RESERVE BANK OF AUSTRALIA

RBAFOI-262702

An application was received in terms of the FOI Act 1982 Cth seeking access to documents as detailed below.

Summary of Request	memos, presentations, modelling, or other finished research generated between 1 January 2020 and 2 July 2026 about the effect of state government credit rating changes on the semi-government bond market (i.e, the market for bonds issued by state and territory Treasuries).
Notes/context to any specific documents released:	The requestor excluded emails and drafts from the scope of the request.

Document Schedule

The following documents were identified as being relevant to the request and were released to the applicant, with redactions made to remove exempt material, or denied from release, in terms of the FOi Act 1982 Cth:

1 - 2020 August - redact s22 - DM Monthly Note - August 2020.pdf

2 - 2021 January - redact s22 - DM Monthly Note - January 2021.pdf

3 - 2024 July - redact s22 - DM Chatter What do the latest state and territory budgets mean for the semis market.pdf

4 - 2025 January - release in full (redact staff names only) - State Debt Sustainability and the Semis Market.pdf

5 - Deny s45 s47E(d) - Market Liaison - redacted - 02 April 2025.DOCX

6 - Deny s45 s47E(d) - Market Liaison - redacted - 16 December 2024.DOCX

7 - Deny s45 s47E(d) - Market Liaison - redacted - 18 July 24.DOCX

8 - Deny s45 s47E(d) - Market Liaison - redacted - 18 September 2023.DOCX

9 - Deny s45 s47E(d) - Market Liaison - redacted - 19 January 2026.DOCX

10 - Deny s45 s47E(d) - Market Liaison - redacted - 20 May 2024.DOCX

11 - Deny s45 s47E(d) - Market Liaison - redacted - 21 January 2026.DOCX

DOMESTIC MARKETS MONTHLY REVIEW – AUGUST 2020

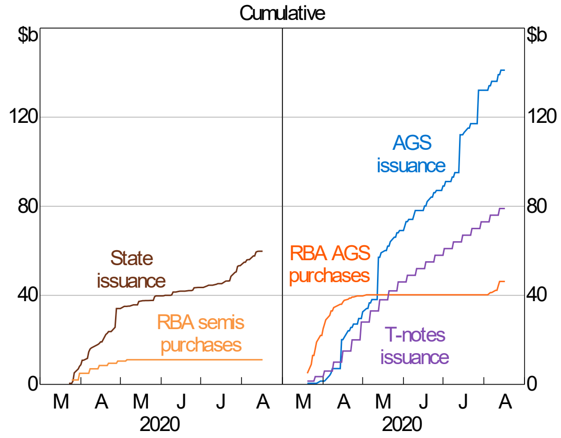
s22

s22

Sizeable government bond issuance has continued to find strong demand. The AOFM's pace of issuance declined in August, following two very large syndications in July, but remains at a higher pace than in recent years. On the other hand, issuance by state and territory borrowing authorities has picked up, driven by the eastern states. The increase in semis issuance has had little impact on semis spreads to AGS, which have narrowed notably in recent weeks. Spreads widened modestly for Victoria in response to Standard & Poor's placing Victoria's AAA credit rating on negative watch and the measures taken to address the current COVID-19 outbreak, though the widening has since been unwound. Contacts continue to report solid demand for medium- and long-term semis from offshore real money funds and local balance sheet accounts in particular.

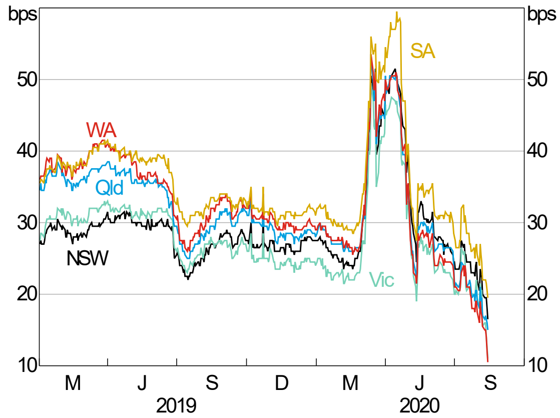
Government Issuance and RBA Purchases

Cumulative



Sources: RBA; Yieldbroker

5-year Semi-government Bond Spreads to AGS



Source: Yieldbroker

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DOMESTIC MARKETS MONTHLY REVIEW – JANUARY 2021

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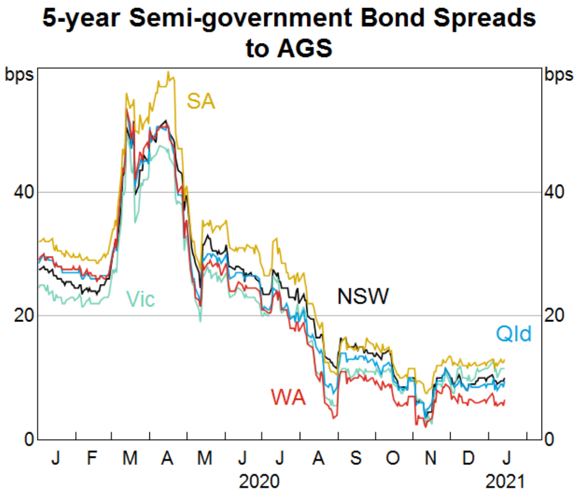
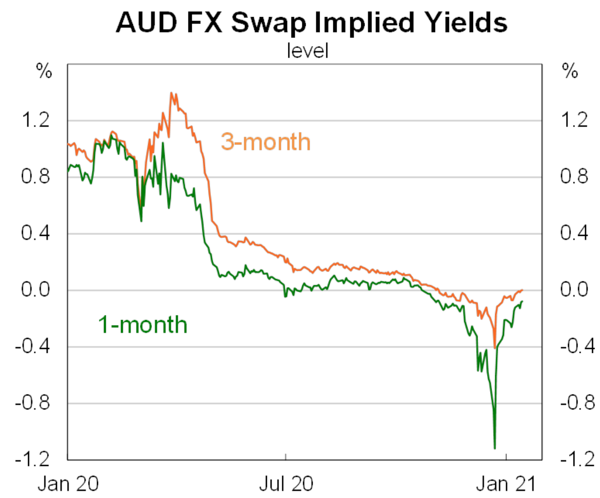
Semi spreads to AGS are little changed

Semis spreads to AGS have been largely unchanged over the past two months, and issuance by the state and territory authorities has been subdued given the holiday period. Overall, the states and territories are roughly on track with their funding task for this financial year.

In early December S&P lowered its long-term credit rating of both the NSW and Victorian state governments. NSW was lowered to AA+ from AAA, reflecting the significant increase in projected debt burden over the next few years. Victoria, which had been placed on CreditWatch back in August 2020, was downgraded from AAA to AA, driven by the negative fiscal outlook as the severe lockdown impacted several of its credit metrics. On the day of the announcement TCV spreads to AGS widened by 5 basis points, while NSW experienced a more muted widening of 2 basis points. More recently, COVID-19 outbreaks in some states have not had any material impact spreads.



Source: Yieldbroker



Sources: RBA, Bloomberg

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DM CHATTER: WHAT DO THE LATEST STATE AND TERRITORY BUDGETS MEAN FOR THE SEMIS MARKET?[1]

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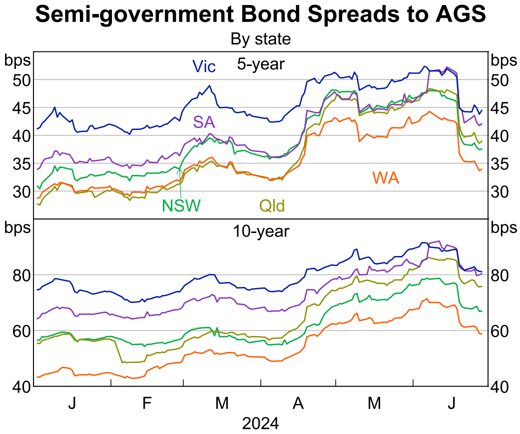
Semis spreads further widen following Budget season, but have since retraced

Semis have underperformed against AGS in recent months (staff name redacted 2024). Semis widened following budget announcements in early May as market participants reacted to increasing state debt, upward revisions to borrowing tasks and the threat of a falling debt rating for Victoria (Graph 5). The spreads of all semis more than retraced following NSW's announcement of a smaller borrowing requirement and as market participants gained certainty on issuance amounts for 2024/25.

Graph 5

Semi-government Bond Spreads to AGS



Sources: RBA; Yieldbroker.

The outlook for semis

Latest borrowing programs indicate that the supply of semis will remain elevated over the coming years. The composition of demand is also shifting, as bank demand declines. Market participants are uncertain about where spreads will stabilise, with some estimates suggesting around current levels (80bps above AGS for 10-year bonds; liaison notes). Sustained levels of higher debt could threaten issuers' credit ratings, which could cause spreads to widen further and therefore worsen the state and territories' fiscal burden.[4]

s22

staff name redacted / Monetary Policy Implementation / 16 July 2024

4 Victorian semis were downgraded in 2022 by Moody's. Ratings agencies threatened that NSW and Victoria's semis could face further downgrades following recent issuance and Budget announcements.

Appendix

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TCV

TCV announced a $34 billion funding task for 2024-25 compared to $30 billion projected in MYEFO (Graph 8). The increased funding task reflects additional expenditure despite increased GST revenue. Victorian net debt is projected to grow from $136 billion this year to $188 billion by 2028. Following Victoria's budget announcement, ratings agencies advised that Victoria's debt rating could fall to AA- due to a high debt-to-revenues ratio and rising loan serviceability costs.

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STATE DEBT SUSTAINABILITY AND THE SEMIS MARKET[1]

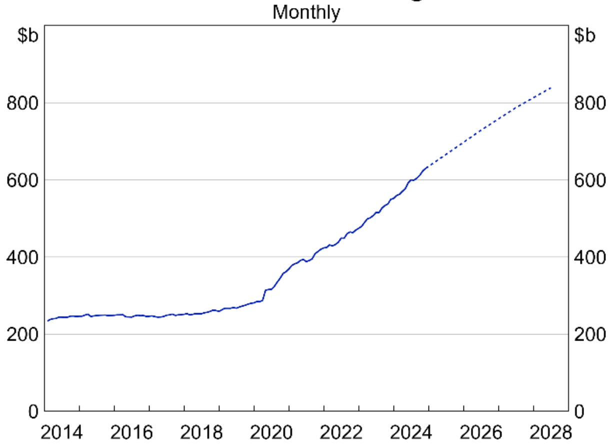
Recent state budgets have raised concerns about the sustainability of state government debt

State mid-year budget updates have shown a material increase in projected fiscal deficits as infrastructure spending, public sector wages and only a gradual approach to post-COVID budget repair continue to weigh on state finances. This has raised concerns about the sustainability of state government debt, with S&P Global cautioning that *"Australian state deficits are among the largest of any sub-national government system in the developed world"* (S&P Global 2025). Notwithstanding this, Australian (federal and state) government debt remains relatively low by global standards (FSR 2024).

The stock of semi-government bonds (semis) is expected to continue to increase rapidly and reach historical highs in coming years

Issuance of semi-government bonds (semis) has been historically large since the pandemic and is expected to remain sizeable in the coming years (staff name redacted 2024). Issuance programs have increased across forward estimates, with latest forecasts from semis issuers suggesting around $60 billion in annual net issuance over the next four financial years (Arman and Batchelor forthcoming). Accordingly, the stock of semis outstanding is expected increase to over $800 billion by 2028, nearly triple pre-pandemic levels (Graph 1).

Graph 1
Semis Outstanding*
Monthly



* Forecasts from latest borrowing announcements.
Source: State and territory treasury corporations.

The large issuance tasks could make semis pricing more sensitive to changes in demand or conditions…

The outlook for the semis market is highly uncertain in coming years. Large issuance programs may result in a greater fiscal burden on state governments and lead to higher yields and wider spreads as compensation to attract additional buyers (and, in the extreme, for potential higher credit risk) (MPI 2024). Key risks to pricing for the semis market include:

- **Credit downgrades**. Ratings agencies have threated semis issuers' credit ratings following recent budget and issuance announcements (e.g. S&P Global 2025). S&P recently revised the state outlook for NSW from stable to negative, with market participants speculating that other state outlooks may also be downgraded (Staff name redacted 2024). NSW, Victoria and Queensland also risk losing their current credit ratings. Semis spreads have historically widened alongside deteriorations in states' credit outlook and ratings.
- **Composition of demand**. Regulatory demand from domestic banks has been a backstop for semis pricing in recent years, although purchases moderated following the maturity of the Term Funding Facility (staff name redacted 2024). Liaison suggests that demand from offshore investors has supported the market, although tends to be more price sensitive than regulatory demand from domestic banks (staff name redacted 2024). For example, offshore investors consider the level of outright yields and spreads, exchange rate levels and the cost of hedging through forwards (staff name redacted 2024). Semis issuers may diversify their future issuance to attract investor demand. For example, banks favour floating-rate and shorter-dated

1 We would like to thank staff name redacted #1, #2 and #3 for their help on this work.

issuance, Japanese investors tend to prefer long-dated issuance and sustainable bonds tend to enjoy increased participation from foreign and other Australian investors (Batchelor and Roberts 2024).

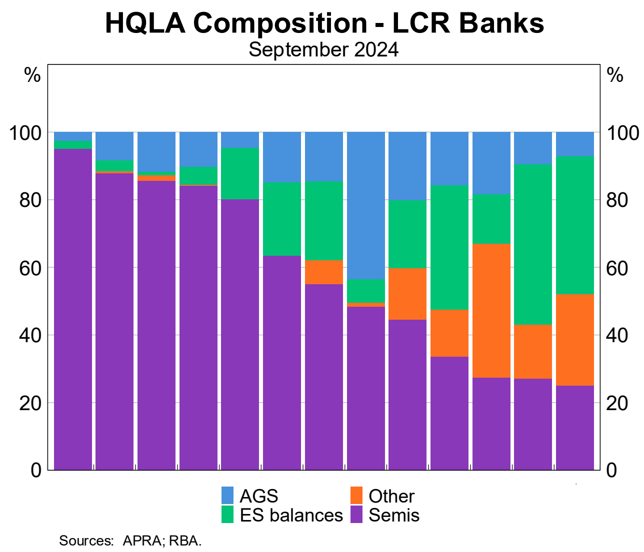
- **Demand for Australian Government Securities (AGS)**. AGS are guaranteed by the Australian Government and are therefore considered almost risk-free (Batchelor and Roberts 2024). Recent concerns about semis issuers' credit ratings may increase demand for AGS over relatively riskier semis. Market participants are uncertain about where semis spreads to AGS will stabilise, with some estimates suggesting around current levels (80bps above AGS for 10-year bonds; staff name redacted 2024).

… including changing demand from domestic banks

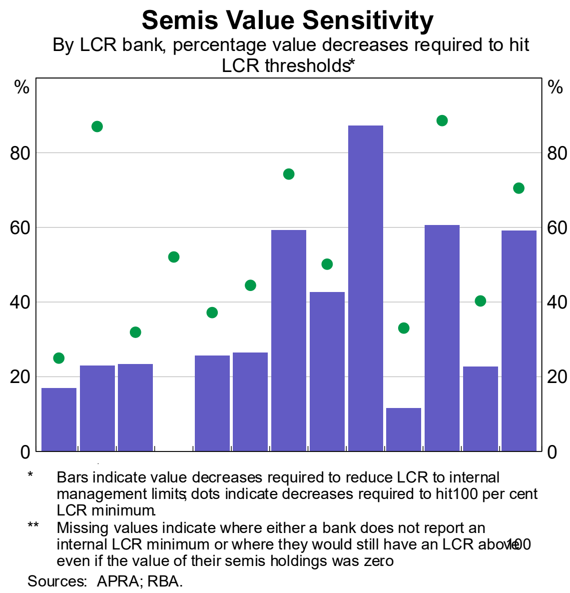
Large banks are subject to the Liquidity Coverage Ratio (LCR) which requires them to hold a minimum amount of high-quality liquid assets (HQLA; comprises cash, AGS and semis).[2] LCR banks' HQLA portfolios consist mainly of semis as they trade at higher yields and so offer higher returns than other HQLA (Batchelor and Roberts 2024). Semis holdings vary across LCR banks, ranging from around 20 per cent to over 90 per cent of HQLA portfolios (Graph 2). Domestic banks currently hold almost 57 per cent of the semis market, close to the highest share on record.

Banks' holdings of semis are required to be valued at market price for the calculation of the LCR (FSR 2023). Banks with high ownership of semis are exposed to changes in semis pricing which decrease the value of their HQLA. Rough analysis suggests that a 25 per cent decline in semis pricing would decrease many banks' LCR to internal minima (Graph 3).[3] Banks have been purchasing more AGS to maintain their target LCRs as the market value of their semis holdings has declined; LCR banks' HQLA allocation to semis has declined from almost 80 per cent to 60 per cent in recent quarters (UBS 2025).

Graph 2



Graph 3



Demand for AGS has also increased as banks may be reaching internal limits on their semis holdings (UBS 2024). Liaison suggests that some LCR banks have been unable to receive semis as collateral in the repo market after reaching concentration limits, although these limits are being lifted (MPI 2024). If semis become less acceptable as collateral in the private repo market, then banks could instead post more semis as collateral at the RBA's market operations in future.

There is limited evidence that concerns about state debt sustainability will impair market functioning, but the semis market may be more sensitive to adverse shocks

As a key source of government funding and an important share of banks' HQLA, recent developments in the semis market may pose risks to the Australian financial system. Semis issuance is expected to remain at or

2 Debt securities of the Export Finance and Insurance Corporation and Housing Australia are also considered HQLA for the purposes of the LCR requirement in Australia (APRA 2021).

3 Australian banks hedge against financial losses on these securities using government bond futures or interest rate swaps (FSR 2023).

above pandemic levels, which may limit state government's fiscal capacity to address future economic downturns and financial crises. High and increasing interest costs as semis issuers rollover existing debt and increase issuance may necessitate higher state debt levels in the medium term.

Semis markets are functioning well despite a large widening in spreads in recent years as demand changed and investors reassessed the states' issuance task and credit outlook (staff name redacted 2024; MPI 2024). It is unclear whether ongoing large increases in semis issuance will harm market functioning, but the semis market could become more sensitive to adverse shocks, particularly if concerns about state debt sustainability continue. FS has previously highlighted that large increases in government debt in advanced economies could increase market fragility (FSR 2024). While liquidity in government bond markets has increased over time, more frequent episodes of illiquidity have been observed globally (e.g. Aliyev et al. 2024). Some central banks have responded to episodes of market dysfunction by acting as the 'market maker of last resort', such as during the UK gilt crisis (staff name redacted et al. 2023).

Conditions in the semis market could deteriorate quickly if investors try to liquidate their holdings alongside large increases in issuance, or if investors seek to increase their holdings of AGS (which are more liquid and perceived by investors to have lower risk) during periods of market stress. Market dysfunction to this effect occurred in the onset of the pandemic, requiring the RBA to purchase semis to support market functioning (Batchelor and Roberts 2024). The ability to liquidate semis holdings without large downward pressure on market prices is a particular concern for banks and super funds that hold semis as contingent liquidity for liquidity stress events (staff name redacted #1 and #2 2024). Disorderly price adjustments or episodes of market dysfunction in the semis market may also amplify financial shocks.

MPI and AFS will continue to monitor conditions in the semis market and impacts on the financial system.

staff name redacted #1, #2 and #3
Monetary Policy Implementation and Australian Financial System
Domestic Markets and Financial Stability Departments
30 January 2025