Central Bank, where it is classed as a High-Quality Liquid Asset. The foreign currency ECP market is deeper and more liquid, when compared to the New Zealand domestic market. This enables NZDM to quickly raise a material volume of ECP, at short notice, with limited market impact.

For both T-Bills and ECP, a minimum volume is required to signal NZDM's commitment to these products, keeping investors engaged and ensuring ongoing access to both markets. Previously, NZDM estimated this minimum volume of T-Bills to be NZ$2 billion and ECP to be US$1 billion.

Ahead of Budget 2023, NZDM undertook a review of its short-term borrowing strategy and concluded there would be benefits from maintaining higher than minimum levels of short-term borrowings. Consequently, at Budget 2023, NZDM announced that the forecast core volume of short-term borrowings would increase to NZ$9 billion.

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[1] S&P Global Ratings: A-1+, Moody's Investors Service: P-1, Fitch Ratings: F1+

However, intra-year, short-term borrowings were expected to vary from NZ$6 billion to NZ$15 billion during normal market conditions.

Benefits of short-term borrowings

Relative to New Zealand Government Bond (NZGB) issuance, the key benefits of short-term borrowings are:

- **i Lower cost:** Due to term premiums, interest costs for T-Bills and ECP, as short-dated debt instruments, are generally lower than interest costs associated with longer term NZGB debt.
- **ii Liquidity management tool:** Unlike term funding, short-term borrowings can be flexed for temporary periods to smooth cash levels. This helps to maintain NZDM's NZ$15 billion minimum liquidity buffer through periods of cash shortfalls.
- **iii Emergency funding tool:** It can also be flexed materially higher, with minimal notice, during a market stress event when the Crown faces increased cash requirements (such as in March 2020).
- **iv Allows new investors to test market:** It supports the Crown's NZGB programme by providing investors a lower risk option for entry into the New Zealand Government Securities (NZGS) market, without needing to commit to longer-dated bonds.
- **v Supporting NZ capital markets:** T-Bills are the largest short-term instrument in the New Zealand capital market, providing a risk-free benchmark for other issuers. This contributes to NZDM's secondary objective of supporting New Zealand capital market development.

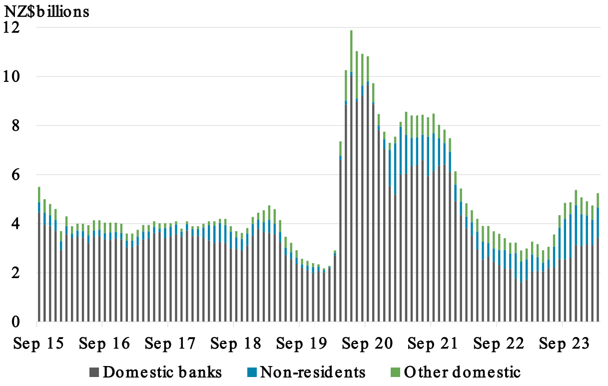
Impacts of higher short-term borrowings

Increased offshore investor support for T-Bills

Domestic banks are a natural holder of T-Bills and represent the key investor group. With higher T-Bills outstanding, the dollar value of domestic bank holdings typically increases (Figure 1). However, recent growth in T-Bills on issue has also led to more active non-resident investors.

Prior to the pandemic, non-resident holdings of T-Bills were less than 10% but are now close to 25%. This non-resident growth is consistent with that experienced in the NZGB programme, where a higher issuance programme has led to increased offshore interest.

Figure 1: T-Bill holdings

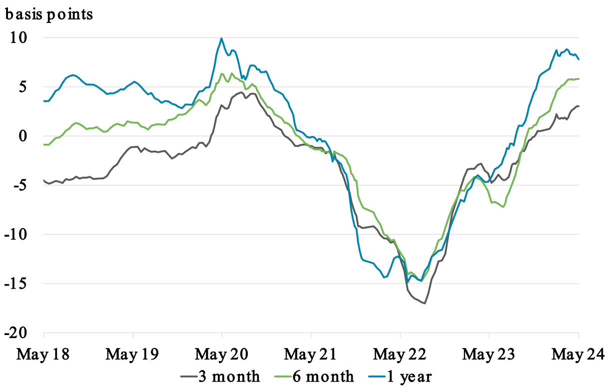


Source: RBNZ

T-Bill pricing trending higher

Recent T-Bill issuance has seen the spread rise above Overnight-Index Swap (OIS) rates, as T-Bills on issue have increased from NZ$3 billion at end-June 2023 to NZ$5 billion currently. At the current rate of issuance, NZ$250 million per weekly tender, T-Bills on issue are expected to stabilise at NZ$6 billion. At these levels, we expect we may continue to see tender yields average above OIS. By comparison, ECP issuance pricing is currently more attractive from an issuer's perspective.

Figure 2: Spread between T-Bill tender yields and equivalent OIS rates



Sources: NZDM, Bloomberg

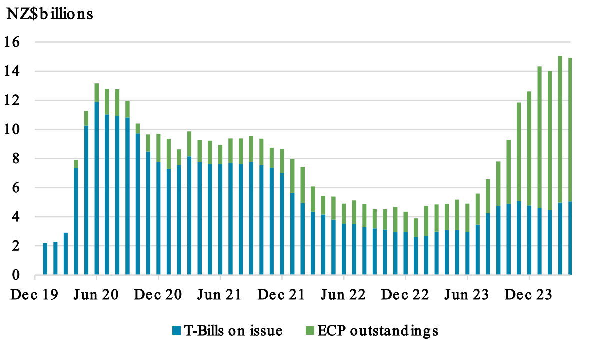
Increased ability to flex ECP and a more diverse investor-base

ECP, until recently, made a very small contribution to NZDM's funding portfolio. However, it has now become an important short-term funding instrument, due to benefits observed from maintaining higher volumes on issue (Figure 3).

Higher volumes of ECP issuance assist with investor diversification, as ECP investors are primarily international investors, independent of the NZD NZGS investor-set. Also, higher levels of ECP on issue, and larger transactions, encourage increased investor participation. Some larger investors have become interested in NZDM-issued ECP since a more meaningful presence was established. These have resulted in a wider possible range of ECP on issue.

ECP yields are generally set below the equivalent domestic OIS rates (influenced by NZD foreign exchange forward points). At these times, it makes it more economic to issue, from an issuer's perspective, than T-Bills.

Figure 3: Historical monthly short-term borrowings



Source: NZDM

Budget 2024 short-term borrowing strategy update

Following the recent review of the short-term borrowing strategy, at Budget 2024 NZDM announced a further increase in the forecast core volume of short-term borrowings on issue. This is now set at NZ$13 billion, up from NZ$9 billion previously.

A flexible approach to short-term borrowing will continue to be undertaken, with short-term borrowings adjusting to smooth cashflows and respond to realised liquidity requirements.

Intra-year, short-term borrowings are expected to range from NZ$10 to NZ$25 billion, under normal market conditions. The range is higher and wider than previously, reflecting the increased core volume and greater ability to flex that a higher core-volume enables.

In the near-term, to cover forecast temporary cash requirements, short-term borrowings are expected to be flexed higher to NZ$18 billion at end-June 2024.

A minimum of NZ$3 billion of T-Bills and US$3 billion equivalent of ECP is now expected to be maintained on an ongoing basis. This is higher than previously estimated minimums required for market access purposes.

Current market dynamics, including higher T-Bill relative to ECP yields, suggests any increase in short-term issuance is likely to be via ECP issuance, in the near-term. It has proved to be a cost-effective alternative to T-Bill issuance.

Risk management

A higher volume of short-term borrowings increases some of the risks associated with debt management operations, including:

i refinancing risk: the risk that an existing debt is not able to be replaced with new debt when required, and

ii interest rate risk: the risk that a change in interest rates will negatively impact on NZDM's cost of borrowing.

To ensure short-term borrowings do not increase such that the risks outweigh the benefits, NZDM has internal risk mitigants. These will include:

i monitoring the proportion of short-term borrowings in the NZGS portfolio

ii ensuring total NZGS maturing over a 1-year period remain within acceptable levels

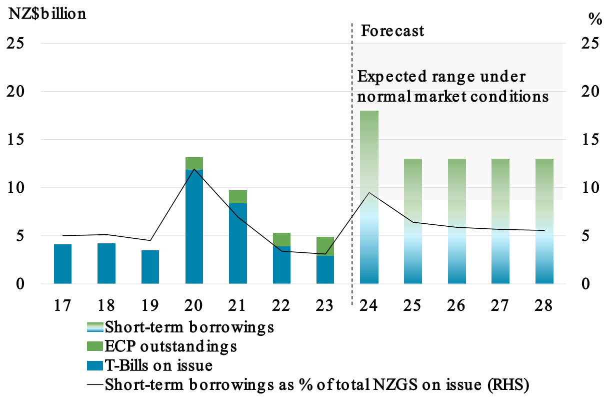
iii compliance measures requiring known cash outflows be prefunded 1-month in advance

iv spreading ECP maturities over the maximum 12-month issuance tenor, and

v holding a minimum NZ$15 billion liquidity buffer to ensure that the Crown can respond to unexpected fiscal shocks or disruptions in funding markets.

With these risk mitigants in place, NZDM is comfortable with increasing core short-term borrowings and the range of issuance volume expected, under normal market conditions. The growth in short-term borrowings has coincided with growth in the overall core Crown borrowing programme, so that NZ$13 billion of short-term borrowings represents only about 5% of NZGS outstanding. This is consistent with the proportion prior to the pandemic (Figure 4).

Figure 4: Annual short-term borrowings

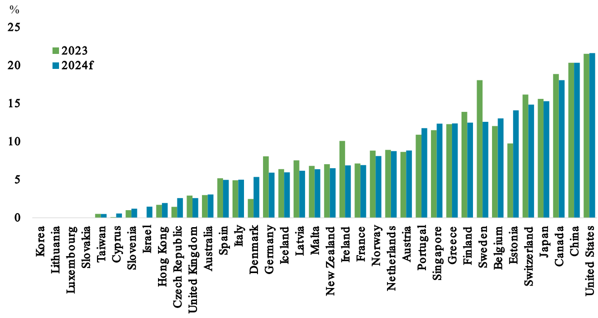


Source: NZDM

International comparison

The proportion of short-term borrowings in New Zealand's debt portfolio compares well with its OECD peer group. NZDM forecasts New Zealand's short-term debt as a proportion of NZGS at 6.5% for end-2024 calendar year, down from 7.0% in 2023 and below the 2024 estimated OECD average of 7.5% (Figure 5). Similarly, NZDM forecasts New Zealand's refinancing requirements (short-term borrowings and NZGBs maturing within 12-months) at 5.6% of GDP for the end of the 2024 calendar year, consistent with the OECD average over the past few years.[2]

Figure 5: Proportion of short-term borrowings in sovereign debt portfolios for OECD countries



Sources: S&P Global Ratings, NZDM (for New Zealand)

Conclusion

There are many benefits to NZDM maintaining a short-term borrowing programme. Relative to term issuance, short-term borrowing is generally at a lower cost, supports the funding strategy by covering temporary liquidity shortfalls, including during risk events, and allows new investors to test the New Zealand market. The expected benefits of increasing our short-term borrowing programme, led to NZDM increasing short-term borrowing forecasts at Budget 2023.

These benefits were not only realised in 2023/24 but it became evident there were benefits to further increasing the volume of short-term borrowings on issue. Consequently, at Budget 2024, NZDM again increased forecast core short-term borrowing, to NZ$13 billion. While higher short-term borrowings increase risks, borrowings will be a similar proportion of the NZGS portfolio as prior to the pandemic. In addition, risks are safe-guarded by the Crown's liquidity buffer, internal compliance limits, and NZDM actively managing maturity concentrations.

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2 OECD Global Debt Report 2023: Bond Markets in a High-Debt Environment

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