TE TAI ŌHANGA
THE TREASURY

New Zealand Government Securities Funding Strategy

2020/21: Edition 1

New Zealand Government

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2020/21 Funding Strategy – at a glance

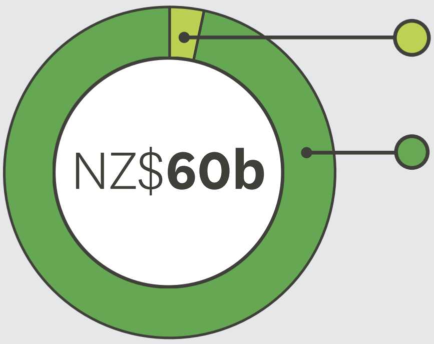
The Treasury's New Zealand Debt Management function has the objective of minimising the Crown's borrowing costs over the long-term with due consideration to risk, while ensuring ongoing access to debt funding markets.

Snapshot

- Monthly tender schedules announced in advance, with multiple bonds offered per weekly tender.
- Forecast inflation-indexed bonds issuance of NZ$1 billion to NZ$2 billion.
- Increased syndicated issuance expected, including syndicated taps.
- New NZGB 2041 syndication expected in July, and NZGB 2027 syndicated tap expected in August.
- Enhanced communication channels to support continued focus on diversification of the investor base.

2020/21 New Zealand Government Bond (NZGB) programme forecasts

Gross NZGB issuance



Product type

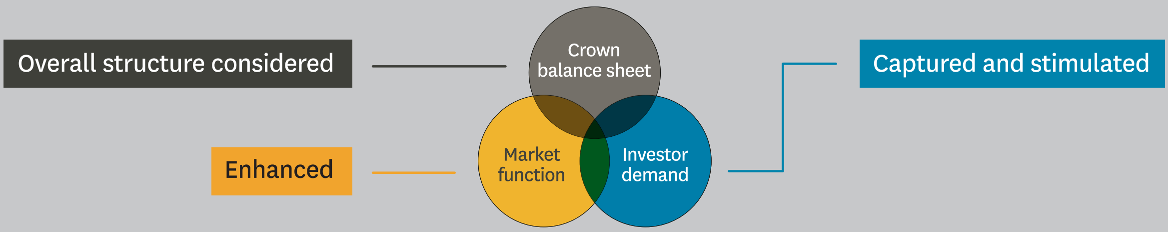
circa NZ$**1b–2b**
Inflation-index bonds

circa NZ$**58b–59b**
Nominal bonds

Net NZGB issuance

NZ$**49b**

Achieving a balance between the following three goals



Guiding principles underpinning the strategy

Transparent

Consistent

Even-handed

New Zealand Debt Management (NZDM) is a function within the Treasury[1] and is responsible for managing the Crown's net cash flows and liquidity position. This document covers recent developments in the New Zealand Government Securities (NZGS) Market and sets out the latest Funding Strategy for the 2020/21 year.

Recent developments

New Zealand's COVID-19 developments

The first COVID-19 case in New Zealand was confirmed in late February 2020, with increasing cases thereafter. As the number of confirmed cases increased, the New Zealand Government introduced border restrictions and implemented a four level alert system. The alert levels specify the public health and social measures taken to address the pandemic.

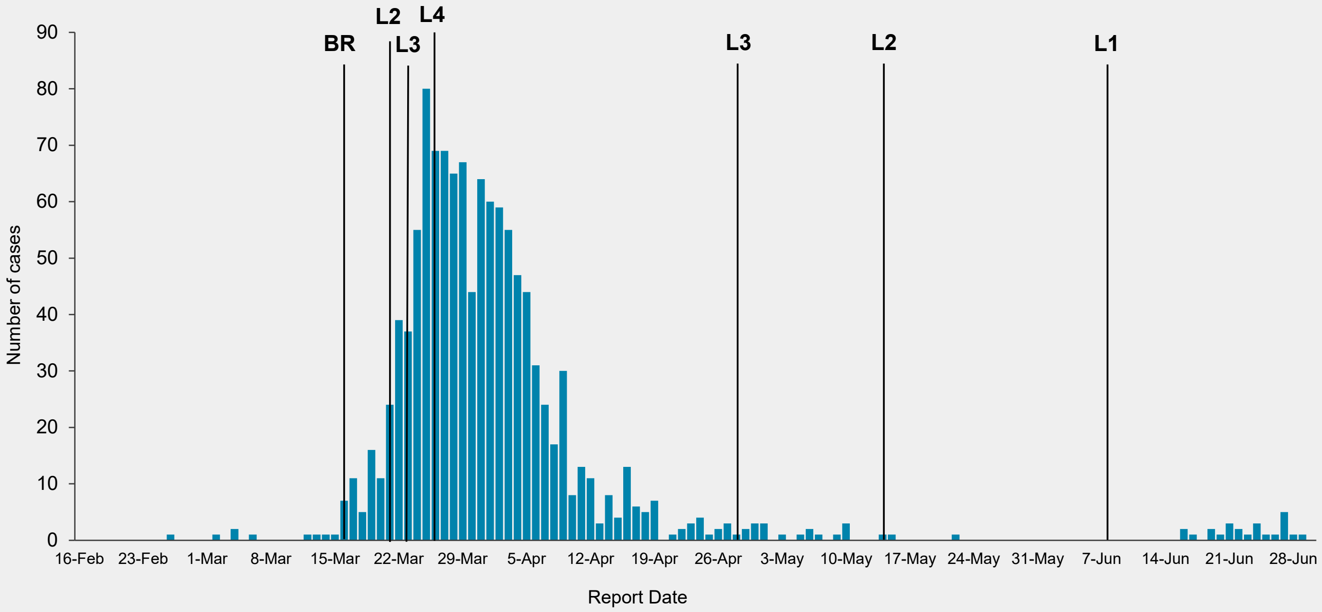
New Zealand is currently at Alert Level 1 (L1). This means that the country is operating business as usual but the international borders are largely closed.

The Alert Level 4 (L4) lockdown, where most businesses were unable to operate, led to a significant contraction in economic activity. March quarter 2020 GDP growth fell 1.6 per cent quarter-on-quarter, reflecting initial restrictions on activity.

To cushion the impact to the economy, the Government announced significant fiscal stimulus – an initial NZ$12.1 billion package announced on 17 March and the NZ$50 billion COVID-19 Response and Recovery Fund (CRRF) announced at the Budget on 14 May. Stimulus packages include a wage subsidy scheme, business support packages, a trades training package, and funding for education, health and other social sectors. Approximately NZ$20 billion of the CRRF remains as an unallocated contingency.

New Zealand's credit ratings are unchanged. Since the onset of COVID-19, both S&P Global Ratings and Moody's Investor Services have reaffirmed New Zealand's long-term local currency credit ratings at AA+ (positive outlook) and Aaa (stable outlook) respectively.

Figure 1: Number of daily confirmed COVID-19 cases in New Zealand



Alert Level Description

Source: Ministry of Health/the Treasury

Alert Level 1 (L1) Prepare – The disease is contained in New Zealand
Alert Level 2 (L2) Reduce – The disease is contained, but the risk of community transmission remains
Alert Level 3 (L3) Restrict – High risk the disease is not contained
Alert Level 4 (L4) Lockdown –Likely the disease is not contained
Border Restrictions (BR) Border restrictions imposed

1 The Treasury is the Government's lead economic and financial adviser. The Treasury provide advice to the Government on its overarching economic framework, on its fiscal strategy and on achieving value for money from its investments.

The impact of COVID-19 on the Crown's fiscal outlook is unprecedented. The *Budget Economic and Fiscal Update* (BEFU) 2020 showed substantial increases to the forecast borrowing programme, of NZ$152 billion, relative to that forecast at the *Half Year Economic and Fiscal Update* (HYEFU) 2019.

Changes to NZGS forecasts in response to COVID-19 Developments

	Year ending 30 June (face value, NZ$ billion)	2020	2021	2022	2023	2024	Total
Gross NZGB issuance	BEFU 2020	29	60	40	35	30	194
	HYEFU 2019	10	10	8	8	6	42
	Change in issuance	19	50	32	27	24	152
T-Bills on issue	BEFU 2020	10	10	10	10	10	n/a
	HYEFU 2019	3	4	4	4	2	n/a
	Change in T-Bills on issue	7	6	6	6	8	n/a

Source: The Treasury

To execute the borrowing programme, NZDM have made significant changes to the Funding Strategy for 2020/21. The following developments have occurred:

- Individual nominal bond line caps were lifted from NZ$12 billion to NZ$18 billion.
- Tender schedules are now published a month, rather than a quarter, in advance.
- Weekly tenders now include multiple bonds rather than one bond.
- NZ$1 billion to NZ$2 billion of inflation-indexed bonds are forecast to be issued in 2020/21, subject to market conditions.
- Tap syndications of existing bond maturities now complement the use of syndications to issue new bond lines.
- Continued focus on core New Zealand Dollar (NZD) funding instruments, but with a small volume of short-dated European Commercial Paper (ECP)[2] on issue, and documentation for long-dated European Medium Term Note (EMTN)[3] issuance maintained.
- Additional communication channels have been created, including the monthly Investor Update and virtual investor meetings.

Funding the Crown[4]

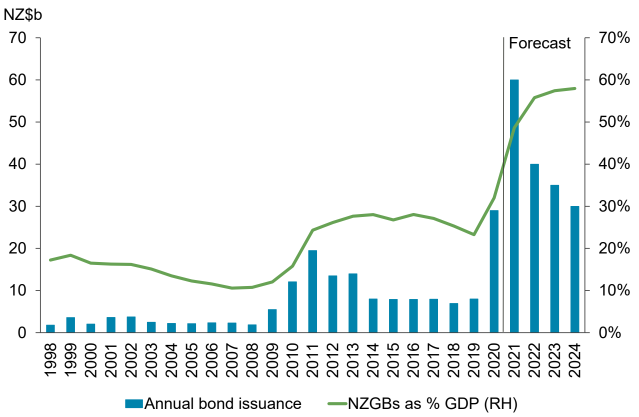
The Treasury's forecasts at BEFU 2020 show a substantial deterioration in the Crown's fiscal position, relative to that forecast at HYEFU in December 2019. Over the five year forecast period in BEFU 2020, a cash shortfall of NZ$151 billion is expected. This is approximately NZ$120 billion higher than forecast at HYEFU in December 2019. This core Crown cash shortfall ('residual cash deficit') is being funded largely through additional borrowing by the core Crown. Forecasts for residual cash are taken into consideration when forecasting the total core Crown borrowing programme, along with liquidity requirements and the projected financial assets position.

The core Crown borrowing programme includes the issuance of both New Zealand Government Bonds (NZGBs), which include nominal bonds and inflation-indexed bonds (IIBs), and short-term borrowings, such as T-Bills. Together, these make up New Zealand Government Securities (NZGSs). Consistent with the profile of core Crown residual cash requirements, NZGB issuance is predominantly weighted towards the early part of the forecast period. Heightened uncertainty remains on the timing, and to a lesser extent the size, of cash requirements, given the variability in economic activity due to COVID-19. To mitigate this uncertainty, the forecast increase in core Crown borrowings is higher than the forecast change in cash requirements. As a result, this leaves a sizeable forecast cash buffer, which allows the Government to be better placed to manage funding and liquidity risks.

In 2020/21, gross issuance of NZGBs is forecast to be NZ$60 billion. When bond maturities and bond buybacks are taken into account, net issuance is expected to be NZ$49 billion. As a per cent of GDP, NZGBs on issue are forecast to rise from 31 per cent in the year ended 30 June 2020, to 57 per cent in the year ended 30 June 2024.

Funding requirements will be revisited ahead of the *Pre-election Economic and Fiscal Update* (PREFU) 2020, which will take place prior to the New Zealand General Election on 19 September 2020.

Forecast NZGB issuance



Source: The Treasury

2 ECP is an unsecured, *short-term* debt instrument that is denominated in a currency differing from the domestic currency of the market where it is issued.
3 EMTN is a *medium-term* debt instrument that is denominated in a currency differing from the domestic currency of the market where it is issued.
4 The Crown is the Head of State of New Zealand. New Zealand Government Securities are issued in the name of "Her Majesty the Queen in right of New Zealand".

Funding Strategy principles and objectives

NZDM's core Funding Strategy principles are transparency, consistency and even-handedness. The objective of the Funding Strategy 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.

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 NZGS markets.

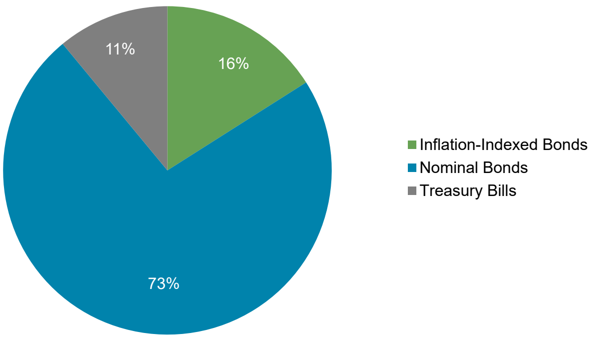
For the NZGB market, this objective is achieved by taking a structured, long-term approach, rather than a short-term tactical approach to funding activities. The aim is to reduce uncertainty or illiquidity premiums associated with NZGBs, by clearly communicating future actions in advance.

Wholesale Funding Strategy 2020/21[5]

Funding instruments

Core Crown funding instruments primarily consist of nominal and inflation-indexed bonds, and T-Bills. The following chart indicates the current proportions of the funding instruments within the overall portfolio.

Current New Zealand Government Securities portfolio



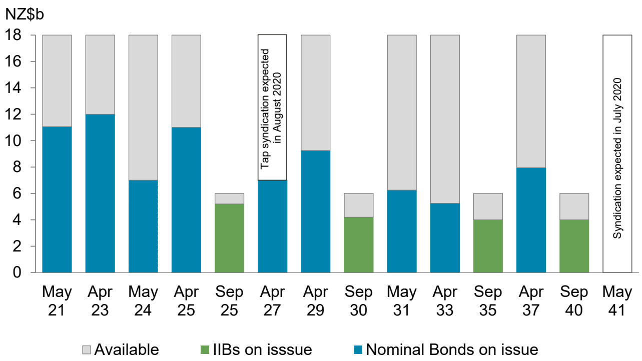
Source: The Treasury

Nominal bonds remain the primary funding vehicle and constitute between NZ$58 billion to NZ$59 billion of the forecast 2020/21 NZGB programme.

Nominal bond line caps are NZ$18 billion. This level allows for the need to promote liquidity in each bond line, while managing the size of maturity cash flows and mitigating refinancing risk. However, the full capacity of any bond line may not be utilised.

The current structure of the NZGB portfolio allows for "in fill" bond maturities to be introduced within the current NZGB curve or for extension of the curve, as market conditions allow.

NZGB portfolio and expected syndication issuance as at 1 July 2020



Source: The Treasury

Inflation-indexed bonds remain an important part of the core Crown borrowing programme. IIBs support diversification of the investor base and enable a portion of interest expenses to be correlated with the economic cycle and thereby fiscal revenues. Individual IIB lines remain capped at NZ$6 billion face value. Although IIB issuance was paused over the June 2020 quarter, it is expected that there will be approximately NZ$1 billion to NZ$2 billion of IIB issuance in 2020/21, subject to market conditions.

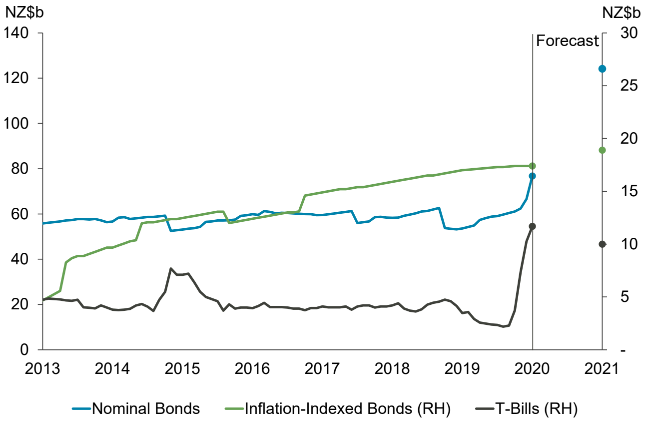
IIBs constitute a sizable proportion of the total NZGS portfolio, at 16 per cent, relative to global peers. While a specific level is not targeted, the proportion has increased over recent years. The appropriate proportion of IIBs within the portfolio, and the appropriate rate of issuance, is assessed on an ongoing basis. While commitment to the IIB product remains constant, IIB issuance will constitute a smaller proportion of total annual issuance in 2020/21, than in recent years. This strategy recognises market feedback and the relative cost of issuance.

Treasury Bills (T-Bills) provide flexibility to address short-term cash needs which may arise as a result of upcoming bond maturities, or seasonal or unexpected changes in cash flows. T-Bills are made available through weekly tenders.

5 Wholesale debt accounts for over 99 per cent of New Zealand Government Securities on issue, with retail debt (Kiwi Bonds) making up the remainder.

T-Bills on issue are forecast to be NZ$10 billion at end-June 2021. This is NZ$6 billion higher than previously forecast at HYEFU, reflecting the current economic and fiscal environment where short-term cash needs are less predictable. The actual volume of T-Bills on issue may vary from forecast, based on factors such as the relative cost of T-Bill issuance versus alternative short-term funding mechanisms and actual short-term cash needs.

New Zealand Government Securities on issue



Source: The Treasury

Alternative funding mechanisms are available to NZDM, which further help to meet any short-term cash needs of the Crown, if, and when, they arise. These include a limited overdraft facility with the Central Bank, The Reserve Bank of New Zealand (RBNZ), and short-dated foreign currency ECP issuance. In addition, NZDM maintain up-to-date legal documentation for an EMTN programme, should this be required.

Primary issuance

Primary Market Framework. NZDM implemented changes to its Primary Market Framework in September 2019. Under the revised Framework, to qualify as a Registered Tender Counterparty (RTC), an intermediary must play a significant role in intermediation of NZGS products to investors, as well as committing to support secondary market liquidity and price transparency. They must also support the primary market through regular participation in NZGS tenders.

Only RTCs are eligible for syndication issuance panels, and NZDM will support other relevant activity conducted by the RTC. RTCs are listed on the New Zealand Debt Management website to create visibility for investors.

Tender issuance. Issuance into existing NZGS lines will primarily occur via regular tenders. Since April 2020, details of the upcoming month's (rather than quarter's) tender schedule are published in advance. The aim is to provide market participants with as much certainty as possible regarding issuance plans, while maintaining some flexibility to adjust the issuance profile throughout the year. At each weekly tender, multiple NZGBs are now offered, compared with just one previously. Tender schedules are announced at the set time of 8am (NZT), on the day prior to the last tender of the previous month. Full details of tender dates, maturities, and volumes are provided.

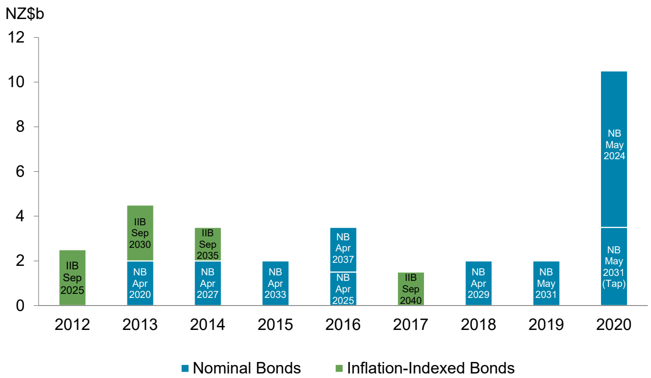
T-Bill tenders take place on a weekly basis. The volumes offered across the 3, 6 and 12 month lines are based on funding requirements and are announced on the day prior to the tender. The amount issued will depend on an assessment of bids received relative to other short-term funding mechanisms, and subject to the operating rules and guidelines (PDF 482KB).

During the month of July 2020, a total of six NZGBs will be offered through weekly tenders. This profile is designed to provide liquidity and price transparency at different maturities across the curve. During July 2020, weekly tender volumes will be approximately NZ$1 billion.

Syndicated issuance. Syndications remain the preferred method for the issuance of new bond lines, as it enables the placement of a large initial volume into the market, promoting immediate liquidity in the new bond. Tap syndications will also be used to add notable volume to existing bond lines. Syndication intentions are generally announced alongside an *Economic and Fiscal Update*, with further details provided alongside subsequent monthly tender schedule announcements. Further operational announcements are made later, relating to the appointment of any syndication panel and launch of the transaction.

As previously announced in the July Tender Schedule subject to market conditions, a new 15 May 2041 nominal bond is expected to be launched in the week starting 13 July 2020. A syndicated tap of the 15 April 2027 nominal bond is also expected to take place in August, subject to market conditions.

History of syndication volumes



Source: The Treasury

Secondary market support

Alongside support from intermediaries, the Funding Strategy aims to enhance secondary market liquidity by prioritising:

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

Undertaking bond buybacks. The Funding Strategy generally incorporates a policy of buying back bonds prior to their maturity. This helps to smooth cash flows around bond maturities, and to enable the recycling of maturity proceeds to investment further out the NZGS curve.

It has been recent practice to buyback outstanding bonds within an 18 month window before a bond matures. The RBNZ typically assumes responsibility for buyback activities during the final six month period before a bond matures, in an effort to ensure overall financial system liquidity.

The repurchase programme of the 15 May 2021 nominal bond, originally outlined at HYEFU 2019, was postponed in the March Borrowing Programme Update, reflecting portfolio requirements. Subsequently, the RBNZ began repurchases of the 15 May 2021 nominal bond for liquidity management purposes and to support market functioning. Therefore, NZDM no longer intends to undertake repurchases of the 15 May 2021 nominal bond.

Focusing on core instruments issued in NZD. The focus is on NZD denominated issuance in the domestic market. This helps to maximise liquidity in existing NZGS, and is currently more cost-effective than issuance in foreign currency. A well-developed NZD denominated NZGS market also supports domestic capital markets.

The 2020/21 borrowing programme forecasts do not include foreign currency issuance. However, NZDM have operationalised the short-dated foreign-currency ECP programme and intend to maintain a small amount of ECP on issue.

Commitment to a minimum level of NZGBs on issue. In recent years, as net debt levels were declining, the Government had made a commitment to "maintain New Zealand Government Bonds on issue at not less than 20 per cent of GDP over time". With NZGB issuance forecast to increase substantially, the commitment to a minimum NZGB market is not expected to become binding in the medium-term.

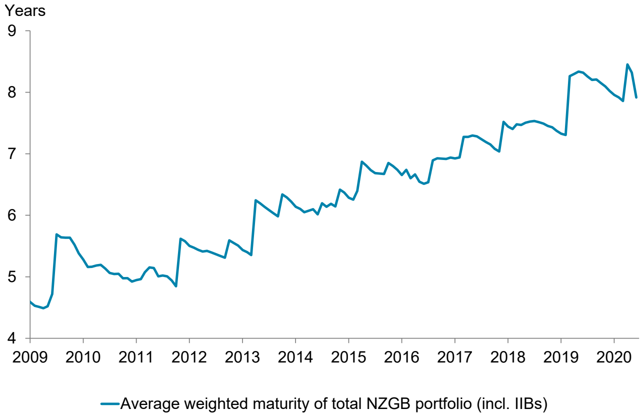
However, in the event Government debt levels decline, the commitment remains. The Government sees a sustainable and readily accessible NZGB market as important in supporting fiscal resilience. A commitment to a minimum NZGB market helps support liquidity and instils confidence in intermediaries and investors when choosing whether to participate in the market.

Broadly matching ACGB maturities. NZDM aim to issue NZGBs with maturities that closely align with Australian Commonwealth Government Bond (ACGB) equivalents so that investors can easily assess relative value between these assets.

Average maturity

In recent years, the Funding Strategy has looked to extend the average weighted maturity of the NZGB portfolio. The average weighted maturity of the NZGB portfolio has increased from approximately 4.5 years in mid-2009 to 7.9 years currently.

Average weighted maturity of NZGB portfolio



Source: The Treasury

Increasing the average weighted maturity has contributed to meeting 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 supported investor diversification by capturing demand from investors with long-dated liabilities. It has also helped reduce refinancing risk and frequency, as well as contributing to the development of New Zealand's capital markets overall. Over the long-term, there is no specific target for the average weighted maturity of the portfolio. Broadly, NZDM continue to see benefits in increasing the average weighted maturity of the bond portfolio. However, issuance decisions will also be informed by an assessment of investor demand and market conditions.

Environmental, Social and Governance (ESG) considerations

On various independent sustainability and ESG metrics, New Zealand is one of the most highly rated sovereigns in the world. This includes a 2019 Sustainable Development Goals (SDG) global rank of 11 out of 162 countries.

The New Zealand Government also has clearly stated wellbeing objectives. The first '*Wellbeing Budget*' was delivered in 2019 and included a package of initiatives to measure progress focused around five Budget Priorities[6].

Included in the *Wellbeing Budget* initiatives was the creation of an independent Climate Change Commission to advise on carbon reduction techniques and setting a provisional emissions target and revised cap and price controls for the Emissions Trading Scheme[7].

6 Mental health, child wellbeing, supporting Māori and Pasifika aspirations, building a productive nation, transforming the economy.

7 Further information can be found https://www.mfe.govt.nz/overview-reforming-new-zealand-emissions-trading-scheme

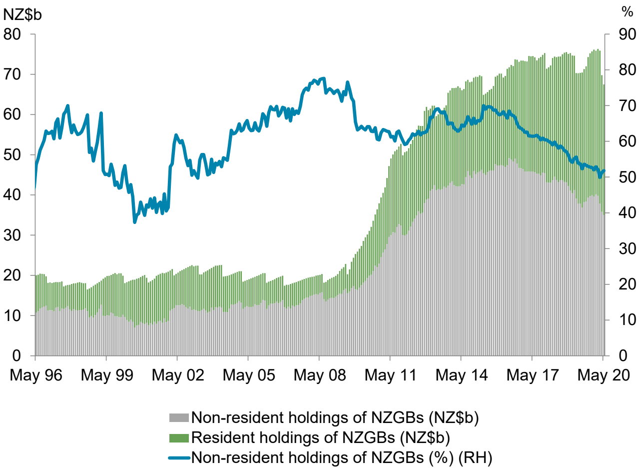
In Budget 2020 however, a number of the new initiatives under the Budget Priorities were postponed in order to fund the targeted, primarily socially-focused, COVID-19 response and recovery measures. That said, the aim of the measures remain prioritising the wellbeing of current and future generations of New Zealanders.

In this context, NZDM have no imminent plans to issue bonds in a specific ESG format. More broadly, NZDM are cognisant of the contribution efficient debt funding can make to support the Government in achieving ESG objectives.

Diversifying investor base

Maintaining an investor base which is diverse by geography, investor type and mandate is achieved through an active investor engagement strategy.

Non-resident holdings of NZGBs



Source: RBNZ

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. Over recent months, the proportion of NZGBs held by non-residents stabilised above 50 per cent with holdings at 51.8 per cent at 31 May 2020. The proportion of nominal bonds held by non-residents remains higher, at 57.8 per cent, compared to 34.5 per cent for IIBs.

There is notable variation in the proportion of non-resident holdings across the different NZGS maturities. The bonds with the highest proportion of non-resident holdings are the 15 April 2027 NZGB and the 20 April 2029 NZGB, at 62.8 per cent and 65.1 per cent respectively. Holdings of T-Bills continue to be dominated by resident investors, with only 1.6 per cent held by non-residents.

As part of its investor engagement strategy, NZDM undertake frequent interactions with its investor base. This includes publication of the monthly Investor Update and a regular meeting and presentation schedule. In the current environment, NZDM have adapted the meeting and presentation schedule to incorporate virtual platforms. More detail on all media and external publications can be found in NZDM's online investor resources.

Summary

COVID-19 is having an unprecedented impact on the New Zealand Government's fiscal position, with a sizeable residual cash deficit forecast in BEFU 2020.

To fund the substantial residual cash deficits, NZDM have increased the annual borrowing programme in each year of the forecast period. Both NZGB and T-Bill issuance forecasts have increased. The increase in the forecast borrowing programme is front-loaded and higher than the residual cash deficit indicates. This enables a larger cash buffer to be built up, compared to that typically held by NZDM, to account for heightened uncertainty. In the 2020/21 year, NZGBs issuance is forecast to be NZ$60 billion. As is standard practice, this will be primarily undertaken through tender issuance, though the frequency of syndicated issuance has increased. Two syndications have been announced, and are planned for the September 2020 quarter.

The focus will remain on nominal bonds as the primary funding vehicle, although IIBs remain an important part of the funding portfolio. Some flexibility is maintained in T-Bill issuance in order to respond to short-term liquidity requirements in an efficient manner. The core principles of transparency, consistency and even-handedness remain important foundations for the Funding Strategy.