

An overview of the money and bond markets in New Zealand

Part 2: The non-Crown debt market

Warren Potter, Financial Markets Department

This is the second of two articles that provide an overview of the money and bond markets in New Zealand. The first article was published in the September 1995 Bulletin and focused on the Crown debt market. This second article describes the non-Crown debt market, covering in some detail debt issued by financial intermediaries, large corporations, State Owned Enterprises (SOEs) and local authorities.

I Introduction

The financial markets provide a source of finance not only for the Crown but also for other borrowers in the economy. These other borrowers include financial intermediaries, such as banks¹, large corporations, State Owned Enterprises (SOEs) and local authorities and, together with borrowing by other smaller organisations and individuals, they comprise the bulk of the non-Crown debt market in New Zealand.

This second article on the money and bond markets in New Zealand examines the non-Crown debt market. It describes the various participants in the market, the financial instruments used by the participants to obtain funds, and how those instruments are issued and traded.

Borrowing by smaller organisations and individuals in the retail market is not covered. These other smaller borrowers, whether they are partnerships, sole traders, trusts, companies, or individuals, obtain finance from financial intermediaries using various modifications of standard loan agreements. These loan assets are usually held on the balance sheet of the lending institution, and are not traded in financial markets although, in recent years, some financial institutions have repackaged loans on their balance sheets into tradeable instruments, and sold these into the market. This securitisation of loan assets is relatively new in the New Zealand context, and the volumes involved remain relatively low. As such the securitisation market, along with the developing structured note market is also not covered.

Appendix 1 contains a glossary of terms used throughout the article.

II The market participants

The participants in the money and bond markets can be separated into investors and borrowers. The main types of investors are:

- financial institutions;
- corporates;
- offshore investors.

The term “financial institution” encompasses a variety of organisations including banks, insurance companies and managed funds.

The main types of borrowers are:

- the Crown;
- financial intermediaries;
- SOEs;
- corporates;
- local authorities.

However, the separation of borrowers and lenders is not clear cut. For example, corporates can be borrowers or investors depending on their cash flow position, while in almost all cases financial institutions act simultaneously as borrowers and lenders in their financial intermediation role.

The remainder of the article is organised as follows: the next section identifies some general factors which differentiate Crown from non-Crown securities, in terms of the yields at which they are issued and trade. Sections IV- VI describe the main categories of tradeable securities issued by corporates, including SOEs, banks and local authorities. Section VII concludes with some brief comments on the most recent, and likely future, developments.

¹ The criteria which organisations must meet to become a registered bank and be able to use the word “bank” in their name are set out in Potter (1995), p178. A list of registered banks is presented as Appendix 2.

III The yield margin between Crown and non-Crown issues

The main difference between securities issued by the Crown and those issued by non-Crown organisations is the margin on the yield between Crown and non-Crown securities. The Crown is the most creditworthy institution in the country due to its statutory power to raise revenue with taxation. Accordingly, investors in securities issued by non-Crown organisations demand higher yields than those prevailing on comparable Crown debt. The size of the yield margin between Crown and non-Crown securities is dependent upon a number of factors including:

- the credit rating of the issuer;
- the characteristics of the issue (eg, type, maturity, coupon interest rate, frequency of coupon payments);
- the amount on issue;
- the liquidity of the particular security.

The credit rating of an organisation is usually provided by a credit rating agency. The two main credit rating agencies rating New Zealand issuers are Moody's Investors Services ("Moody's") and Standard and Poor's Ratings Group ("Standard and Poor's"). Although organisations pay to be rated by these agencies, there are a number of resulting benefits. In particular, an organisation with a good credit rating benefits from:

- lower borrowing costs;
- an increased range of funding alternatives;
- good publicity.

The following table presents the Standard and Poor's credit ratings for both long-term and short-term domestic security issues for a variety of organisations. These ratings are for the organisation, and the specific details of particular security issues can result in ratings that differ from those presented in the table.

Table 1

**Short-term and long-term Standard and Poor's domestic issue credit ratings for a variety of organisations
As at 1 October 1995***

	Domestic long-term	Domestic short-term
Air New Zealand Limited	BBB	A-3
ANZ Banking Group (New Zealand) Limited	A+	A-1
ASB Bank Limited	AA-	A-1+
Auckland City Council	AA	A-1+
Bank of New Zealand	AA	A-1+
Bankers Trust New Zealand Limited	AA-	A-1+
Countrywide Banking Corporation Limited	A	A-1
Dunedin City Council	AA	A-1+
Fletcher Challenge Limited	BBB	
Lion Nathan Limited	BB+	B
Mortgage Corporation of New Zealand Limited	A+	A-1
The National Bank of New Zealand Limited	AA-	A-1+
Natural Gas Corporation Limited	BBB+	
Telecom Corporation of New Zealand Limited	AA+	A-1+
Trans Power New Zealand Limited	AA+	A-1+
Trust Bank New Zealand Limited	A	A-1
World Bank	AAA	A-1+.
The New Zealand Government (the Crown)	AAA	A-1+

* Appendix 3 provides an explanation of these ratings.

IV Corporate and State Owned Enterprise security issues

Corporates and SOEs issue securities in the money and bond markets to obtain funds for their activities. These securities are issued mainly in the wholesale market and are usually in the form of:

- (i) corporate and SOE bonds;
- (ii) bills of exchange
- (iii) commercial paper and promissory notes;

Each of these securities and the markets in which they are traded is described in turn.

(i) Corporate and SOE bonds

The larger corporates and SOEs issue bonds as a means of meeting their long-term funding requirements. The main characteristics of these bond issues are presented in box 1. Many of the issues in the market are similar in structure to bonds issued by the Crown, although some of the issues are convertible and can be converted into the equity of the issuer.

It is useful to examine this class of security from the point

Box 1: Characteristics of corporate and SOE bonds

Issuance:	Bonds are issued by the borrower as either a registered or bearer security.
Registration:	If they are issued as a registered security then they must be registered with a registrar.
Maturity:	Maturities range from one to fifteen years, with the most common maturities being in the three to seven year range.
Principal:	The principal is usually redeemable at par on maturity.
Coupon:	The coupon rate and frequency is 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 upon the borrower's requirements and the likely demand from investors. Typically bonds are issued in parcels of \$1,000,000 or more in the wholesale market. In the retail market smaller parcels can be purchased with the minimum size dependent on the specific terms of each issue.
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 cashflows approach, adapted to the parameters of the particular security.
Sale:	Bonds are usually sold by tender or by private placement. A number of bond issues are sold through brokers to retail investors.
Margin:	The yield premium above yields applicable to government bonds reflects the increased credit and liquidity risks associated with corporate and SOE securities.

* This pricing formula is presented as an appendix in Potter (1995).

of view of the primary and secondary markets. Primary markets are markets in new securities, while secondary markets involve trading in securities by parties other than the original purchaser.

Primary market

Corporate and SOE bond issues in their current form date from 1988 when large bond issues were made by two SOEs of the time, Electricity Corporation of New Zealand (ECNZ) and Telecom Corporation of New Zealand (TCNZ). These bond issues signalled an end to the period from the late 1970s to 1988 when longer term debt issues were avoided in favour of shorter term domestic and overseas borrowing.

Following the TCNZ and ECNZ issues two other SOEs, the Housing Corporation and the Rural Bank also successfully issued bonds on the open market, as more recently have a number of other large corporations.

The issuers target the wholesale and/or retail market depending on the objectives of the issue, although in many cases the wholesale market provides cheaper borrowing for the issuer. However, issuing into the retail market provides other benefits to the issuer. These benefits include improved public relations and a better public image for the organisation as well as other marketing and advertising benefits. When an issue is placed onto the retail market the issuer is governed by the Securities Act 1978. This Act requires, amongst other things, that the issuer provide prospectuses for the issue.

Some of the larger corporate and SOE bond issues of recent years are summarised below.

Electricity Corporation of New Zealand (bonds)

ECNZ is the largest non-Crown issuer of bond market securities in New Zealand. These bonds were targeted mainly at wholesale investors. As at the end of September 1995 ECNZ had on issue bonds with a value of over NZ \$1.5 billion placed into three maturities:

- 15 June 1996 10 percent coupon with \$930m on issue;
- 15 Oct 2001 10 percent coupon with \$620m on issue;
- 15 April 2009 8 percent coupon with \$16m on issue.

These bonds are similar to government bonds in their structure and operation.

Fletcher Challenge Industries Limited (capital notes)

Since 1990 Fletcher Challenge Industries Limited, a wholly owned subsidiary of Fletcher Challenge Limited has issued nine series of capital notes with a face value of \$822 million. These notes were targeted mainly at retail investors.

Capital notes are long-term fixed rate unsecured subordinated notes, with fixed interest coupons. These notes do not have a particular maturity date but have what is called an "election date". On each election date the coupon interest rate and the term to the next election date of the capital note will be reset. Holders may then choose either to keep their capital notes on the new terms or to convert the principal amount and any accrued interest into Fletcher Challenge Limited Ordinary Division shares and Forest Division Shares, at 98 percent of the then current market price of the shares. Instead of issuing shares to holders who choose to convert, Fletcher Challenge Limited may, at its sole option, purchase the capital notes for the cash value of the principal amount plus any accrued interest.

Fletcher Challenge Industries Limited currently has on issue capital notes with election dates falling due between 1997 and 2005 with coupons ranging from 9.50 percent to 14.50 percent. The capital notes are held by both institutional and retail investors.

Fletcher Challenge Limited and Fletcher Challenge Industries Limited have been rated BBB by Standard and Poor's as at 1 October 1995. The capital notes themselves do not carry a rating.

Lion Nathan Limited (bonds)

Lion Nathan Limited has issued bonds to the value of \$197 million with a 10 percent coupon maturing on 1 September 1997. Lion Nathan has also issued bonds to the value of \$12 million with maturities ranging from March 1996 to March 2001. Both sets of bonds were targeted mainly toward retail investors.

As at 1 October 1995 the Lion Nathan bond programme carried a Standard and Poor's credit rating of BB+.

Natural Gas Corporation Limited (notes)

The Natural Gas Corporation has issued notes to the value of \$300 million with maturities ranging from 15 July 1997 through to 15 July 2001. The notes are issued so that in each maturity there is a note issue with either a 13.75 percent or a 14 percent coupon. These notes are unse-

cured and are subordinated obligations of the Natural Gas Corporation.

The Natural Gas Corporation Limited has a Standard and Poor's rating as at 1 October 1995 of BBB+ in respect of its senior unsecured debt. The unsecured and subordinated notes described above have not been rated.

Telecom Corporation of New Zealand (bonds)

TCNZ Finance Limited and certain other subsidiaries have issued a range of "Telebonds", which are guaranteed by the Telecom Corporation of New Zealand. These bonds are issued with maturities of one to 15 years with the longest maturity being \$60 million maturing on 15 September 2008. As at 30 September 1995 Telebonds to a total value of \$573 million were outstanding, with \$330 million issued to wholesale investors and \$242 million issued to retail investors. Telebonds are not particularly liquid due to the number of different maturities.

As at 1 October 1995 the Telebond programme was rated Aa1 by Moody's and AA+ by Standard and Poor's.

Trans Power Finance Limited (bonds)

Trans Power Finance Limited (Transpower) has issued bonds to a value of \$410 million into three maturities.

- 15 Feb 2001 8 percent coupon with \$50m on issue;
- 15 March 2002 8 percent coupon with \$250m on issue;
- 15 June 2005 8 percent coupon with \$110m on issue.

The bonds were targeted mainly at wholesale investors. As at 1 October 1995 the Transpower bond programme was rated AA+ by Standard and Poor's and rated Aa1 by Moody's.

Secondary market

The secondary market for corporate and SOE bonds is relatively illiquid compared to that for Crown debt. There are only very few market makers for corporate and SOE bonds and these market makers mainly quote prices on the larger issues that are held by institutional investors. Secondary market trading is also arranged by brokers who have close links with the market participants and are able, in most cases, to arrange transactions between buyers and sellers when required. The lack of liquidity and higher credit risk than government bonds mean that corporate

and SOE bond issues trade at a margin over the yields on government bonds. However, this offers the investor a higher yield investment with relatively low risk of default.

(ii) Bills of exchange

In their various forms, bills of exchange are the most common non-Crown short-term security in New Zealand. Bills of exchange are a discount instrument issued by organisations that wish to undertake short-term borrowing. The bills are governed by the Bills of Exchange Act 1908 and the Bills of Exchange Amendment Act 1979.

A bill of exchange is "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to bearer."²

There are two types of bills covered by the above definition; commercial bills and bank bills.

Bank bills are bills of exchange that have been accepted or endorsed by a bank. A bank accepted bill means that the bank will pay the face value of the bill to the holder on maturity. In contrast, a bank endorsed bill has been accepted by another organisation and endorsed (signed) by a bank. The effect of endorsing the bill is that if the acceptor fails to make payment of the face value on maturity then repayment can be sought from the bank that endorsed the bill. A bill can have a number of endorsers and, if the acceptor of the bill should default, the holder of the bill can seek payment from the endorsers, usually in the order that they endorsed the bill.

A commercial bill is a bill of exchange that has not been accepted or endorsed by a bank. The lack of backing by a bank and the consequent higher credit risk means that commercial bills are traded at higher discounts than bank bills.

The majority of bills of exchange issued are bank bills and only bank bills will be examined in this article. Their main characteristics are outlined in box 2.

Primary market

Commercial bills were first issued in New Zealand in the 1960s. They were primarily a means of financing trade

2 Bills of Exchange Amendment Act 1979.

Box 2: Characteristics of bank bills

Issuance:	Bills are issued by the borrower and are accepted or endorsed by a bank.
Maturity:	Bills are issued with maturities ranging from 7 to 365 days. The majority of issues have maturities of 30, 60, or 90 days. The face value of the bank bill is repaid in full on the maturity date.
Coupon:	Bank bills are discount instruments and pay no coupon.
Amount:	The minimum size of a bill is \$50,000 and it increases in multiples of \$5,000 thereafter. Banks usually bundle together smaller bill amounts into parcels that can be traded on the wholesale market. The usual parcel size in the whole-sale market is \$1,000,000.
Pricing:	<p>The pricing of bank bills follows the same formula as used for Treasury bills.*</p> <p>For the investing organisation the discount rate is usually the bank bill bid (buy) rate.</p> <p>For the borrowing organisation a line fee for the provision of the facility and an acceptance or endorsement fee must be incorporated into the pricing. These fees are usually expressed in terms of basis points added to the bank bill bid rate.</p>
Sale:	When a bank has arranged a bill facility for a borrower and accepted the bill it is able to sell the bills in the money markets. The bills are traded in parcels of \$1,000,000 or greater in the money markets.
Margin:	<p>Bank bills trade at a margin slightly above Treasury bills. This margin reflects the differences in credit ratings between banks and the Crown.</p> <p>Recently the margin has been in a range of 10-40 basis points (0.1 -0.4 per-cent).</p>

* This pricing formula is presented as an appendix in Potter (1995).

transactions and it was not until the 1970s that applica-tions beyond trade finance were serviced.

The operation and issuance of a bank bill follows a number of steps which are consistent across nearly all issues.

- 1 The typical bank bill is initiated when an organisa-tion approaches a bank to arrange short-term borrow-ing through a bank bill credit line facility .
- 2 Under this facility the bank lends to the borrower the discounted nominal value of the bill, which the bank will either hold in its portfolio, or sell into the mar-ket.

- 3 The discount rate will be the prevailing market bank bill buy rate plus a margin for the credit risk specific to the borrower.
- 4 The rate used to discount a bank bill when it is sold is the bank bill sell rate prevailing in the market at the time of the sale, which typically is a few (up to about five) basis points below the bank bill buy rate. The difference between the buy rate and sell rate repre-sents the normal dealing spread in the secondary market for bank bills.
- 5 At maturity the bank pays the face value of the bill to the holder of the bill and simultaneously is repaid the face value of the bills by the original borrower.

Box 3: Characteristics of promissory notes

Issuance:	Promissory notes are issued by the borrower who must have a credit rating and standing in the market that is sufficient to enable the note to be issued without endorsement or acceptance by a bank. The notes are usually underwritten by financial institutions to ensure that the borrower obtains the desired amount of funds.
Maturities:	Promissory notes are issued with maturities ranging from 7 days to over one year. The common maturities are for 30 and 90 days. The face value of the note is repaid in full to the bearer on maturity.
Principal:	The face value of the notes is redeemable at par on maturity.
Coupon:	Promissory notes are discount instruments which pay no coupon.
Amount:	The minimum size of a promissory note is \$500,000. The usual issue size is \$1,000,000.
Costs:	The costs associated with a promissory note issue include: <ul style="list-style-type: none">◦ underwriting fees;◦ issue costs (advertising, printing and legal costs).
Pricing:	The pricing formula for a promissory note is identical to that for Treasury bills.
Sale:	Promissory notes are commonly issued in three ways: <ul style="list-style-type: none">◦ through open market tenders;◦ through dealer issues; and◦ by unsolicited private placement. <p>The specifics of these issue methods are discussed below.</p>
Margin:	Promissory notes are usually issued at, and trade at, a margin over Treasury bills and bank bills, reflecting the usually lower credit ratings of issuers and the relatively illiquid nature of the market.

The bank bill document specifies the nominal value of the bill to be paid to the holder at maturity, the maturity date, the name of the borrower (the “drawer”), and the name of the bank (the “acceptor”). When a bank bill has been endorsed the details of the endorser(s) are also specified on the bank bill document.

Secondary market

Bank bills are an important source of both short-term borrowing and investing for secondary market participants. The secondary market is very liquid, particularly for the

more common 30, 60 and 90 day maturities, and this is due to:

- the large volume of bank bills on issue at any one time;
- a large pool of investor funds, both domestic and foreign, particularly from Asia;
- the good credit rating of New Zealand’s registered banks making bank bills a relatively secure short-term investment offering yields slightly above Treasury bill yields; and
- the existence of markets in 90 day bank bill futures and options which allow investors to hedge, arbitrage and speculate on these instruments.

(iii) Commercial paper and promissory notes

Corporates and SOEs can also obtain short-term funds through the issue of promissory notes. A promissory note is a discount security, issued under the borrower's own name.

Promissory notes are defined as "an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or bearer."³ This definition gives a promissory note a similar legal standing to a bill of exchange such as a bank bill. While the definition specifies that repayment can be on demand, almost all promissory notes are written to be repaid on a fixed maturity date.

Promissory notes are bearer securities and as such the borrower pays the face value of the promissory note to the bearer (holder) of the note on maturity. A bearer security allows the original holder to sell the security very easily and transfer ownership without endorsement. Promissory notes are also known as P-notes, bearer notes, commercial paper and one-name paper. The last name is derived from the fact that promissory notes carry only the name of the issuer (the borrower), unlike bank bills which carry the name of both the issuer and the bank that has accepted or endorsed the bill.

Box 3 contains the characteristics common to most promissory notes.

Primary market

The first promissory notes were sold by the Bank of New Zealand in 1982. Since then a large volume of notes has been issued by non-Crown organisations, including SOEs and corporates through commercial paper programmes. However, as promissory notes rely on the financial standing of the issuer alone, they have been confined mainly to organisations with relatively high credit ratings.

Three common methods exist for the sale of promissory notes. The first is an open market tender similar to that used for issuing government bonds. Bids are lodged with the programme manager acting for the borrower. The second method is via a dealer issue. This type of issue is similar to a normal tender except that the bidding is restricted to the dealers appointed to the dealer panel. An alternative method gaining increased popularity is unsolicited private placement. Under this method the promis-

sory notes are sold on a tap basis in response to demand by investors. This method offers cheaper funding for the borrower and consequently a lower return for the investor as a result of the flexibility that the investor has gained and the borrower has given up.

The major cost associated with issuing promissory notes is the premium above the bank bill rate required to sell the notes. This premium typically ranges from 5-50 basis points depending on the borrower's credit rating, which is usually lower than those of registered banks.

Other costs of issuing promissory notes may include:

- issuing and management costs paid to the manager of the issue;
- underwriting fees to guarantee the proceeds from the sale of the notes.

Again, due to the short-term nature of promissory notes, and hence changing issue details, no specific note issues will be detailed in this article.

Recently a new security has emerged that is similar to a promissory note but it is in a registered rather than physical form. As such they are not under the control of the Bills of Exchange Act and its amendments. However, as a financial instrument these new securities behave identically to usual promissory notes. Currently there is approximately \$500 million of these new securities on issue.

Secondary market

The secondary market for promissory notes is not as liquid as that for bank bills, particularly for notes issued by organisations with lower credit ratings. This lack of liquidity emanates from two main sources. First, there are few issuers with sufficiently strong credit ratings to issue promissory notes, which results in a reluctance by investors to purchase promissory notes on the secondary market. Secondly, most promissory note issues are purchased by end investors who hold them to maturity. This lack of liquidity has contributed in part to a widening in the margin between bank bills and promissory notes. However, recent investor demand for promissory notes has seen some investment grade note issues trading at yields close or even, in some cases, below that of bank bills.

The credit rating of the issuer plays an important role in the success of the promissory note issue because investors are obliged to rely solely on the issuer's credit standing.

3 Bills of Exchange Amendment Act 1979.

Box 4: Characteristics of certificates of deposit

Issuance:	Certificates of deposit are issued by the bank borrowing the money.
Maturities:	Certificates of deposit are issued with maturities ranging from 7 to 365 days.
Principal:	The face value of the certificates is redeemable at par on maturity.
Coupon:	Certificates of deposit are almost always issued as discount instruments which pay no coupon. Some transferable certificates of deposit are issued with interest paid on maturity. However, these issues are rare in New Zealand.
Amount:	<p>The minimum issue size for a transferable certificate of deposit is \$20,000.</p> <p>The minimum issue size for a negotiable certificate of deposit is \$500,000, which rises in multiples of \$100,000 for larger issues.</p>
Pricing:	The pricing of certificates of deposit is equivalent to the pricing of Treasury bills.
Sale:	<p>The certificates are issued by banks via a tender system or through private placement.</p> <p>Tender sales are based on a market based bidding system similar to that employed for the sale of government bonds.</p> <p>A sale by private placement involves the issuing bank and the purchaser reaching a private agreement on the details of the sale. The certificates are then transferred according to the conditions reached in the agreement.</p>

V Bank security issues

In New Zealand banks use certificates of deposit and - to a lesser extent - bonds as their main source of raising finance in wholesale markets. These two types of security are discussed in detail below.

(i) Bonds

Bonds issued by banks have many of the characteristics of corporate and SOE bond issues. Currently we estimate that bank bonds to the value of around \$600 million are outstanding. Of this around \$250 million is in the form of subordinated debt that is used by banks to meet the capital requirements as well as for general financing requirements. The remaining bank bonds on issue are in various forms and are used as a long-term funding source.

The generally superior credit quality and standing of banks in the financial system means that banks can often issue bonds at yields below other non-Crown institutions. Essentially bank bonds have the same characteristics as corporate and SOE bond issues.

(ii) Certificates of deposit

The second instrument commonly issued by banks is a certificate of deposit. Certificates are issued at a discount and are one of the main sources of short-term funding for banks. They have a fixed maturity date, but provide flexibility for investors who are able to liquify their investment by selling them in the secondary market prior to maturity.

Certificates of deposit are issued in two forms which reflect the process for transferring ownership -transfer-

able certificates of deposit and negotiable certificates of deposit. A negotiable certificate of deposit is a bearer security and can be sold and transferred to another investor very easily and quickly. A transferable or registered certificate of deposit is a non-bearer security issued by a bank and registered with that bank or another registrar. Transfer of these certificates requires notification to the bank or registrar at which they are registered and more formal transfer procedures. Transfer of registered certificates of deposit is usually conducted via the Austraclear New Zealand system ("Austraclear"). The main characteristics of both types of certificates are presented in box 4.

Primary market

Transferable certificates of deposit were first issued by banks in November 1971. Subsequently a number of changes were made to their structure in terms of the minimum issue size and minimum maturity before the current status was settled on. Negotiable certificates of deposit were first sold in November 1977.

The participants in the primary market are the issuing banks and investors.

Secondary market

In many cases negotiable certificates of deposit and bank bills are interchangeable in the inter-bank market due to their similar credit quality, operation and form. Since negotiable certificates of deposit and - to a lesser extent transferable certificates of deposit - also have liquidity approaching that of bank bills they generally trade at yields in line with those of bank bills. Also, given that certificates of deposit are one of the main sources of short-term funds for banks the yields associated with them have a relatively direct impact on the interest rates banks charge on their lending.

Occasionally New Zealand banks also issue commercial paper (promissory notes) as a means of short-term funding.

VI Local government security issues

The reform of local government in late 1989 and early 1990 significantly reduced the number of local government organisations in existence. Those that remain are either a regional or territorial authority. Territorial authorities include both city and district councils.

Most local government organisations either receive Crown funding and/or have rights to levy rates, fees and charges. Accordingly, they can virtually guarantee that interest and principal repayments will be met. In turn, credit ratings on these local government organisations are usually very good.

Bonds

In the past the design of local government bond issues reflected the immediate cash needs of the individual organisations, and little emphasis was placed on either the marketability or on any long-term financial strategy. Thus the characteristics of local government bond issues varied greatly in terms of maturity, coupon and issue size. That lack of homogeneity contributed substantially to these bonds being sold at a sizeable discount relative to equivalent government bonds, and in many cases the discount was significantly higher than could be explained by the differences in credit quality between local government organisations and central government.

More recent issues of bonds by local authorities have been more successful. Local authorities are now issuing bonds with coupon structures and maturities matching government bond issues and investors are now able to make informed comparisons more easily. However, even with these changes the secondary market for local authority bonds continues to be relatively illiquid.

The characteristics of local authority bonds are similar to those of corporate and SOE bonds.

Short-term debt issues

Historically local government organisations could not resort to most forms of short-term borrowing because of constraints imposed within the Local Authority Loans Act 1956. However, the recent reform of local government forced organisations such as Harbour Boards and electrical supply authorities to become corporate entities which enabled them to borrow in the short-term market like other corporates. Also, many other local government organisations have now established purpose-built corporate structures to get around the Local Authority Loans Act and thus enable them to access short-term debt. The short-term instruments available to local authorities in these cases are similar to those of other non-Crown organisations and include promissory notes and bank bills.

VII Conclusion

Since the deregulation of New Zealand's financial markets in the mid-1980's the non-Crown debt market has developed steadily. Nevertheless, when compared with a number of more developed non-Crown debt markets abroad, domestic markets generally remain small in relation to the size of the economy. For example, in 1993 long-term non-Crown debt on issue was only equivalent to around 8 percent of the overall New Zealand bond market.⁴

Moreover, it appears that the bond market will continue to be dominated by Crown borrowing for a number of years yet. The current target of eliminating the Crown's net foreign currency debt in preference to domestic debt implies that the Crown's domestic debt is likely to remain essentially static for a number of years - until the goal of eliminating net public foreign currency debt is achieved. Once the foreign debt objective has been met there may be scope for reducing domestic Crown debt, provided the fiscal scene remains healthy. This could encourage non-Crown issues in the bond market, particularly if reduced premiums between Crown and non-Crown debt emerged in the face of unsatisfied investor demand.

In the past few years some new financial instruments have entered the market, providing alternative sources of funding for creditworthy organisations and new opportunities for investors. As discussed above these include corporate bonds and SOE bonds. In addition, a range of derivative financial instruments has been introduced, and these will be discussed in a forthcoming issue of the *Bulletin*.

References

- Anderson, S. (1993), 'The Austraclear New Zealand System', *Reserve Bank of New Zealand Bulletin*, Vol 56, No 2, June 1993, pp 147-152.
- Merrill Lynch & Co (1994), 'Size and Structure of the World Bond Market', *Global Fixed Income Research*, October 1994.
- New Zealand government bond prospectus
- New Zealand government treasury bills prospectus
- Potter, W. (1995), 'An overview of the money and bond markets in New Zealand Part 1: The Crown debt market', *Reserve Bank of New Zealand Bulletin*, Vol. 58 No. 3, 1995, pp 177-192.

⁴ Source: Merrill Lynch & Co (1994).

Standard and Poor's Ratings Services (1995), *Monthly Bulletin Australia and New Zealand*, 1 October 1995.

Appendix 1

Glossary of Terms

Primary market

The primary market for securities is the market in which securities are first issued.

Secondary market

The secondary market covers all sales of a security apart from the initial issuance of that security.

Wholesale market

Wholesale financial markets are characterised by transactions of typically \$1 million or more undertaken by professional institutional investors. Wholesale markets cater for the investing and borrowing needs of large institutions (including the Crown, local governments, registered banks, other financial institutions and large companies).

Retail market

Retail markets involve smaller transactions, some less than \$1,000, tailored to the needs of smaller organisations, individuals, and others whose requirements cannot be met through the wholesale market. Interest rates in the retail market are usually set on a periodic basis by the institutions involved in that market and tend to vary in line with wholesale rates. The same institutions usually participate in both the wholesale and retail markets. Public security issues in the retail market must meet the requirements of the Securities Act 1978. One particular requirement of the Act is that prospectuses must be provided.

Coupon securities

A coupon security is a long-term (greater than one year to maturity) instrument that provides fixed regular interest payments to the holder with principal repaid at maturity. The fixed regular interest payments are determined by the coupon rate on the instrument and its face value. The most common coupon security in New Zealand is the government bond issued by the Crown. Coupon securities are also issued by some State Owned Enterprises, local governments and a few large corporations.

Whether the coupon rate is above, equal to, or below the prevailing interest rate for a security will determine whether it is sold at a premium at par or at a market discount.

Par

A security issued at par is one for which the price paid is equal to the face value of the security. This situation occurs when the coupon on the security is equal to the prevailing market interest rate.

Discount

A security issued at a discount is one for which the price paid is below the face value of the security. This situation occurs when the market interest rate exceeds the coupon rate.

Premium

A security issued at a premium is one for which the price paid is above the face value of the security. This situation occurs when the market interest rate is below the coupon rate.

Discount securities

A discount security is a short-term instrument, with no coupon payments, sold at a price below its face value. It should not be confused with a coupon security issued at a discount. The difference between the sale price and the face value is known as the discount on the instrument and is set to generate the desired interest rate (yield) on the instrument. Discount instruments sold in New Zealand include Treasury bills, Reserve Bank bills, bank bills, certificates of deposit issued by banks, and promissory notes issued by other market participants such as corporations.

Fixed interest securities

A fixed interest security in New Zealand has the following characteristics:

- a fixed maturity date;
- the payment of a fixed amount of interest at regular intervals;
- the payment of a fixed principal at maturity.

Floating rate securities

A floating rate security, as its name suggests, has a variable rate of interest. The floating rate can move in line with market interest rates or can change in line with some other variable, such as the inflation rate. The rate can move continuously or be adjusted periodically.

Hybrid securities

New instruments have blurred the distinction between traditional debt instruments and other types of securities.

Subordinated notes

Although a blend of debt and equity, subordinated notes are similar to other forms of debt securities in that they have a fixed coupon rate and a fixed maturity. However, subordinated notes rank below the senior debt of the borrowing organisation. This subordinated ranking means that in a winding up, the subordinated debt will be repaid only after other senior debt has been repaid. Thus, there is a greater possibility that the subordinated note holders may not be paid the face value of the notes when they reach maturity. Such subordinated notes have some of the characteristics of shares (equity), as shares are repaid only after the debt obligations have been satisfied. The equity quality of the instrument clouds the boundaries between debt and equity.

Convertible notes

Convertible notes are corporate debt securities that contain an option for the holder to convert the note into the equity of the issuing company. Consequently, the convertible note also clouds the boundary between debt securities and equity securities.

One form of the convertible note is the capital note. Capital notes are long-term coupon instruments that do not have a particular maturity date but have what is called an "election date". On an election date the coupon interest rate and the term to the next election date of the capital note will be reset. Holders may then choose either to keep their capital notes on the new terms or to convert the principal amount and any accrued interest into the equity of the issuing company.

Structured notes

Structured notes are usually derived from overseas security issues that are repackaged by financial intermediaries into New Zealand dollar denominated instruments to meet the particular investment preferences of domestic investors better.

Mortgage securitisation

Mortgage securitisation is the process where individual mortgages are bundled together and repackaged as a group before being onsold.

Other terms

*Austraclear*⁵

Australclear is a computerised trade matching, transfer and settlements system that enables the trade of securities to occur without the physical transfer of security documentation. Austraclear handles the largest amount, by value, of security transfers in the New Zealand money and bond market.

Derivative instruments

A derivative contract is defined as a financial instrument which derives its value from an underlying instrument and relates to the ownership or potential ownership of that underlying instrument. Examples of derivative instruments include options, futures, forward contracts and swaps. These contracts can be based on an underlying commodity such as gold or wool, or on a financial instrument such as an interest or exchange rate, or a stock exchange index.

Appendix 2

Registered banks as at October 1995

ANZ Banking Group (New Zealand) Limited
ASB Bank Limited
Bankers Trust New Zealand Limited
Bank of New Zealand
Banque Indosuez
Barclays Bank Plc
BNZ Finance Limited
Citibank NA
Countrywide Banking Corporation Limited
Hong Kong and Shanghai Banking Corporation
The National Bank of New Zealand Limited
Primary Industry Bank of Australia
Trust Bank New Zealand Limited
TSB Bank Limited
Westpac Banking Corporation.

5 For a full description of the Austraclear New Zealand system see Anderson (1993).

Appendix 3

Summary of Standard and Poor's ratings categories

Long-term		Short-term	
AAA+	Extremely strong capacity to meet interest payments and principal repayments.	A-1+	Extremely strong safety regarding timely payments.
AAA			
AAA-	Strong capacity to meet payments.	A-1	A strong degree of safety regarding timely payments.
AA+			
AA			
AA-	Strong capacity but more susceptible to adverse effects or changed circumstances.	A-2	Satisfactory capacity for timely payment.
A+			
A			
A-			
	Adequate capacity to meet payments. Adverse conditions may lead to a weakened capacity.	A-3	Adequate capacity for timely repayment. More vulnerable to the adverse effects of changes in circumstances than obligations carrying the higher designations.
BBB+			
BBB			
BBB-			
(BB, B, CCC, CC & C have predominantly speculative characteristics with respect to payment ability.)			
BB+	Less vulnerability than below but face major ongoing uncertainties or exposure.	B	Speculative capacity for timely payment.
BB			
BB-			
B+	Greater vulnerability but currently capable of meeting payments.		
B			
B-			
CCC+	Vulnerable to default - dependent on favourable conditions.	C	Doubtful capacity for repayment.
CCC			
CCC-			
CC	Debt subordinated to CCC debt.		
C			
D	In default.	D	In default.