

Trends in Australian Banks' Bond Issuance

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Abstract

Bonds account for around 10 per cent of Australian banks' funding, and bonds issued by banks account for about half of the non-government bond market. The Australian bank bond market is primarily driven by the five largest banks, which issue most of the banks' bonds. This article explores trends in Australian banks' senior unsecured bond issuance since the global financial crisis. The COVID-19 pandemic, and the policies implemented in response, significantly influenced bank bond issuance. In particular, banks' bond issuance declined for a period as they accessed funds through the Reserve Bank's Term Funding Facility; however, issuance has increased recently as the economy has recovered from the initial phase of the pandemic.

Introduction

Around half of all outstanding Australian non-government bonds are bank bonds. This is high relative to banks' share of Australia's stock market capitalisation (21 per cent) or economic activity (8 per cent), consistent with the higher leverage involved in banking compared with other industries. Bonds are an important source of stable long-term funding for banks, and comprise just over 10 per cent of their total funding; by comparison, the average for Australian non-financial corporations is around 6.5 per cent. This article explores trends in Australian banks' issuance of

senior unsecured bonds, with respect to the volume issued, markets accessed, tenor of issuance and pricing.^[1]

Issuance volume: Responding to the GFC and the COVID-19 pandemic

Trends in bank bond issuance are driven by Australia's five largest banks – ANZ, Commonwealth Bank (CBA), National Australia Bank (NAB), Macquarie and Westpac (Graph 1). These large banks, which together hold about 90 per cent of banking assets, issue around three-quarters of senior unsecured bank bonds, although this varies

over time in response to funding needs and market conditions. By contrast, issuance from the mid-sized banks – defined here as the domestic banks (other than the five largest) that are subject to the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) regulatory requirements (APRA 2022) – has been relatively steady since the global financial crisis (GFC). The 'other' banks, which are primarily Australian branches of foreign banks, have more variable issuance with little discernible trend.

The stock of Australian bank bonds outstanding peaked at \$530 billion in late 2010 (Graph 2). This followed high issuance around the GFC, which included a record \$229 billion issued in 2009. During this time, issuance was boosted by the Australian Government Guarantee Scheme, which was introduced in response to the crisis in the financial sector (Black, Brassil and Hack 2010; Schwartz and Tan 2016).

From 2011 onwards, bond issuance returned to levels more akin to those prior to the GFC. In this period, funding needs were lower than otherwise because of the precautionary funding that had occurred during the GFC, as well as slower credit growth in the wake of the crisis.

Annual issuance increased steadily each year through to 2016. One reason for this increase was because the large banks were preparing for the introduction of the NSFR, which came into effect in 2018. The NSFR was introduced globally following the GFC to reduce banks' use of short-term funding

by promoting more stable funding sources such as bonds. As a result, it reduced banks' vulnerability to liquidity stresses. Issuance outpaced maturities, and the stock of bonds outstanding reached a post-GFC peak of \$485 billion in early 2019.

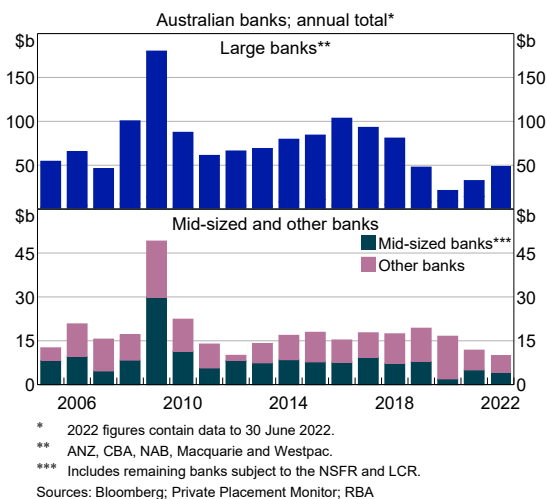
In March 2020, bond markets were severely disrupted by the economic impacts of the COVID-19 pandemic (Johnson, Lane and McClure 2022). A range of policies were introduced by the government, the Reserve Bank and regulators to support the economy through this period and improve market conditions (Debelle 2021). The policy with the most direct influence on bank funding and, by extension, bank bond issuance, was the Reserve Bank's Term Funding Facility (TFF).

The TFF provided low-cost three-year funding to banks operating in Australia, available for drawdown between April 2020 and June 2021 (Black, Jackman and Schwartz 2021). The amount of funding available to a bank was based on its credit outstanding, with an additional allowance available to banks that expanded their lending to businesses. In aggregate, \$188 billion was accessed across 92 banks – 88 per cent of the total available. Take-up differed slightly across banks; the large and mid-sized banks accessed almost all of their available TFF allowances, while other banks accessed less.

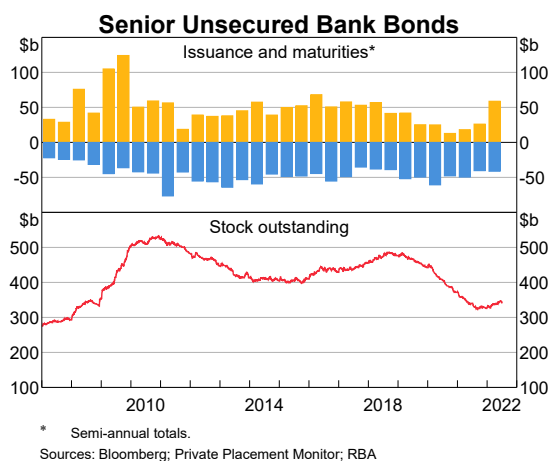
Senior unsecured bond issuance by the large and mid-sized banks was very low following the onset of the pandemic, and during the initial period that TFF funding was available for drawdown (Graph 3). This lower activity reflected the low cost of funding

Graph 1

Senior Unsecured Bank Bond Issuance



Graph 2



through the TFF compared with the cost of bond funding. In addition, funding needs declined as the banks were experiencing strong growth in deposit funding, in part due to the creation of deposits through Reserve Bank bond purchases. More generally, the economic outlook and expectations for future lending growth were very uncertain at the time.

Issuance by 'other' banks, many of which are Australian branches of foreign banks, was less affected by the pandemic (Graph 3). Lower use of the TFF partially explains this difference compared with the large and mid-sized banks. A few of these 'other' banks issued some atypically large bonds in the early stages of the pandemic, perhaps to take advantage of comparatively favourable funding conditions in Australia relative to other countries at that time. This issuance would have benefited from the gap in activity from the larger Australian banks. Towards the end of the TFF drawdown period, the large and mid-sized banks started to raise more senior unsecured bond funding again. Since then, issuance has been at a slightly faster-than-average pace in comparison with the pre-pandemic period. Issuance has outpaced maturities in 2022 so far, and the outstanding bank bond stock has begun to grow once more.

Looking ahead, issuance decisions will be influenced by bank asset growth as well as the availability of other funding sources, including deposits. It is likely that banks will issue bonds to refinance some of the TFF funding maturing in

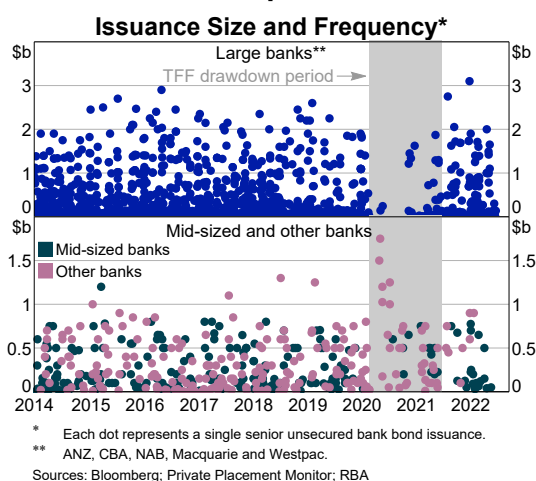
2023 and 2024; however, it is only one funding source available for them to do so. The winddown of the Committed Liquidity Facility (CLF) by the end of 2022 might also be affecting banks' bond funding decisions.^[2]

Markets of issuance: Offshore issuance is more variable than domestic issuance

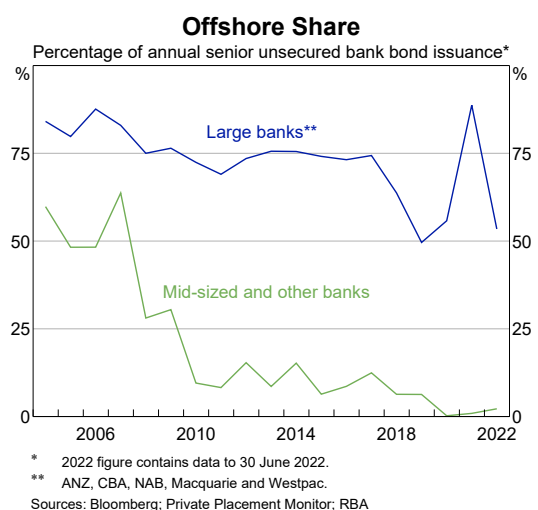
The large banks typically raise about three-quarters of their bond funding offshore (Graph 4). Offshore funding provides several benefits, including funding diversification. Offshore markets also have greater capacity to absorb large issuance and offer a deeper pool of investors looking for longer tenors than is available in the domestic market. The large US insurance industry is one example of this kind of investor.

Fluctuations in the large banks' issuance have largely been driven by changes in their offshore issuance, while domestic issuance has remained fairly steady (Graph 5). For example, the decline in total issuance between 2016 and 2019 was driven by lower offshore issuance from the large banks, with their offshore issuance falling to 50 per cent of their total 2019 issuance. The share of offshore issuance from mid-sized and other Australian banks fell sharply around the GFC, and has remained low since; in part, this reflects the fact that St George Bank, which had been a large offshore issuer pre-GFC, was acquired by Westpac (Graph 4).

Graph 3



Graph 4



The majority of banks' offshore issuance is denominated in USD (Graph 6). Even so, banks hedge most of their foreign currency liabilities back into Australian dollars (Berger-Thomson and Chapman 2017). Hedging enables banks to diversify their funding mix offshore without exposing them to exchange-rate risk.

Rate type: Most domestic issuance pays floating rate interest

The interest rate paid on bonds can be fixed or floating, whereby it varies with a benchmark rate. The most common benchmark in Australia is the three-month bank bill swap rate. Most domestic bond issuance pays a floating rate, irrespective of bank type, although fixed-rate issuance picked up in 2022 (Graph 7). Floating-rate issuance has the

advantage of matching the liability to the floating rate interest received on much of the banks' assets (i.e. variable-rate loans). Offshore issuance typically pays a fixed rate, as this form of interest payment is more prevalent in offshore markets. However, where banks issue fixed-rate bonds, they frequently use interest rate swaps to hedge these fixed-rate liabilities into floating-rate liabilities.

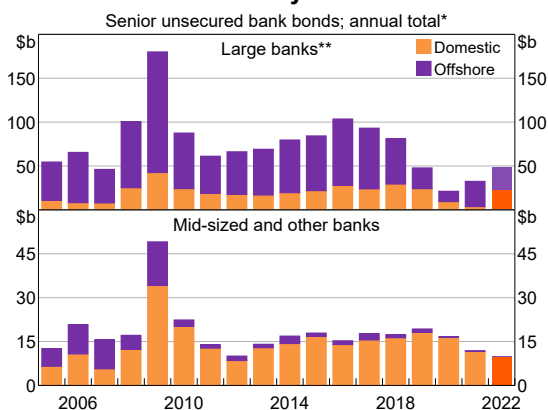
Bond tenors: Domestic tenors were shorter than offshore tenors in recent years

The average tenor of domestic and overseas issuance declined in 2007 in the early phase of the GFC, as investors became less willing to commit funds for an extended period (Graph 8). Another factor contributing to the decline in tenors during and in the aftermath of the GFC was the reduced use of very short-term instruments, such as one- and three-month funding, as part of a broader shift in liquidity management. Banks had previously issued longer tenor bonds to balance the liquidity risk of these instruments; with less use of these instruments, the counterbalancing long-tenor bonds were no longer required.

Large banks' offshore funding is spread across a broad range of tenors, which reflects the diversity available in offshore markets (Graph 9). By contrast, the tenor of domestic issuance rarely exceeds six years.

Graph 5

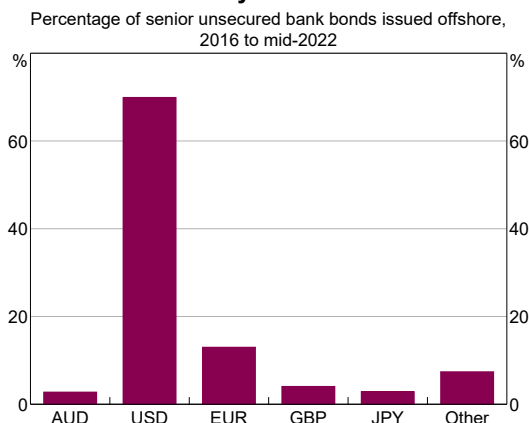
Issuance by Market



* 2022 figure contains data to 30 June 2022.
 ** ANZ, CBA, NAB, Macquarie and Westpac.
 Sources: Bloomberg; Private Placement Monitor; RBA

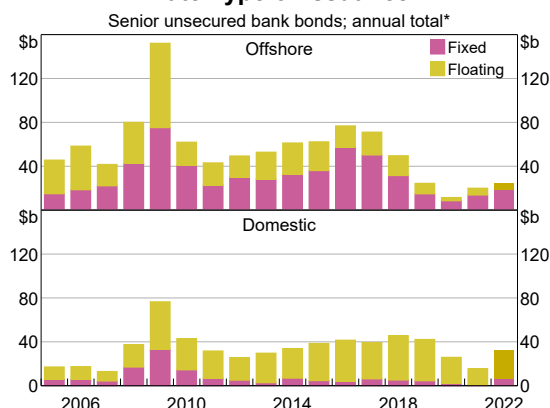
Graph 6

Currency of Issuance



Graph 7

Rate Type of Issuance



* 2022 figure contains data to 30 June 2022.
 Sources: Bloomberg; Private Placement Monitor; RBA

Pricing: Spreads were tight during the pandemic but have recently widened

Bank bond pricing is usually expressed in terms of the difference, or 'spread', between bank bond yields and other benchmark rates of comparable maturity. Two commonly used benchmark rates are the yield on Australian Government Securities (AGS) and the swap rate. By isolating the part of the yield that is over and above reference rates, it is possible to identify different factors affecting bond pricing. The spread to AGS provides a measure of the compensation that investors require to cover factors such as credit and liquidity risk for holding a bank bond compared with an AGS. The swap rate, under certain assumptions, measures the expected interest rate on short-term bank debt over a given period of time. This means that one interpretation

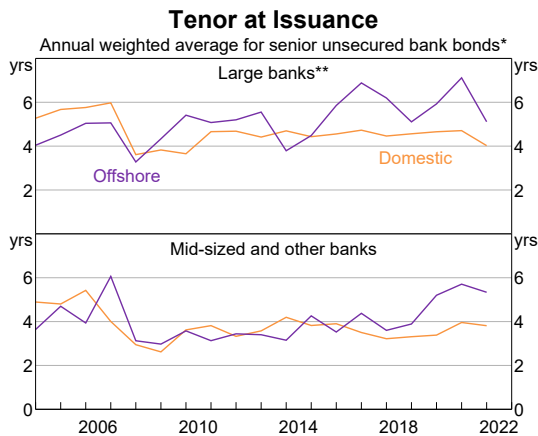
of the spread to swap is the cost of locking in bond funding rather than the expected cost of rolling over short-term debt. Because these two measures both involve the bank bond yield, they tend to move together (Graph 10). However, they diverge when the relationship between the swap rate and AGS changes.

Bank bond spreads vary over time, reflecting changes in the demand for, and supply of, bank bonds. Variations in investor demand for bank debt also affects the volume of bond funding available, as well as the tenor of those bonds. Bank bond spreads increased around the GFC. There was also an increase around 2012, which was associated with concerns about sovereign debt sustainability in the euro area, and the links between sovereign and bank balance sheets (RBA 2012). Between 2012 and 2020, bank bond spreads trended down alongside market interest rates more generally.

During the pandemic, after a brief rise, bank bond spreads declined and yields reached historical lows (Graph 10). That the widening was relatively short lived in spreads reflected the fiscal and monetary policy responses to the pandemic, as well as the fact that the pandemic stress arose from outside the banking sector and so investors were less concerned about the risks from holding bank bonds than was the case in previous crises when banks were a central source of financial market stresses (e.g. during the GFC).

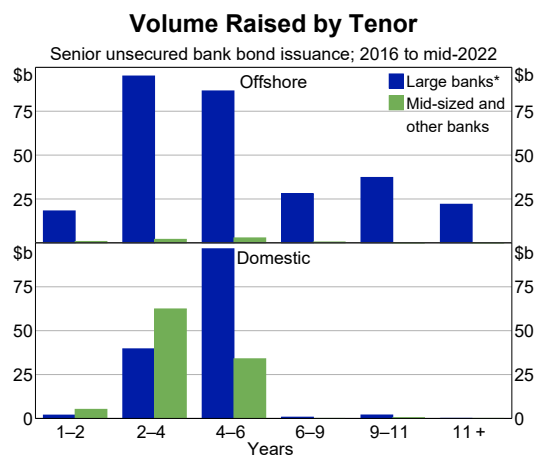
More recently, bank bond yields have risen sharply along with monetary policy tightening and higher

Graph 8



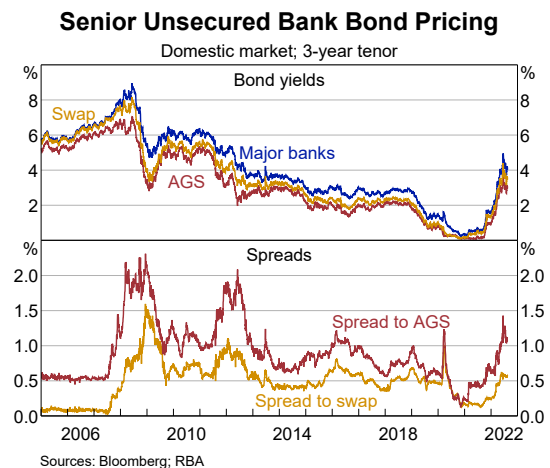
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Graph 9



* ANZ, CBA, NAB, Macquarie and Westpac.
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Graph 10



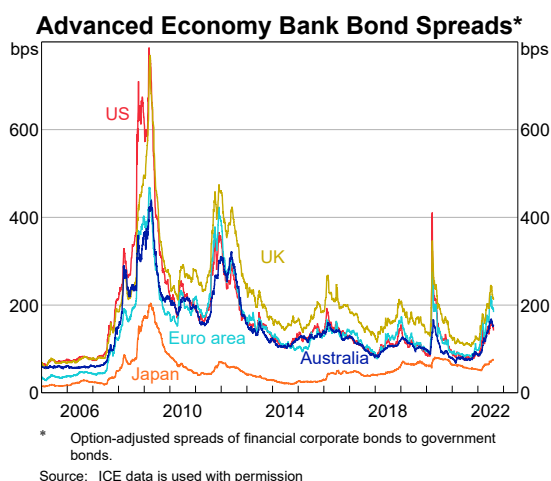
inflation in Australia and globally. Bank bond spreads have also widened, reflecting strong demand for funding and a broader increase in risk premiums. In May 2022, yields on three-year major bank bonds reached 4 per cent for the first time since 2013.

The spreads paid by banks across different economies tend to move together (Graph 11). It follows that the cost to Australian banks of issuing bonds domestically and offshore tends to be closely related (Graph 12). However, there are times when a differential may emerge as financial conditions vary across economies.

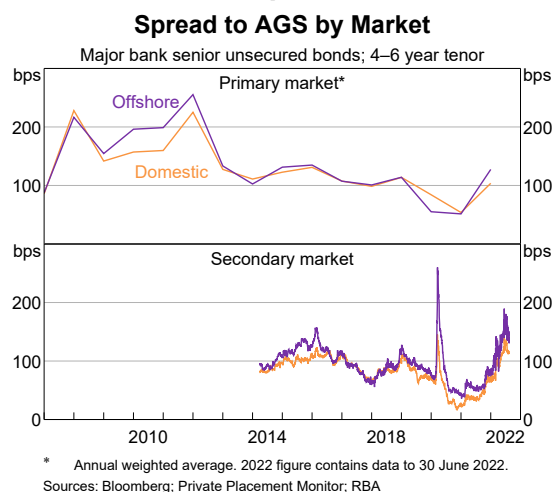
Conclusion

Bonds are an important source of funding for banks, and bank bonds account for around half of the Australian non-government bond market. The pandemic and the ensuing policy responses significantly influenced bank bond issuance activity. In particular, banks' bond issuance declined for a period as they accessed funds through the TFF, though issuance has recently increased. ❖

Graph 11



Graph 12



Endnotes

- [*] The author is from Domestic Markets Department.
- [1] Banks issue three broad types of bonds: senior unsecured bonds; covered bonds; and hybrid bonds. The most common type – senior unsecured bonds – are not secured by particular assets; they are senior bonds because the holders of these bonds are repaid before holders of subordinated bonds in the event that the issuer enters bankruptcy. Covered bonds are secured by a pool of assets. Hybrid bonds can be converted into equity under certain conditions; because of this feature, they can be used to meet some capital requirements, and issuance

- patterns often reflect regulatory requirements and risk management considerations.
- [2] This is because banks might choose to issue bonds to fund the purchase of additional high-quality liquid assets (HQLA). On the other hand, many banks have been maintaining an LCR well above the regulatory minimum and so have the option to allow their LCR to decline rather than purchasing additional HQLA. For more information on the CLF, see Brischetto and Jurkovic (2021).

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