THE TREASURY

Kaitohutohu Kaupapa Rawa

New Zealand Government Securities Funding Strategy

2018/19: Edition 2

New Zealand Government

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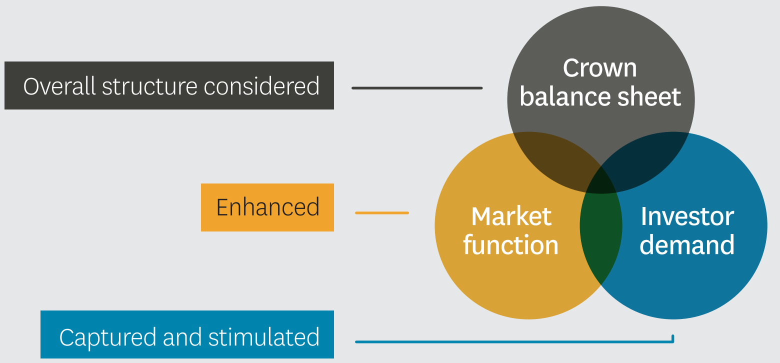
Funding Strategy – at a glance

The Treasury's New Zealand Debt Management function has the objective of minimising the Crown's borrowing costs over the long-term while keeping risk at an appropriate level. To achieve this objective, a strategic rather than tactical approach to funding is taken.

Achieving a balance between the following three goals:

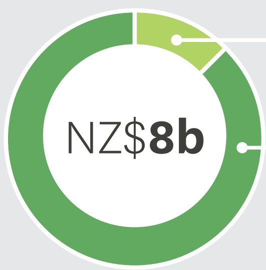


Guiding principles underpinning the strategy

- Transparent
- Consistent
- Even-handed

2018-19 New Zealand Government Bond (NZGB) programme forecasts

Gross NZGB issuance



Product type

circa NZ$**1b**
Inflation-Index bonds

circa NZ$**7b**
Nominal bonds

Net NZGB issuance

NZ$**-3.2b**

Key elements

- Focus on core instruments issued in NZD
- Buyback programme for NZGBs with less than 18 months to maturity
- Weighted average maturity of NZGB portfolio to increase further
- Flexible approach to T-Bill issuance
- T-Bills on issue forecast to be NZ$2 billion at end of 2018/19
- Continued focus on diversifying investor base

Government commitment to maintain NZGBs on issue at not less than 20 percent of GDP over time.

Recent developments

Since the first edition of the New Zealand Government Securities Funding Strategy was published in August 2018, the following developments have occurred:

- The Half Year Economic and Fiscal Update (HYEFU) was released.
- It affirmed the 2018/19 New Zealand Government Bond (NZGB) programme at NZ$8 billion.
- It also added the 2022/23 year to the forecast period, with a NZ$6 billion programme. This forecast programme directly considered the Government's stated commitment "to maintain the level of NZGBs on issue at not less than 20 percent of GDP over time."
- No syndication plans were announced alongside HYEFU 2018.
- The NZGB tender schedule for the March 2019 quarter was released, showing forecast issuance in the NZGB 2025, NZGB 2029 and NZGB 2037 nominal bonds and the NZGB 2040 inflation-indexed bond.

Funding the Crown

New Zealand Debt Management is one of the functions of the New Zealand Treasury, responsible for managing the Crown's net cash flows and liquidity position.

The Treasury's forecasts at HYEFU 2018 show the total Crown operating balance, including gains and losses, in surplus in 2018/19. However, capital spending is forecast to exceed net operating cash flows, resulting in a core Crown residual cash deficit. Cash projections are taken into consideration when forecasting the total borrowing programme, along with liquidity requirements and the projected financial assets position.

NZGBs constitute the greatest proportion of the total borrowing programme. In the year ending June 2019 (2018/19), NZ$8 billion of gross issuance of NZGBs is forecast. When projected maturities and buybacks are taken into account, net issuance is forecast to NZ$-3.2 billion. At the end of 2018/19, NZGBs on issue are forecast to be NZ$71 billion.

Total borrowing programme

Year ending 30 June (face value)	2018 actual	2019 forecast
Gross NZGB issuance ($ billion)	7.0	8.0
NZGB maturities and buybacks ($ billion)	7.2	11.2
Net NZGB issuance ($ billion)	-0.2	-3.2
NZGBs on issue ($ billion)	74.2	71.0
NZGBs on issue (percent of GDP)	25.5%	23.5%
T-Bills on issue ($ billion)	4	2

Source: The Treasury

As is standard practice, funding requirements will be revisited ahead of the May Budget Economic and Fiscal Update (BEFU) 2019. At this time the focus will shift to the borrowing programme and funding strategy for 2019/20.

Funding strategy principles

The objective of the funding strategy is to minimise the Crown's borrowing costs over the long-term while keeping risk at an appropriate level.

For the NZGB market, it is believed this objective is currently best achieved by taking a strategic, rather than short-term tactical approach to funding activities. The aim is to reduce uncertainty or illiquidity premiums that are associated with NZGBs, through a strategic approach where future actions are well communicated in advance. This is prioritised over tactically trying to capture short-term pockets of 'value'.

The strategy that best achieves the objective may change if the funding environment changes significantly. However, the core principles of transparency, consistency and even-handedness will not change.

The funding strategy is aimed at balancing three key goals; considering the overall structure of the Crown's balance sheet, capturing and stimulating investor demand, and promoting well-functioning and liquid New Zealand Government Securities markets.

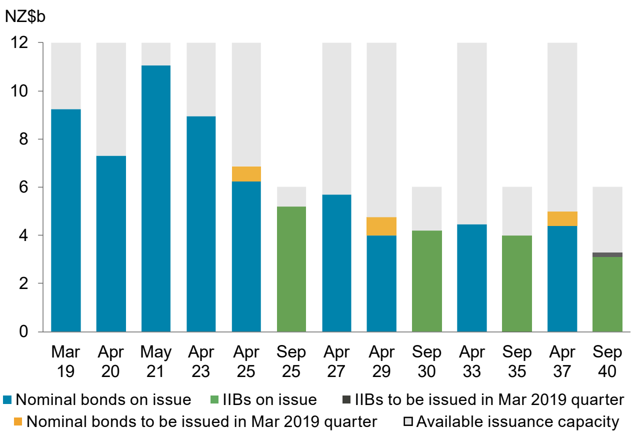
Wholesale funding strategy 2018/19

Funding instruments

Nominal Bonds remain the primary funding vehicle and will constitute around NZ$7 billion of the 2018/19 NZGB programme.

During the March 2019 quarter, three nominal NZGB maturities will be tendered. A total of NZ$600 million is forecast to be tendered into each of the 15 April 2025 and 15 April 2037 NZGBs. NZ$750 million is forecast to be tendered into the 20 April 2029 NZGB. This profile is designed to provide liquidity at three distinct points on the NZGB curve and help build volume in key 'benchmark' lines.

NZGB portfolio and issuance in March 2019 quarter



Source: The Treasury

For the remainder of the fiscal year, tender volumes will likely continue to be in a range of NZ$100-NZ$300 million, with a single bond offered per tender.

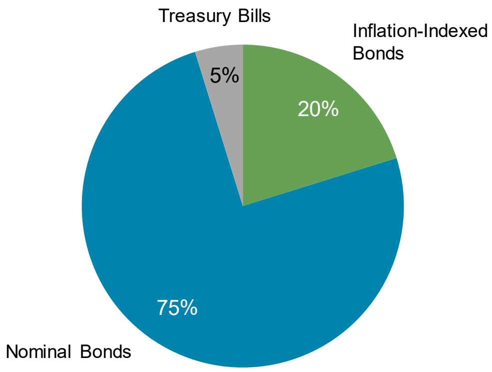
Individual nominal NZGB lines are capped at NZ$12 billion face value. This level balances the need to promote liquidity in each line, while managing the size of maturity cash flows and mitigating refinancing risk.

Inflation-Indexed Bonds (IIBs) remain an important part of the funding portfolio. IIBs enable a portion of interest expenses to be correlated with the economic cycle and thereby fiscal revenues. In addition, IIBs assist with diversification of the investor base. It is expected that there will around NZ$1 billion of IIB issuance in 2018/19. Individual IIB lines are capped at NZ$6 billion face value.

During the March 2019 quarter, one IIB maturity will be issued, the 20 September 2040.

IIBs constitute a sizable proportion of the total funding portfolio, at 20%, relative to global peers. The proportion has increased over recent years, although a specific level is not targeted. The appropriate proportion of IIBs within the portfolio is assessed on an ongoing basis. However, a commitment to the product remains constant.

Current New Zealand Government Securities portfolio



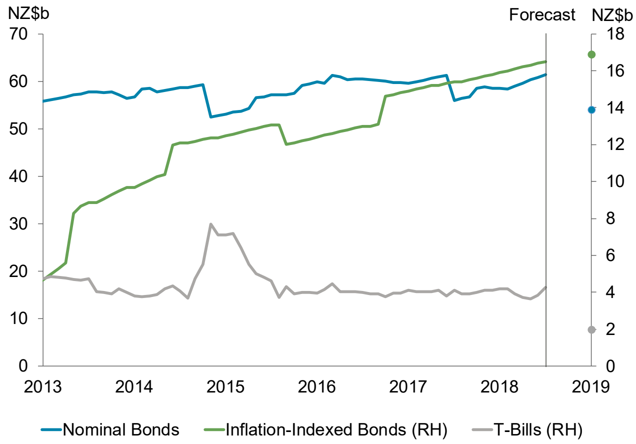
Source: The Treasury

Treasury Bills (T-Bills) provide flexibility to address short-term liquidity requirements. Requirements may arise as a result of upcoming bond maturities, or seasonal or unexpected changes in cash flows.

Although T-Bills on issue were at NZ$4.3 billion at the end of the calendar year, HYEFU forecasts show that T-Bills on issue will decline toward NZ$2 billion by 30 June 2019. These reflect forecast liquidity needs at the end of 2018/19. However, the actual volume of T-Bills on issue may vary from forecast, based on an assessment of the relative cost of T-Bill issuance versus alternative short-term funding mechanisms.

Over time, it is recognized that there is value in being able to access short-term funding through the T-Bill market. Therefore, the intention is to maintain a minimum of NZ$2 billion of T-Bills on issue, and this is the base forecasting assumption for annual borrowing programmes.

New Zealand Government Securities on issue



Source: The Treasury

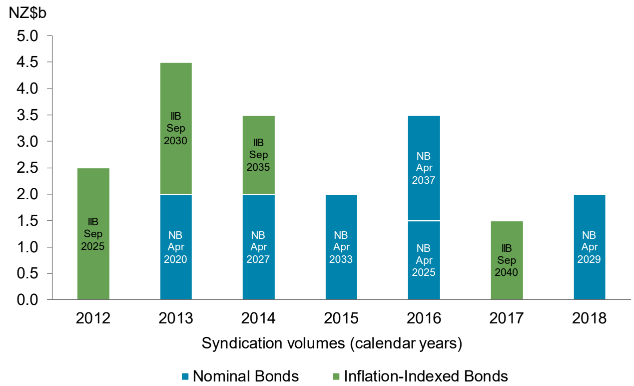
Primary issuance methods

Issuance into existing nominal NZGB and IIB lines will continue to occur via regular tender. Full quarterly bond tender schedules will continue to be announced ahead of each quarter, including tender dates, maturities, and volumes. This will generally occur at the time of the confirmation announcement for the last tender of the preceding quarter.

Syndications remain the preferred method for the issuance of new bond lines. This method enables the placement of a large initial volume into the market, promoting immediate liquidity in the new bond. An intention to launch a new bond by syndication is generally announced alongside Budget or HYEFU. Then, typically, when the syndication becomes imminent a syndication panel is announced, followed by a launch confirmation announcement. No plans were announced alongside HYEFU 2018.

T-Bill tenders will continue to take place on a fortnightly basis. The volumes offered across the 3 month, 6 month and 12 month lines will be based on liquidity and portfolio requirements and will be announced on the day prior to tender. The amount issued will depend on the assessment of bids received relative to other short-term funding mechanisms, subject to the relevant operating rules and guidelines.

History of syndications



Source: The Treasury

Secondary market support

Intermediaries play an important role in maintaining a well-functioning secondary market. In addition, the funding strategy aims to enhance secondary market liquidity. It prioritises:

- undertaking bond buybacks ahead of upcoming maturities
- focusing on core instruments issued in NZD
- recommending a Government commitment to a minimum level of NZGBs on issue
- broadly matching NZGB issuance maturities to Australian Commonwealth Government Bonds (ACGBs)
- building volume in 'benchmark' lines
- using syndications to launch new lines.

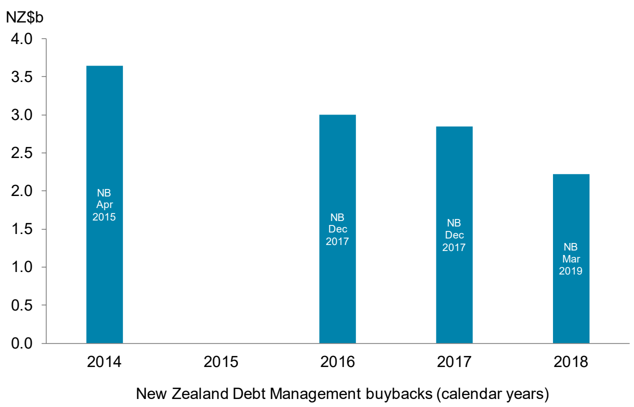
Undertaking bond buybacks

The current funding strategy incorporates a policy of buying back bonds as they approach maturity. This helps to smooth cash flows around maturities, and to enable the recycling of investments further out the curve.

It has been recent practice to buyback outstanding bonds within the 18 month window before a bond matures. A buyback programme of the 15 April 2020 NZGB is planned to commence before 30 June 2019. Buybacks will be undertaken at levels that are assessed as economic and in keeping with liquidity requirements and portfolio needs. There is no target for a specific volume of buybacks.

The Reserve Bank of New Zealand (RBNZ) typically assumes responsibility for buyback activities during the final 6 month period before a bond matures, in an effort to ensure overall financial system liquidity.

Recent buyback activity



Source: The Treasury

Focusing on domestic NZD issuance and core instruments

The current focus is on NZD issuance in the domestic market. This helps support liquidity in NZD denominated issues. NZD issuance is also currently more cost-effective than foreign currency alternatives. An additional benefit of a well-developed NZD denominated Government Securities market is the support it provides to domestic capital markets more broadly.

The 2018/19 borrowing programme forecasts do not include any foreign currency issuance.

However, up-to-date legal documentation is maintained for both an ECP and EMTN programme. ECP is seen as a potential alternative instrument to address short-term liquidity requirements.

Attention is given to maximising liquidity in existing core instruments. Alternative funding instruments eg, green bonds, are assessed with respect to the impact on liquidity, relative cost and investor diversification and with regard to wider benefits or risks.

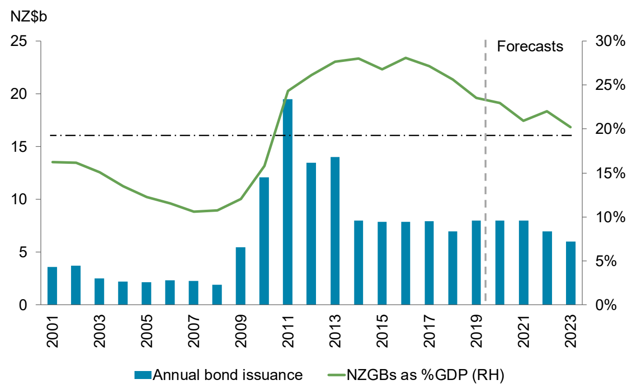
Commitment to a minimum level of NZGBs on issue

In recent years, as the Government has been running operating surpluses, and reducing net debt, it has made a commitment, on the Treasury's recommendation, to a minimum level of NZGBs on issue. Since Budget 2017 the Government has had a stated commitment to "maintain New Zealand Government Bonds on issue at not less than 20 percent of GDP over time".

The Government sees a sustainable and readily accessible NZGB market as important in supporting fiscal resilience. A commitment to a minimum NZGB market also instils confidence in intermediaries and investors when they are choosing whether to participate in the market. This helps support liquidity.

The forecast bond programme will see NZGBs on issue at 20.2% of GDP at the end of 2022/23. When setting the forecast annual programme for that year (NZ$6 billion), for the first time, it was necessary to directly consider the Government's commitment to a minimum NZGB market.

NZGBs on issue to remain above 20% of GDP



Source: The Treasury

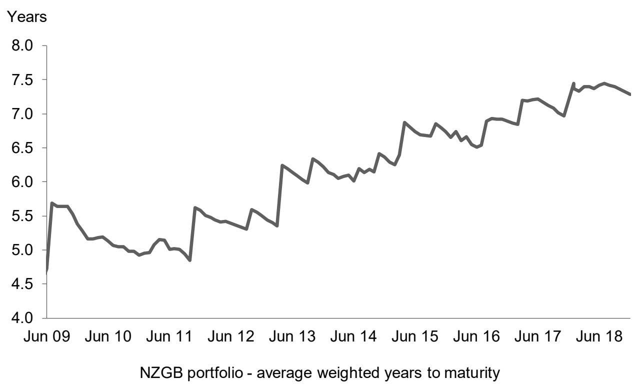
Broadly matching ACGB maturities

The aim is to issue NZGBs with maturities that closely align with their ACGB equivalents. This promotes the ability for investors to easily assess relative value between these assets.

Average maturity

In recent years the funding strategy has included a policy of extending the average weighted maturity of the NZGB portfolio. The average weighted maturity of the NZGB portfolio has increased from around 4.5 years in mid-2009 to close to 7.3 years currently.

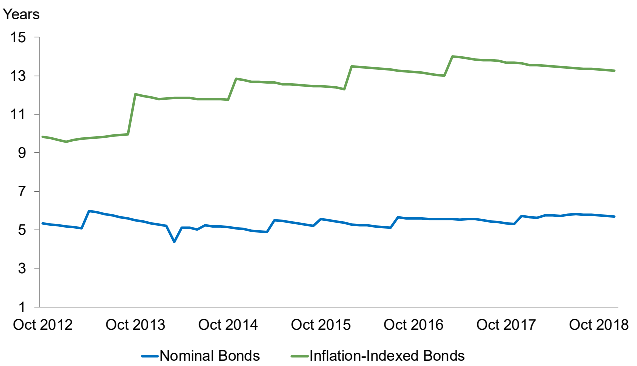
Average weighted maturity of NZGB portfolio



Source: The Treasury

This meets several objectives. It has improved the Crown's asset-liability matching, taking into account the interest rate sensitivity of the Crown's long-dated assets. It has contributed to further diversity in the investor base, capturing demand from investors with long-dated liabilities. It has reduced refinancing risk. In addition, it has contributed to the development of New Zealand's capital markets.

Average weighted maturity by security type



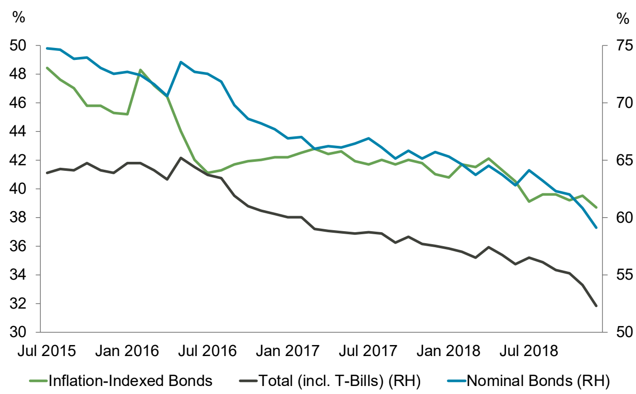
Source: The Treasury

There is no specific target for the average weighted maturity of the portfolio. However, the average weighted maturity of the NZGB portfolio is expected to increase further in 2018/19, as the 15 March 2019 NZGB matures and issuance continues further out the curve.

Diversifying investor base

Diversity in the investor base is targeted through the funding and investor relations strategy. Diversity by geography, investor type and mandate are valued.

Non-resident holdings of NZGBs



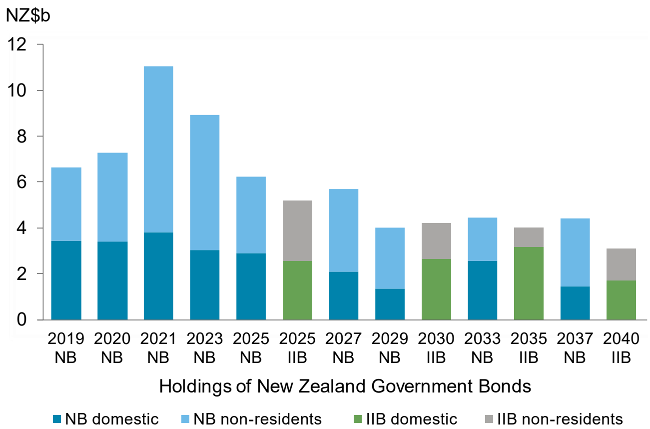
Source: The Treasury

In recent years, the proportion of NZGBs held by New Zealand residents has increased, although the majority of bonds are still held by non-residents. Non-resident holdings of NZGBs were at 52.3% at 31 December 2018. This is their lowest level since late 2003. The proportion of nominal bonds held by non-resident remains higher, at 59.1%, compared to 38.7% for IIBs.

There is notable variation in the proportion of non-resident holdings across the different NZGB maturities. The bonds with the highest proportion of non-resident holdings are the NZGB 2023, NZGB 2029 and NZGB 2037 at 66-67% each. In the fiscal year to date, non-resident investors have continued to increase the value of their holdings in the bonds where tendered issuance has taken place. They have decreased the value of their holdings in non-tendered bonds, particularly the NZGB 2019, where a buyback programme has been implemented.

T-Bills remain predominately held by resident investors, with only 11.4% held by non-residents.

Resident and non-resident holdings of NZGBs



Source: RBNZ

Summary

The forecast 2018/19 borrowing programme will manage scheduled NZGB maturities and buyback activity rather than providing 'new' funding to the Crown. Net issuance of NZGBs is forecast to be NZ$-3.2b after projected maturities and buybacks are taken into account. Gross issuance is forecast to be NZ$8 billion.

The focus will remain on nominal bonds as the primary funding vehicle, although inflation-indexed bonds remain an important part of the funding portfolio. It is expected that IIBs will make up around NZ$1 billion of the 2018/19 programme. In the March quarter, three nominal and one IIB maturity will be issued via regular tender: the 15 April 2025, 20 April 2029 and 15 April 2037 and the 20 September 2040. A buyback programme for the 15 April 2020 NZGB is planned to commence before 30 June 2019.

Overall, the funding activities will be undertaken in a strategic manner where actions are well communicated in advance. However, some flexibility is maintained in the T-Bill issuance process in order to respond to short-term liquidity requirements in an efficient manner. The central principles of transparency, consistency and even-handedness remain important foundations for the funding strategy.