THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand Government Securities Funding Strategy

2018/19: Edition 1

New Zealand Government

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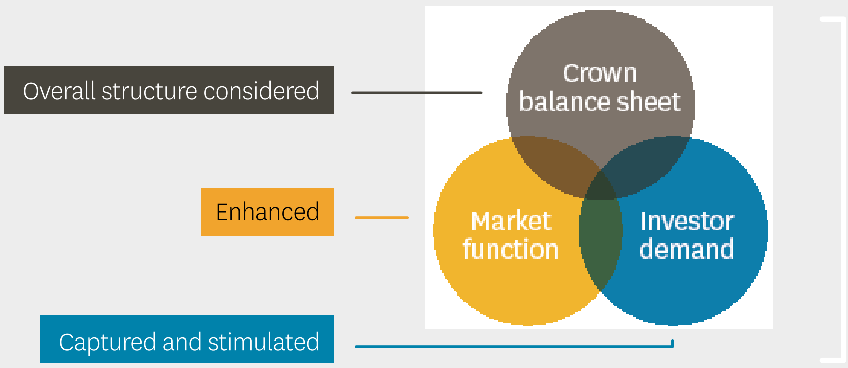
Funding Strategy – at a glance

The Treasury's New Zealand Debt Management Office (NZDMO) 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, the NZDMO takes a strategic rather than tactical approach to funding.

Achieving a balance between the following three goals:

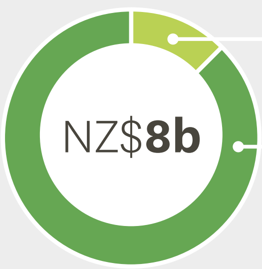


Guiding principles underpinning the strategy

- 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.

Funding the Crown

The New Zealand Treasury's Debt Management Office is responsible for managing the Crown's net cash flows and liquidity position.

The Treasury's forecasts at Budget 2018 show the total Crown operating balance, including gains and losses, in surplus in 2018/19. However, capital spending is forecast to exceed 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.

New Zealand Government Bonds (NZGBs) constitute the greatest proportion of the total borrowing programme. In the year ending June 2019 (2018/19), NZ$8 billion of gross issuance of NZGBs is forecast. When projected maturities and buybacks are taken into account, net issuance is forecast to be NZ$-3.2b. 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%	23.3%
T-Bills on issue ($ billion)	4	2

As is standard practice, funding requirements will be revisited ahead of the December Half Year Economic and Fiscal Update (HYEFU) 2018. The forecast borrowing programme will be restated or amended alongside HYEFU.

Funding strategy principles

The objective of the debt management strategy is to minimise the Crown's borrowing costs over the long-term with due consideration to risk.

For the NZGB market, it is believed that 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 aim is prioritised over 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.

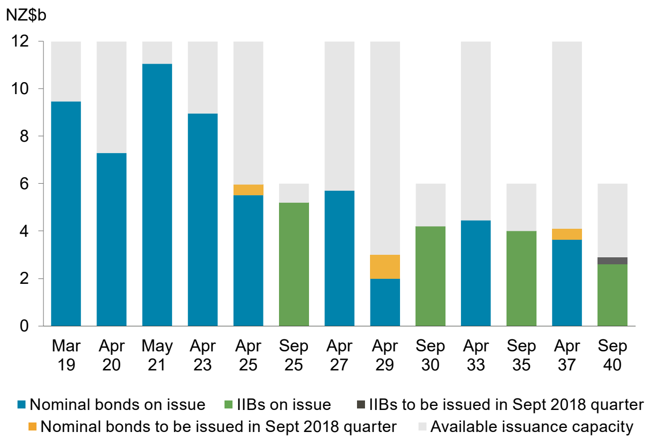
Wholesale funding strategy 2018/19

Funding instruments

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

During the September 2018 quarter, three nominal NZGB maturities will be tendered, the 15 April 2025, 20 April 2029 and 15 April 2037. 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 September 2018 quarter



It is envisaged that there will be capacity to issue into three nominal NZGBs each month in the fiscal year, with the exception of the period when issuance is curtailed during the Christmas season. Tender offerings will likely continue to be in a range of NZ$100-NZ$300 million for any line.

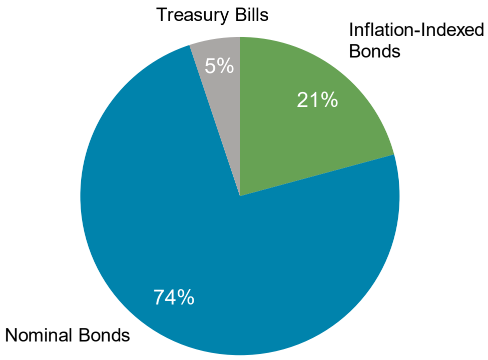
Individual nominal NZGB lines are 'capped' at NZ$12 billion face value. This is seen as a level that balances the need to promote liquidity in each line, with managing cash flows and mitigating refinancing risk.

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

During the September 2018 quarter, one IIB maturity will be issued, the 20 September 2040.

Currently IIBs constitute just over 20% of the total funding portfolio (including T-Bills). While there is no specific target, this proportion is considered reasonable under the funding strategy. Individual IIB lines will be 'capped' at NZ$6 billion face value.

Current New Zealand Government Securities portfolio

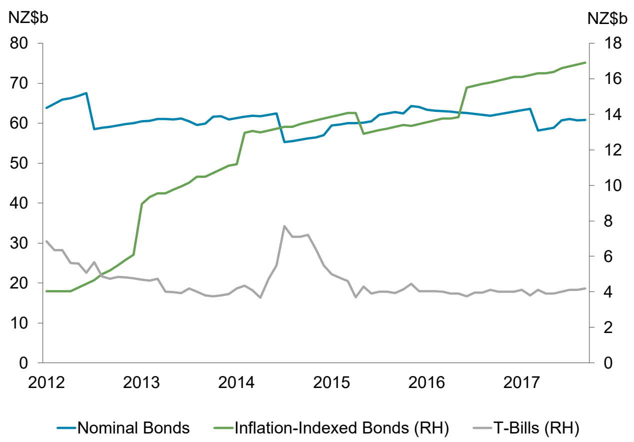


Treasury Bills (T-Bills) provide flexibility in addressing short-term liquidity requirements. Requirements may arise as a result of upcoming bond maturities, or seasonal or unexpected changes in cash flows.

Budget 2018 forecasts showed T-Bills outstanding to be NZ$2 billion at the end of 2018/19, from NZ$4 billion at the end of 2017/18. These forecasts represent current expectations as to how forecast cash liquidity needs at the end of 2018/19 will be met. However, the actual volume of T-Bills on issue, may vary from forecast, based on the issuer's assessment of the relative cost of T-Bill issuance versus alternative short-term funding mechanisms. Within the year, the volume of T-Bills on issue will also vary based on short-term cash liquidity needs.

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

New Zealand Government Securities on issue



Primary issuance methods

Issuance into existing nominal NZGB and IIB lines will continue to occur via regular tender. Only registered tender counterparties may participate in tenders.

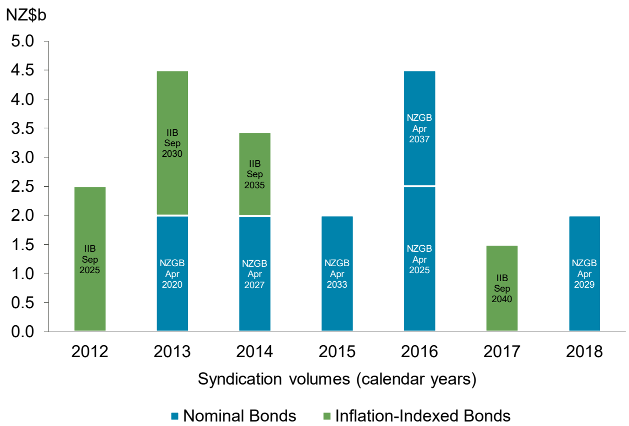
Full quarterly bond tender schedules will continue to be announced ahead of each quarter, including tender dates, maturities, and volumes. This will generally occur at the time of the confirmation announcement for the last tender of the preceding quarter.

Tenders take place within established operating rules and guidelines[1]. The issuer reserves the right to issue less than the maximum amount of Government Securities for each tender.

Syndications remain the preferred method for the issuance of new bond lines. This method enables the placement of a large volume into the market, promoting immediate liquidity in the new bond. Plans to launch a new bond by syndication are typically announced alongside Budget or HYEFU. No plans were announced alongside Budget 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 announced on the day prior to tender. However, the amount issued may vary, depending on the assessment of bids received, relative to other short-term funding mechanisms, subject to the relevant operating rules and guidelines.

History of syndications



Secondary market support

The important role that intermediaries play in maintaining a well-functioning secondary market is recognised. In addition, the funding strategy aims to promote secondary market liquidity. It prioritises:

- undertaking bond buybacks ahead of upcoming maturities
- focusing on domestic NZD issuance and core instruments
- recommending a Government commitment to a minimum level of NZGBs on issue

1 https://www.nzdmo.govt.nz/sites/default/files/media/media_attachment/Operating%20Rules%20and%20Guidelines.pdf

- broadly matching NZGB issuance maturities to ACGBs
- building volume in 'benchmark' lines
- using syndications to launch new lines

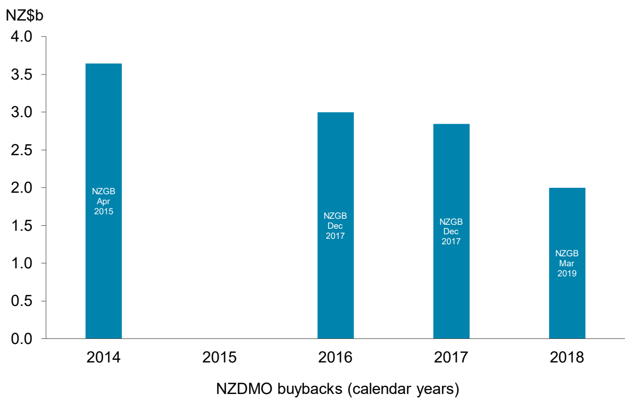
Undertaking bond buybacks

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 March 2019 NZGB is currently being undertaken. Plans to commence a buyback programme of the 15 April 2020 NZGB in 2018/19 were announced alongside Budget 2018. 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 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



Focusing on domestic NZD issuance and core instruments

The current focus is on New Zealand dollar (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[2] and EMTN[3] 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. The issuer remains open to the use of alternative funding instruments. However, these will be assessed with respect to the impact on liquidity, relative cost, and investor diversification and with regard to reputational benefits or risks.

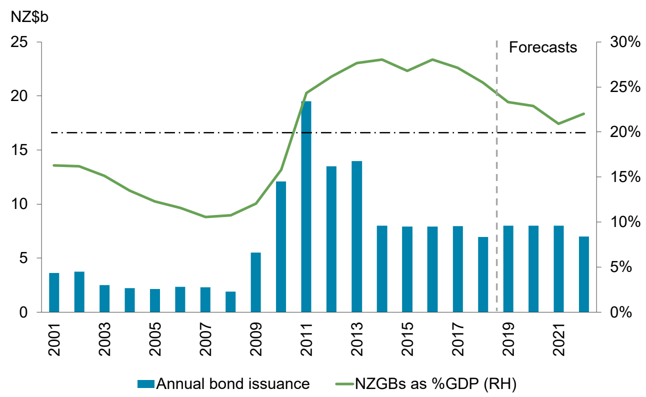
Commitment to a minimum level of NZGBs on issue

In recent years, as the Government has been running operating surpluses, and reducing net debt, it has made a commitment, upon the Treasury's recommendation, to a minimum level of NZGBs on issue. Alongside Budget 2017 the Government made a statement that it would "maintain New Zealand Government Bonds on issue at not less than 20 percent of GDP over time". This statement was reiterated alongside HYEFU 2017, following a change of Government.

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 23.3% of GDP at the end of 2018/19. This is consistent with the Government's commitment. However, adjustments to the programme were not required to specifically meet this commitment.

NZGBs on issue to remain above 20% of GDP



Broadly matching ACGB maturities

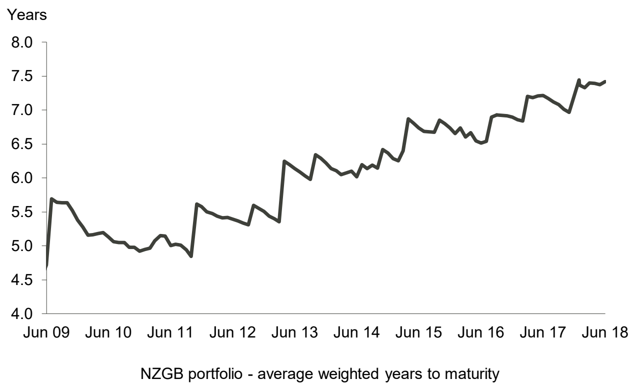
The aim is to issue NZGBs with maturities that closely align with their Australian Commonwealth Government Bond (ACGB) equivalents. This promotes the ability for investors to easily assess relative value between these assets.

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 7.5 years currently.

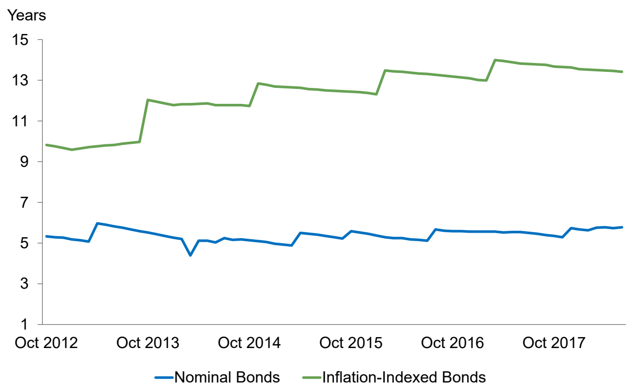
2 European Commercial Paper
3 Euro Medium Term Note

Average weighted maturity of NZGB portfolio



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

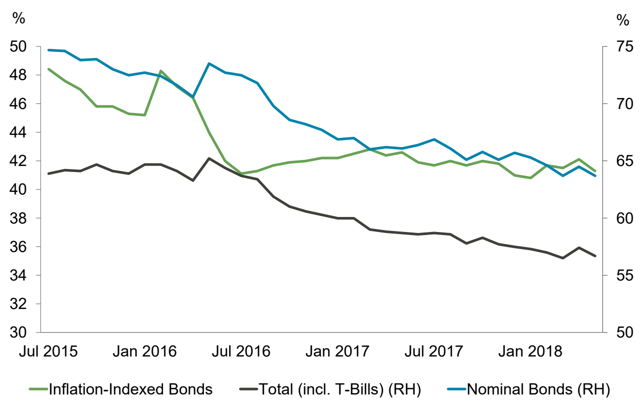


There is no target for a specific average weighted maturity for the portfolio. However, the average weighted maturity of the NZGB portfolio is expected to increase further in 2018/19, as the 15 March 2019 NZGB matures and issuance continues further out the curve.

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.

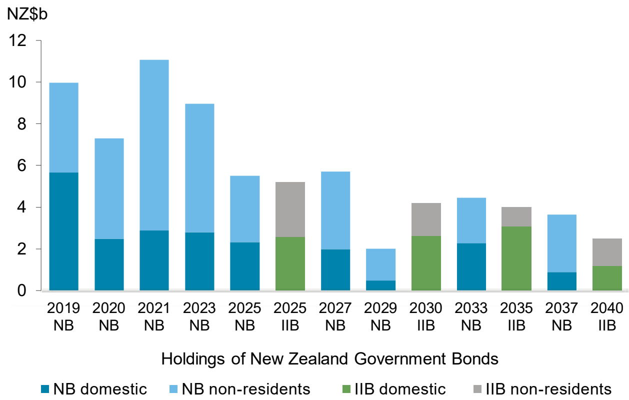
Non-resident holdings of NZGBs



Non-resident holdings of NZGBs, at 58%, currently sit at the lower end of their range of the past decade. The proportion of nominal bonds held by non-resident remains higher, at 63%, relative to 41% for IIBs. There are notable variations in the proportion of non-resident holdings across the different NZGB maturities.

T-Bills remain predominately held by domestic investors with only 18% held by non-residents, although this proportion has recently been increasing.

Resident and non-resident holdings of NZGBs



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.

A strategic, as opposed to tactical funding approach will continue to be undertaken, underpinned by the core principles of transparency, consistency and even-handedness.

The funding strategy aims to balance three key goals; considering the overall structure of the Crown's balance sheet, capturing and stimulating investor demand and promoting well-functioning New Zealand Government Securities markets. Liquidity is an important component of the latter, where intermediaries play a crucial role. In addition, the funding strategy aims to assist in promoting secondary market liquidity.

The focus will remain on core domestic NZD funding instruments. Nominal NZGBs will remain the primary funding vehicle, though IIBs remain an important part of the funding programme. Around NZ$1 billion of IIB issuance is expected in 2018/19. Comprehensive tender issuance plans for NZGBs will be announced ahead of each quarter. By contrast, a more flexible approach will be taken to T-Bill issuance, in order to address short-term liquidity requirements.

Engagement with investors will remain crucially important in 2018/19, in line with the aim of continuing to diversify the investor base. Feedback on the funding strategy is welcomed from investors and intermediaries.