

The New Zealand corporate bond market

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Introduction

The paper explains how the domestic corporate bond market operates in New Zealand today, and outlines the form and types of issuance, as well as the breakdown of outstanding issues by credit rating and sector. It also provides a summary of the offshore New Zealand dollar (NZD) corporate bond market, which has experienced a period of significant growth in recent years as a result of New Zealand's relatively high interest rates and current account imbalance.

The New Zealand corporate bond market consists of all bonds that are not issued by the central government. This categorisation includes stated-owned enterprise (SOE) bonds, local authority bonds, mortgage-backed securities (MBSs), rated bonds issued by New Zealand corporates and lower-grade hybrids issued by New Zealand corporates.

The majority of New Zealand's corporate debt is issued in the three- to ten-year tenor of the yield curve; however, there have been issues with maturities as long as 15 years. Typically, New Zealand corporates have obtained short-term (one–five years) funding from banks, and have turned to the corporate bond market for longer-term funding.

New Zealand's corporate bond market started to develop in the late 1980s, following the deregulation of the country's financial system and floating of the NZD in 1985. Prior to this time, bond market activity consisted of local government bodies issuing small amounts of paper on a tap² basis.

The first issuance of larger tranches of corporate bonds by non-government entities occurred in the late 1980s, and these were by SOEs. Since the early 1990s, several commercial entities have used the corporate bond market as an alternative source of funding.

However, there has been little growth in the New Zealand domestic corporate bond market since that initial flourish. There are a number of possible reasons for the stagnation, including:

- The New Zealand fund management industry has experienced very little growth over the last decade, and has not created demand for financial assets;
- New Zealand has had a negative or flat yield curve for much of the period since deregulation, and highest point on the yield curve has often been 90 days. This has made short-term bank deposits very attractive with household savers and made it difficult to attract long term funds at a lower yield than the short term yield; and
- New Zealand has a well-developed and actively traded FX market, with the result that domestic corporates can access offshore capital markets, and hedge currency risks efficiently using the currency and interest-rate swap markets.

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² Local authorities often issued loans in small tranches up to a set level. As the need for funding arose, the local authorities would "tap" the market with a new tranche at a specified yield. The dollar value of many of these loans was very small and the amount "tapped" each time could be as low as a few tens of thousands of dollars. Tendering of bonds started in the mid-1980's with government bonds.

Table 1

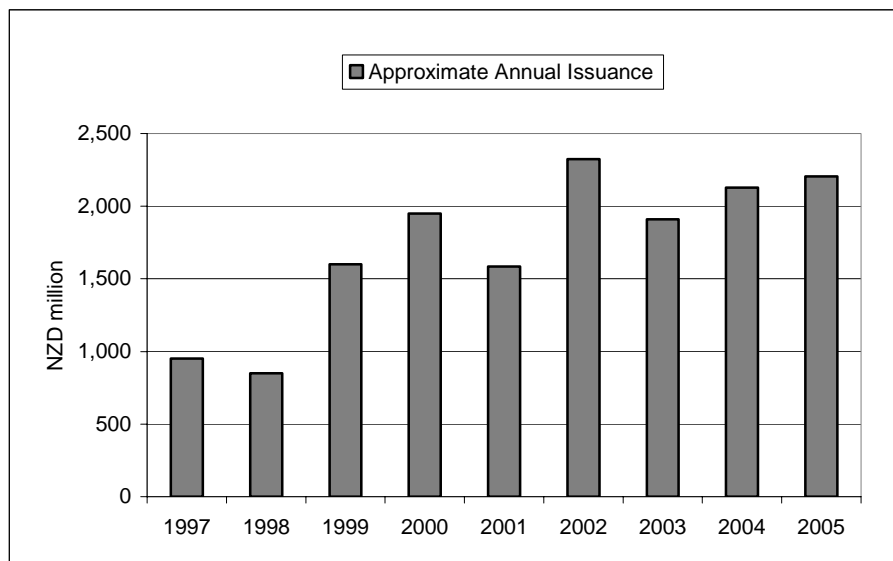
The characteristics of most corporate debt issues are similar to those of government debt issues

Issuance	Bonds are issued by the borrower as a registered security.
Registration	The bonds must be registered with a registrar.
Maturity	Maturities typically range from one to ten years, with maturities most often being in the two to seven year range.
Principal	The principal is usually redeemable at par on maturity.
Coupon	The coupon rate and frequency of payment are specified when the bond is issued. Most bonds are issued with semi-annual coupons to facilitate comparisons with government bonds.
Amount	The size of the issue is dependent on the borrower's requirements and the likely demand from investors.
Pricing	The formula for pricing bonds that pay a semi-annual coupon is the same as that used to price government bonds. Other types of bonds are priced on the same present value of future cash flows approach, but adapted to the requirements of the specific security.
Sale	Bonds are usually sold by tender or private placement. A number of bond issues are sold through brokers to retail investors.
Margin	The majority of corporate bonds are issued at a margin relative to the interbank swap rate.

Issuance

Annual issuance in the corporate bond market is set out in Graph 1.

Graph 1
**New Zealand corporate bond market:
 approximate annual issuance**
 (NZD millions)



Sources: RBNZ and Bloomberg.

Corporate debt is issued in a number of different ways, principally by dealer panel (typically associated with a fixed-rate re-offer), and through tender and tap issues. Under New Zealand securities law, there are two main types of issuance: wholesale and retail.

A wholesale issue does not require the issuer to produce a prospectus, but can only be sold to professional and habitual investors. In New Zealand, there are less than a dozen major fund management companies, but a couple of hundred smaller investment pools. Wholesale issues are targeted at both these groups and, typically, will have a minimum purchase amount of NZD 100,000.

A retail issue must be sold under a prospectus, and can be sold to all members of the public (including wholesale investors). The minimum purchase amount can be as little as NZD 1,000.

Anecdotal evidence suggests that 99.9% of issuance is done by dealer panel, particularly when issue size is greater than NZD 50 million. Dealer panels are usually comprised of a small number of market participants appointed by the issuer. Panel members have exclusive distribution rights for the primary issue, as well as facilities for borrowing stock and relevant market information. Most deals bigger than NZD 50 million have a “co-lead manager”, though panels do not usually have more than three members.³ The trend is for these panels to do a road show, conducting one-to-one meetings with client representatives, issue managers and “A-list” investors. A-list investors are often divided between the lead and co-managers to avoid over-marketing the debt. In most cases, issuers pay performance-based fees to panel members to reflect support of primary issues, the promotion of these securities in the secondary market, and the provision of economic and debt management advice.

The other two methods of issuance, tap and tender, have been recently introduced in New Zealand. NZ Telecom has issued some tap debt, and Auckland City Council has issued via tenders. Tap issues are less liquid than others, and, consequently, trade at a premium. Smaller borrowers, such as GMAC and Primus, seem to prefer tap issues, as these are more easily adapted to prevailing business conditions and borrowing requirements.

Rate setting for corporate debt

Rate setting on corporate debt is done in a variety of ways by market participants. Some will do the rate set at 11.30 am by faxing three or four other banks and asking them for rates. They will also refer to the swaps screen. New Zealand government bond (NZGB) tender results are not used. Other dealers will use the Reuters page for an underlying NZGB rate, or look at a broker’s swaps screen (eg the Reuters page FISSWAP as depicted in Graph 2).

³ In Australia, dealer panels can range in size from five to 20 members, who tend to be the most active players, demonstrating a commitment to price-making in the secondary market.

Graph 2

Example of Reuters FISSWAP page

05:02 19DEC05		ICAP (NEW ZEALAND)				NZ00256				FISSWAP	
SWAPS		BPV \$M	SPREAD		SHORT	BOND	LONG	BOND	NZGS CLOSES		
1Y	7.521 - 7.481	94.65			Mat	FV\$m	Mat	FV\$m	02/06	6.895	
2Y	7.215 - 7.155	183.25	114.0	108.0	07-08	15.6	07-08	0.0	11/06	6.805	
3Y	6.991 - 6.931	266.82	92.5	86.5	07-08	12.8	07-09	7.3	07/08	6.085	
4Y	6.886 - 6.826	344.73	86.5	80.5	07-09	17.4	11-11	2.6	07/09	6.065	
5Y	6.804 - 6.744	418.20	86.0	80.0	07-09	10.0	11-11	10.4	11/11	5.885	
7Y	6.700 - 6.640	552.09	88.5	82.5	11-11	5.0	04-13	14.2	04/13	5.810	
10Y	6.635 - 6.575	723.49	84.5	78.5	04-15	20.1	04-15	0.0	04/15	5.800	
15Y	6.615 - 6.555	943.89							12/17	5.825	
-----SPREAD CALCULATOR-----											
								NZD BANK v USD LIBOR---			
1YR	2YR	3YR	4YR	5YR	7YR	10Y	BILLS		FLAT Q/Q		
	+31.6	+53.9	+64.4	+72.6	+83.1	+89.6	1YR	PLUS +7.00	/PLUS	+5.00	
2YR	-31.6	+22.4	+32.9	+41.1	+51.5	+58.0	2YR	PLUS +4.75	/PLUS	+2.75	
3YR	-53.9	-22.4	+10.5	+18.7	+29.2	+35.6	3YR	PLUS +4.50	/PLUS	+2.50	
4YR	-64.4	-32.9	-10.5	+8.2	+18.7	+25.1	4YR	PLUS +4.50	/PLUS	+2.50	
5YR	72.6	41.1	18.7	8.2	10.5	16.9	5YR	PLUS +4.50	/PLUS	+2.50	
7YR	-83.1	-51.5	-29.2	-18.7	-10.5		7YR	PLUS +3.50	/PLUS	+1.50	
10Y	-89.6	-58.0	-35.6	-25.1	-16.9	-6.5	10YR	PLUS +3.25	/PLUS	+1.25	
15YR							15YR	PLUS +5.50	/PLUS	+2.50	
RBNZ DATES:		CONTACTS: ICAP / +64 4 4990009						ICAP INDEX <FISINDEX>			
26/01/06 MPS		KERRY WILKINS / +64 21 581169						CLOSING RATES <FISCLOSE>			
09/03/06 OCR		RICHARD PETERSEN / +64 21 669409									
27/04/06 MPS		ANDREW JOHNSTONE / +64 21 676353									
08/06/06 OCR		OSCAR NILSSON / +64 21 511462									

Source: Reuters.

Secondary market in corporate bonds

In New Zealand, there is only a small and relatively illiquid secondary market for corporate bonds. There are no official market-makers; however, dealer-panel members are expected to make markets in the securities they have brought to market, which means that they often quote two-way prices continuously in the secondary market. Demonstrating that they are willing and able to provide liquidity gives panel members a greater chance of getting primary issue business.

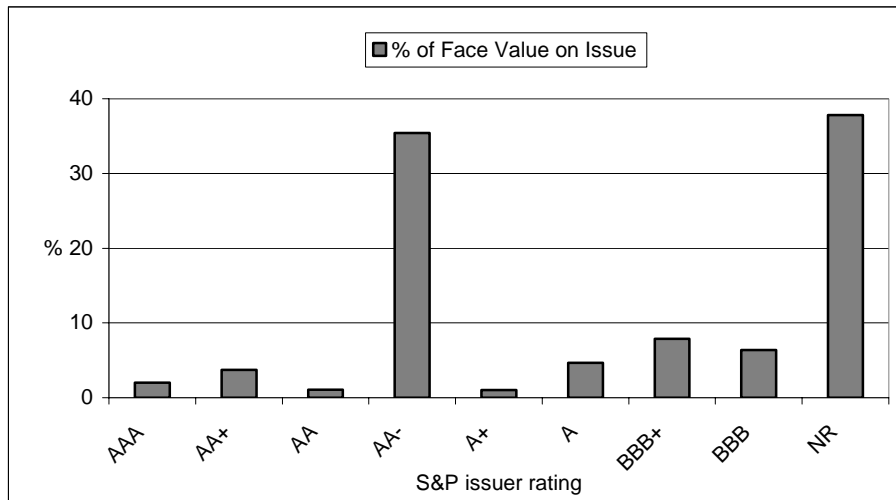
Most secondary market deals are done on a best-endeavour basis. Some of the local banks, however, do undertake to make markets for their better clients. Spreads in this market are wider than those in the government bond market, and will often depend on the client and the volume to be dealt. One to six basis points is typical.

Typical owners of New Zealand corporate debt are retail investors, top fund managers, institutional investors and banks. Non-profit and religious organisations also hold corporate debt on their balance sheets. There is not much overseas interest in the New Zealand corporate debt market because of tax issues. "Credit is expensive in New Zealand" is the main reason given for the lack of offshore interest. Also, some issues have clauses that confine sales to the local market.

Credit ratings for corporate debt issued in 2005

Graph 3 shows the rating profile of corporate debt outstanding. At the moment, there are approximately 30 major domestic issuers of corporate bonds in New Zealand. Of domestic issues outstanding, just under 50% had ratings of A or higher, while the remainder had ratings of BBB+ or lower or were unrated.

Graph 3
Credit ratings of New Zealand corporate debt

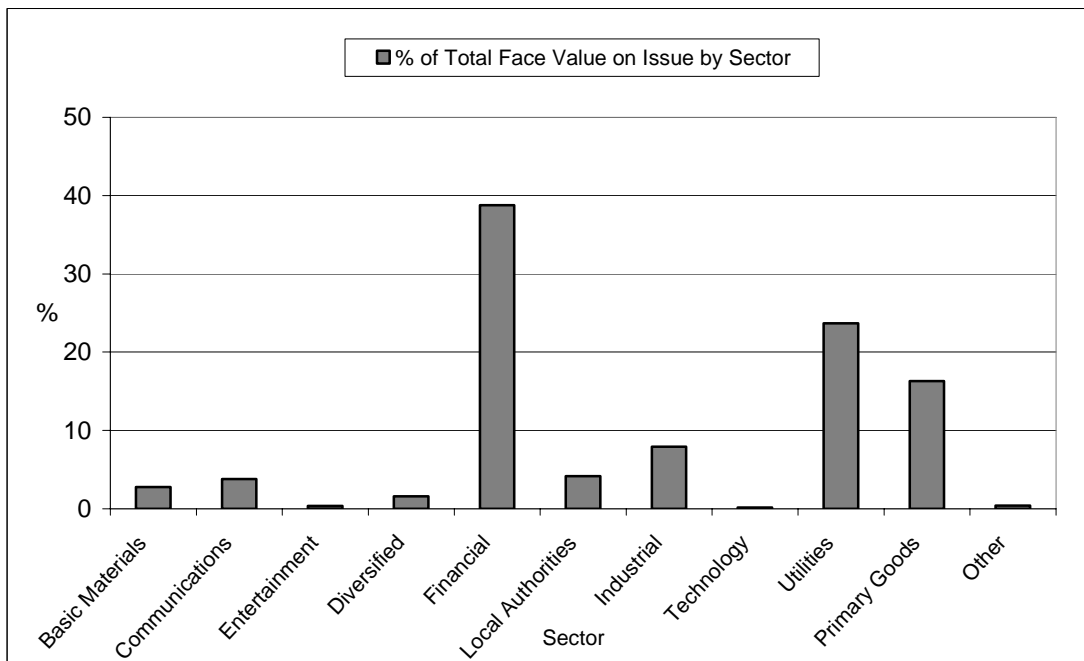


Note: The percentages are based on the face value of debt in the market with such a rating.
 Source: Bloomberg.

NZ corporate bonds by sector

Graph 4 provides a breakdown of corporate debt in New Zealand by sector. Utilities and the financial sector are clearly the largest issuers of debt.

Graph 4
Issuance of New Zealand corporate bonds by sector



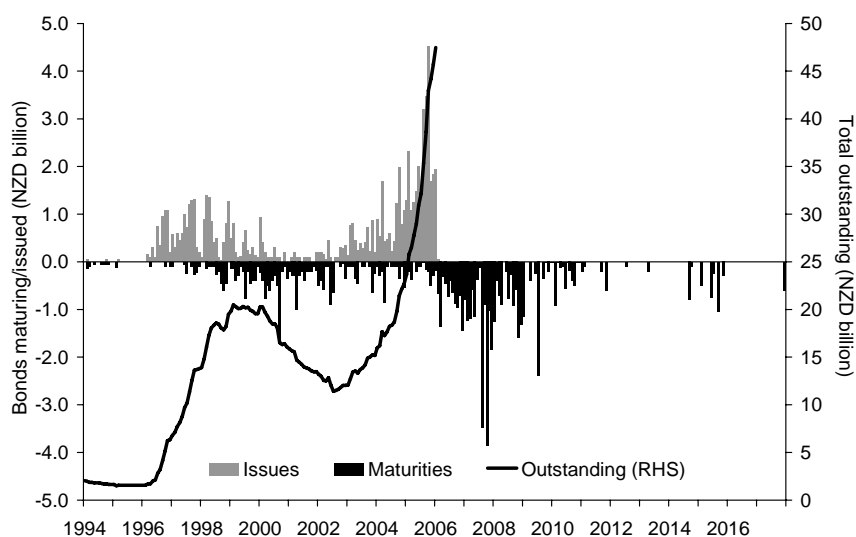
Source: Bloomberg.

Issuance of offshore NZD debt - the Eurokiwi/Uridashi market

Offshore NZD bond issuance - mainly Eurokiwi and Uridashi⁴ bonds - has been especially strong over the past year 2005. These bonds usually have two- to three-year maturities, and are issued mainly by internationally known overseas institutions (such as the World Bank), and sold to overseas investors (particularly in Europe and Japan). At the same time, many New Zealand corporates and banks have found it more efficient to raise funds in the offshore capital markets (mainly in US dollars) - principally because offshore markets can provide greater volumes of longer-term funding than the domestic markets can - and swap these funds back into NZD. Furthermore, the high yields on New Zealand dollar denominated assets have made NZD investment very popular with global investors. The Eurokiwi and Uridashi issues have provided New Zealand issuers with a cost-effective mechanism for converting (ie swapping, and thus hedging) their overseas borrowings into NZD. In effect the New Zealand market has evolved to enable domestic and global participants to exploit their respective niches. At first glance this may appear to be to the detriment of the purely local, New Zealand market, but from a wider perspective, it has improved the overall access to capital.

Graph 5

NZD bond issuance in offshore markets (Eurokiwi and Uridashi bonds)



Source: RBNZ.

A very large amount of Eurokiwi and Uridashi bonds is now outstanding, reaching more than NZD 45 billion at the end of 2005. This is more than double the previous peak of NZD 20 billion, reached in 1999 (Graph 5). Questions arise, therefore, about the nature of the adjustment that would take place if issuance were to abruptly dry up, and/or the large amount scheduled to mature between 2006 and 2009 were not at least in part rolled over into new issues.

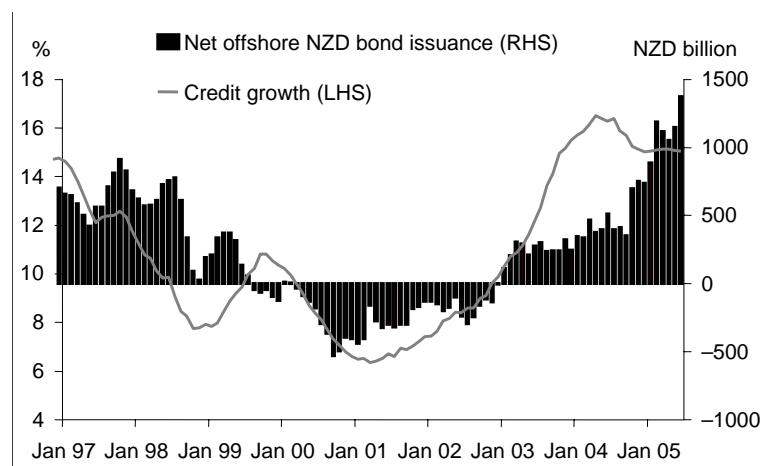
The last time a substantial amount of offshore NZD bonds matured (around 1999-2002), there was little disruption to the wider financial system. However, that was partly because the decreased supply of funds from offshore investors coincided with a slowing of demand for credit from New Zealand borrowers (Graph 6). While the maturing/redemption of offshore NZD bonds is likely to have made

⁴ In this article, NZD denominated bonds issued offshore by non-New Zealand resident borrowers to non-resident investors are referred to as either "Eurokiwi" or "Uridashi" bonds. In general, European and global issues are Eurokiwis whereas bonds issued to retail investors in Japan are Uridashis. The non-resident borrowers will normally swap the NZD proceeds into the currency that is actually required. For a detailed explanation of this market and its rationale, see Drage, Munro & Sleeman (September 2005): "An update on Eurokiwi and Uridashi bonds", *RBNZ Bulletin*, 68 (3) pp 28-38, available from the RBNZ's website: http://www.rbnz.govt.nz/research/bulletin/2002_2006/2005sep68_3dragemunrosleeman.pdf.

some contribution to the substantial fall in the NZD exchange rate in late 2000/2001, other factors dominated. In particular domestic economic conditions, fears in the market that the RBNZ had over tightened monetary policy and a stubbornly high current account deficit all weighed on the currency.

Graph 6

Net offshore NZD bond issuance and credit growth in New Zealand



Note: Net offshore NZD bond issuance is a six-month moving average.

Source: RBNZ.

This previous experience provides some basis for thinking that adjustment to a drop-off in Eurokiwi and Uridashi issuance would again be coped with by the financial markets.

Conclusion

During the last decade, the New Zealand corporate bond market has gone down two separate paths, developing into a domestic market and an offshore market.

The domestic corporate debt market has not grown significantly for over a decade, but has met the needs of New Zealand domiciled borrowers and investors. The domestic market is dominated by domestic issuers, intermediaries and investors.

During the same period, the offshore market has experienced rapid growth. The participants in this market are predominantly foreign-based issuers, intermediaries and investors. The foreign issuers have used the highly developed New Zealand currency and interest-rate swap market to convert NZD funds back into USD funds - which, in turn, has allowed New Zealand-based issuers to efficiently hedge their foreign currency borrowings sourced from offshore capital markets back into NZD.

It will be interesting to see if the impediments preventing the two markets from integrating can be identified and removed.