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A primer on New Zealand's capital markets

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This article describes New Zealand's capital markets, and the role they play in the functioning of financial markets and the real economy. It describes the instruments and players involved, and analyses a unique dataset to provide some detail on the size of both the bond and equity markets, which together comprise local capital markets. The article also summarises regulatory and policy initiatives since the publication of a report from the Capital Markets Taskforce in 2009.

1. Introduction

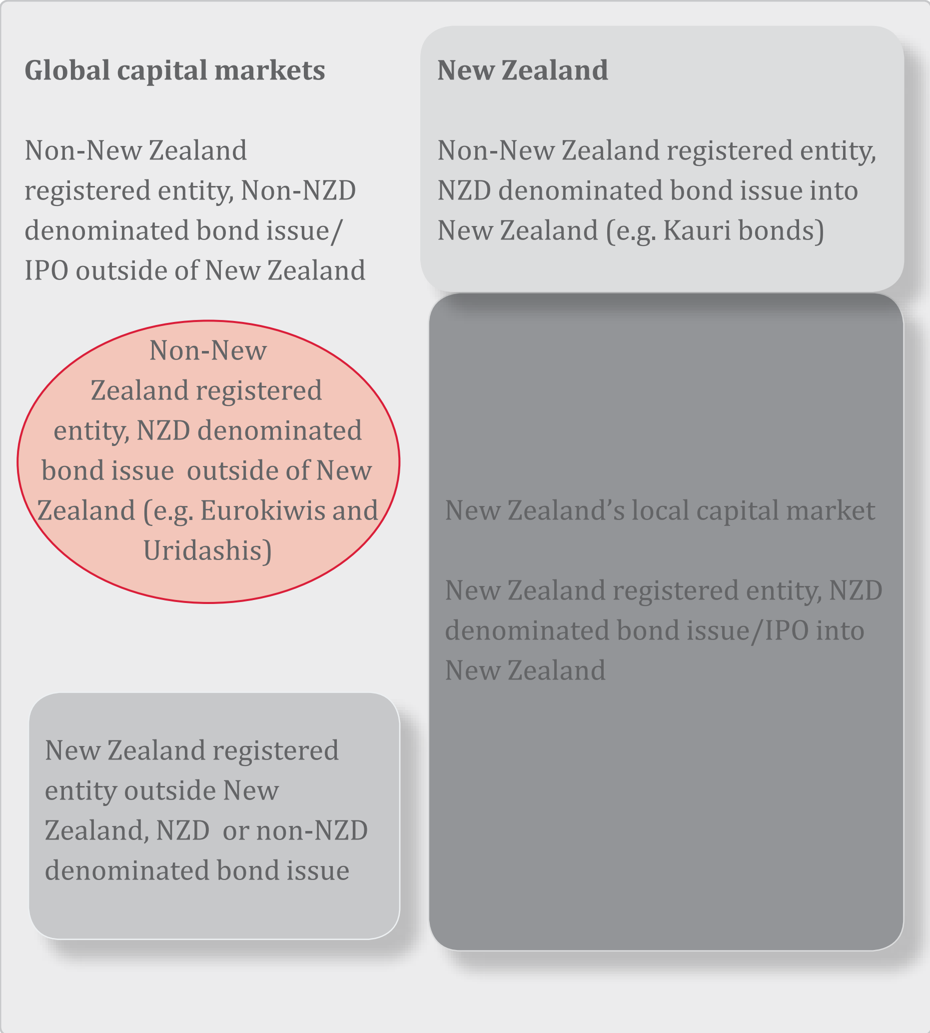
New Zealand's capital markets are an integral part of the domestic financial system. The previous Reserve Bank *Bulletin* articles describing New Zealand's capital markets were published 20 years ago (Potter 1995, 1995b). The landscape has changed dramatically since then – local capital markets have grown substantially, although remain small compared with those in many other advanced economies.

The Reserve Bank has a wide-ranging interest in New Zealand's capital markets. The *Financial Stability Report* (FSR), for example, reports on the soundness and efficiency of the financial system, including capital markets. Capital markets that function effectively are important for the way monetary policy affects the wider economy. The Reserve Bank's prudential regulation of financial institutions can also influence the type and nature of capital market instruments that develop in the local market.

Section two of the article describes capital markets in general, and defines New Zealand's capital markets in a global context. The instruments and players involved are explained. Section three discusses

1 The authors would like to thank Michael Reddell, Johan van der Schyff and Glen Sorenson for their helpful comments, and the institutions that provided the unit data. Lauren Rosborough was employed by the Reserve Bank of New Zealand at the time the work for this article was undertaken.

Figure 1
The boundary between global and New Zealand capital markets – by issuer



Note: 'IPO' refers to 'initial public offering' on a public stock exchange. The definition of New Zealand's local capital markets described in this chart is tied to both the residency of the issuer, and the location and currency of issuance. Kauri bonds, for example, are not defined as part of the local bond market, since this issuance is not funding New Zealand resident entities. This chart does not identify who holds capital securities. As explained in section 2.3, securities issued in the local capital markets can be held by offshore investors.

why capital markets are important for any economy, while section four highlights the Reserve Bank's interest in capital markets. Section five describes New Zealand's capital markets and uses a unique dataset to provide detail on the size of the non-government bond market in particular. Section six notes developments since the 2009 Capital Markets Taskforce review.

2. What is the capital market?

Capital markets are the part of the financial system that involve buying and selling long-term securities – both debt (bonds) and equity instruments. Capital markets are used to fund investment or to facilitate takeovers, and to provide risk mitigation (for example via derivatives) and diversification. There is no strict definition of 'long-term'; Potter (1995) defines capital market instruments as having a maturity of greater than one year, and we retain this classification here, noting that capital market instruments may also have no maturity date (as in the case of perpetual bonds or equity).[2] This article further classifies the domestic capital market as all resident entities issuing into the local economy in New Zealand dollars (NZD) (figure 1). The article also touches on resident entities issuing bonds offshore, and non-resident entities issuing into New Zealand in NZD.

2 Capital markets are distinct from money markets (certificates of deposit, commercial paper, and Treasury bills), which deal with instruments of less than 12 months' duration. The money market facilitates firms' liquidity demands and funds their working capital requirements.

2.1. Private and public markets

There are a number of dimensions to capital market activity. First, the issuance of equity and bond instruments can be in either public or private markets. Public markets are open and visible to all participants, with activity typically occurring on an exchange. Private markets are, by definition, not visible, and transactions often occur via brokers or individual institutions. Securities issued in private markets may be sold by means of a private offering – either using a tender system to a few chosen investors, or in a transaction matching a firm's desire to fund with select investors willing to lend. Private markets give firms an alternative way to obtain funding and have less onerous reporting requirements.

2.2. Primary and secondary markets

The initial issuance of capital market securities occurs on the primary market, and subsequent transactions between investors occur on the secondary market. Securities offered in the primary market (such as an 'initial public offering' in the case of shares) are often sold via a bank or brokerage firm. Primary bond market issues can be via competitive tender or syndication.

In a tender system, the bond's details are announced to the public. A competitive tender, or auction, is frequently used for homogenous bonds – such as regular government debt issues of a pre-announced maturity date. On the tender (or auction) date and time, interested and registered parties submit their offers in a competitive bidding system, usually in amounts of $1 million or multiples thereof. The number of successful bidders and the price paid are subsequently announced. Tenders are often used when the level of demand for the issue and its price can be reasonably well predicted.

By contrast, in a syndication the issuer employs a bank or brokerage firm to market and distribute the bonds (or in a joint syndication, employs more than one bank or brokerage firm). Often these bonds are less homogenous and the issue is a 'one-off', with greater uncertainty surrounding the degree of demand and the price that can be achieved. The institutions employed use their networks to place the bonds with interested parties using a guide price. Once the degree of interest is known, the guide price can be firmed up and the bonds distributed. A syndication allows the placement of a larger volume of bonds than a tender, but typically costs more, as the issuer has to compensate the bank or broker for its time and effort, and the risk it takes on if it underwrites the issue.[3] An issuer may also increase the size of the issuance at a later date, known as a 'tap'.

The secondary market may have an exchange where securities are transacted, such as the New Zealand stock exchange (NZX), or the New Zealand Debt Market exchange (NZDX) in the case of bonds. Transactions may also occur 'over the counter' (OTC), via a dealer/broker network. In the OTC market, the prices paid are not readily visible to other market participants. Most debt trading in New Zealand occurs off-exchange.

2.3. Owners of capital securities

There are many reasons why an investor may choose to own securities issued in the capital markets ('capital securities'). From a relative perspective, stocks and bonds can provide a return that exceeds that received by owning a term deposit with a bank. Capital securities receive a regular stream of income in the form of dividends (stocks) and coupon payments (bonds). But the higher return typically also comes with a

3 Underwriting is when the bank/brokerage firm is required to buy any unsold portion of the issue.

greater risk; both equities and bonds can give the investor a potential capital gain or loss. Investors may also choose to hold capital securities to diversify their wealth, or to gain exposure to a particular company or industry.[4]

The holders of capital securities can be resident institutional investors, local retail investors, or their offshore counterparts. Institutional (or wholesale) investors are those that typically buy and sell securities on behalf of a company or financial institution. Such transactions are individually large, often greater than $750,000 in the New Zealand context.[5] Retail investors are 'mum and dad' investors who hold securities for their own personal account. Bonds are sometimes specifically tailored to be purchased by retail investors; consequently, the size of the transaction tends to be significantly smaller, frequently in $5,000 lots. In the case of stocks, the size of retail transactions can be as small as the value of an individual share.[6] Under the new Financial Markets Conduct Act 2013 (FMC Act), primary issues aimed at retail investors must be offered with a Product Disclosure Statement.[7] Non-resident holders of New Zealand securities tend to be institutional investors.

2.4. Risk mitigation

While capital securities are issued primarily to fund an entity's investment requirements, capital markets also provide derivative instruments that can help market participants manage a variety of risks. Such instruments allow firms to help offset the costs associated with borrower default, shield against unfavourable or unexpected changes in interest rates, and help manage exposure to fluctuations in the exchange rate. While important, this aspect of capital market activity is not a focus of this article. Instead, this article focusses on the primary debt and equity markets.

3. Why are capital markets important?

The cross-country literature suggests that a higher level of financial development – defined as deeper and more liquid financial markets, together with a more developed banking system – helps promote long-run economic growth (Laeven 2014, Demirguc-Kunt and Levine 2008, Wurgler 1998).[8] The development of both capital markets and financial intermediaries (banks and other financial institutions) is a response to the inherent costs involved when two or more economic agents enter an economic relationship. These costs include lenders needing to know information about potential borrowers, and those related to monitoring borrowers (and enforcing contracts) once a loan is made (Cihak et al, 2012, p. 4).

Banks and capital markets offer different ways of addressing these underlying costs. As Claus, Jacobsen, and Jera (2004) explain, "financial markets provide low cost arms-length debt or equity finance to a smaller group of firms able to obtain such finance, while financial intermediaries offer finance typically with a higher cost reflecting the expenses of uncovering information and ongoing monitoring" (p. 6). Bank funding is

4 They may also have philanthropic reasons to assist in a company's expansion.

5 Technically, the definitions of wholesale and habitual clients are more wide-ranging.

6 Many brokerages have a minimum purchase value for stocks of either $300 or $500.

7 In addition to lodging the product with the registrar, regulated retail offers also must have a registered entry (electronic register), which is publicly available (the FMC Act replaced the Securities Act 1978 in December 2014).

8 This empirical result takes into account the possibility of reverse causation; i.e. that faster economic growth can itself promote financial development.

suitable where the information asymmetries between those entities that require funding (borrowers) and those that ultimately supply this funding (savers) are the greatest. A bank may be the sole external provider of funds to such a borrower, and manages this risk itself by, for example, holding a large portfolio of loans (diversification).

Capital markets provide an alternative source of funding to that available from financial intermediaries, particularly for larger entities, where there is generally more public information available about the entity itself and the viability of any planned investment project that requires funding. Moreover, information is quickly revealed via changes in prices, particularly in the secondary public market. Capital markets also play a key role in helping economic agents address uncertainty and risk. Firms in the very early stages of development may find the private capital market (such as angel and venture capital) is a more readily available source of funding (compared to banks), particularly where the success of a project is subject to a high degree of uncertainty. As noted above, capital markets also provide a wide range of financial products and instruments to help market participants manage their risks in both equity and bond markets.

Capital markets and the banking sector typically evolve together over time, and this mutual development plays a key role in supporting long-term economic growth. For example, financial intermediaries, such as banks, use financial instruments supplied by capital markets to manage their own balance sheet risks (e.g. hedging products such as derivatives). On the other hand, some financial institutions such as investment banks play an important role in arranging the placement and distribution of debt and equity securities to large investors, and may underwrite the issue. Financial institutions also participate in capital markets by issuing both bonds and equity to fund their operations.[9] New Zealand banks source long-term debt financing from both the domestic and offshore markets, in addition to funding themselves from customer deposits and from their owners. Financial institutions can also be an important investor in the capital market, holding government debt for example, together with the bonds of other financial and non-financial companies.

The development of local or domestic capital markets can provide a number of specific benefits for any given economy. As Laeven (2014) explains, these include:

- more efficiently allocating capital, since these markets can act as competitive sources of funding for large and reputable firms, vis-à-vis the banking system. In addition, domestic capital markets that are open to foreign investors can help lower the overall cost of capital for firms and other entities, thereby sharing risks across geographical borders;

- providing a facility to manage risks, by allowing both local investors to invest in a broader range of local currency financial products, and financial institutions to manage their balance sheets, thereby improving overall financial stability;

- enabling the Government to finance fiscal deficits and reduce its exposure to exchange rate risk;

- helping the implementation of monetary policy. The long term bond market provides valuable information on the conduct and transmission of monetary policy, including expectations about macroeconomic developments and reactions to monetary policy changes; and

9 None of the large registered banks in New Zealand is listed on the NZX Main Board, although investors can gain equity exposure to Heartland New Zealand Limited.

- providing market discipline, by improving the quality and disclosure of information that firms provide to markets.

In sum, capital markets are an important mechanism for the channelling of funds between savers (investors) and borrowers. Well-functioning capital markets allow risk to be transferred to those most willing to bear it and enables investors to hold the appropriate degree of risk to suit their risk/return profile. The effective management of risk and degree of transparency around the price (cost) of capital underpins economic growth (Duisenberg, 1999).

4. New Zealand's capital markets and the Reserve Bank's role

The Reserve Bank's interest in capital markets is explicitly enshrined in the Reserve Bank of New Zealand Act 1989, through a role to promote a sound and dynamic monetary and financial system. The Reserve Bank also owns NZClear, the real-time settlement system for all registered debt capital transactions. The Reserve Bank's interest in New Zealand's capital markets is wide-ranging:

- The Reserve Bank has a broad monitoring and data reporting role, related to a statutory requirement to report on the soundness and efficiency of the financial system as a whole in the six-monthly FSR. The FSR covers a range of corporate bond markets and (to a lesser extent) the equity market, from the standpoint of both their short term (dis)functioning, and structural issues related to the development of domestic capital markets over time.

- The Reserve Bank has prudential oversight of the banking system, non-bank lenders, and insurers. As such, it can influence the development of specific capital market instruments and products in New Zealand. For example, the capital adequacy framework for banks sets out what instruments can be classified as 'capital' in a regulatory sense. Under the Basel III rules (implemented in New Zealand in 2013), all capital instruments (except for ordinary shares) must either be written off or converted to ordinary shares if the bank is assessed as financially non-viable.

- Capital market instruments play a role in the Reserve Bank's liquidity facilities and ensure that the money and bond markets function adequately to assist in the transmission of monetary policy (see Nield, 2008 for more details). These instruments are also important in times of stress when the central bank can play a role as 'lender of last resort' to the banking system.

- The Reserve Bank monitors the day-to-day movements and developments in capital markets and the degree of risk-taking or risk aversion amongst financial market participants.

5. New Zealand's capital markets: an overview

Figure 2 is a stylised representation of New Zealand's capital markets. Historically, the size and functioning of New Zealand's equity market has been more frequently discussed than the non-government bond market, due its relative size, the public availability of information on shares issued and held, and the relative ease of comparison with other countries. This article includes a brief overview of the New Zealand equity market but dwells on the lesser-known debt markets, in particular the primary issuance of non-government bonds. It also touches on some aspects of the secondary bond market and offshore issuance by New Zealand domestic entities. An 'entity' in this context could be the Government (both central and local), a state-owned enterprise (SOE), a financial institution (such as a bank or insurance company), or another type of firm (defined here as a non-financial corporate).

We have been able to obtain unit data on bond issuance from several sources.[10] Our bond database covers both non-financial and financial institutions, including issuance of non-NZD debt and offshore private placements. Information about the private equity markets in New Zealand was provided by the New Zealand Private Equity and Venture Capital Association (NZVCA) and the Ministry of Business Innovation and Development (MBIE).

New Zealand's debt market has traditionally been dominated by government issues, followed by the larger banking institutions issuing bonds into both the wholesale and retail markets. Similarly, the top 10 companies on the share market represent 54 percent of the value of the NZX 50, with the top two companies making up a third of this alone (18 percent of the overall index). However in recent years, New Zealand's capital markets have become more diverse with crowd- and peer-to-peer funding a growing phenomenon, and the market has deepened as the pooling of assets has become more common; for example in the developing covered bond market,[11] and following the formation of the Local Government Funding Agency (LGFA). By contrast, smaller firms tend to obtain external financing from family or friends or from financial institutions (typically from the banking system). The regulatory and accounting requirements are often considered too onerous and expensive for smaller firms, discouraging them from public market issuance of both debt and equity – although recent regulatory reforms have lowered the disclosure and compliance costs for smaller firms in these markets (see box B in section 6 for more detail).

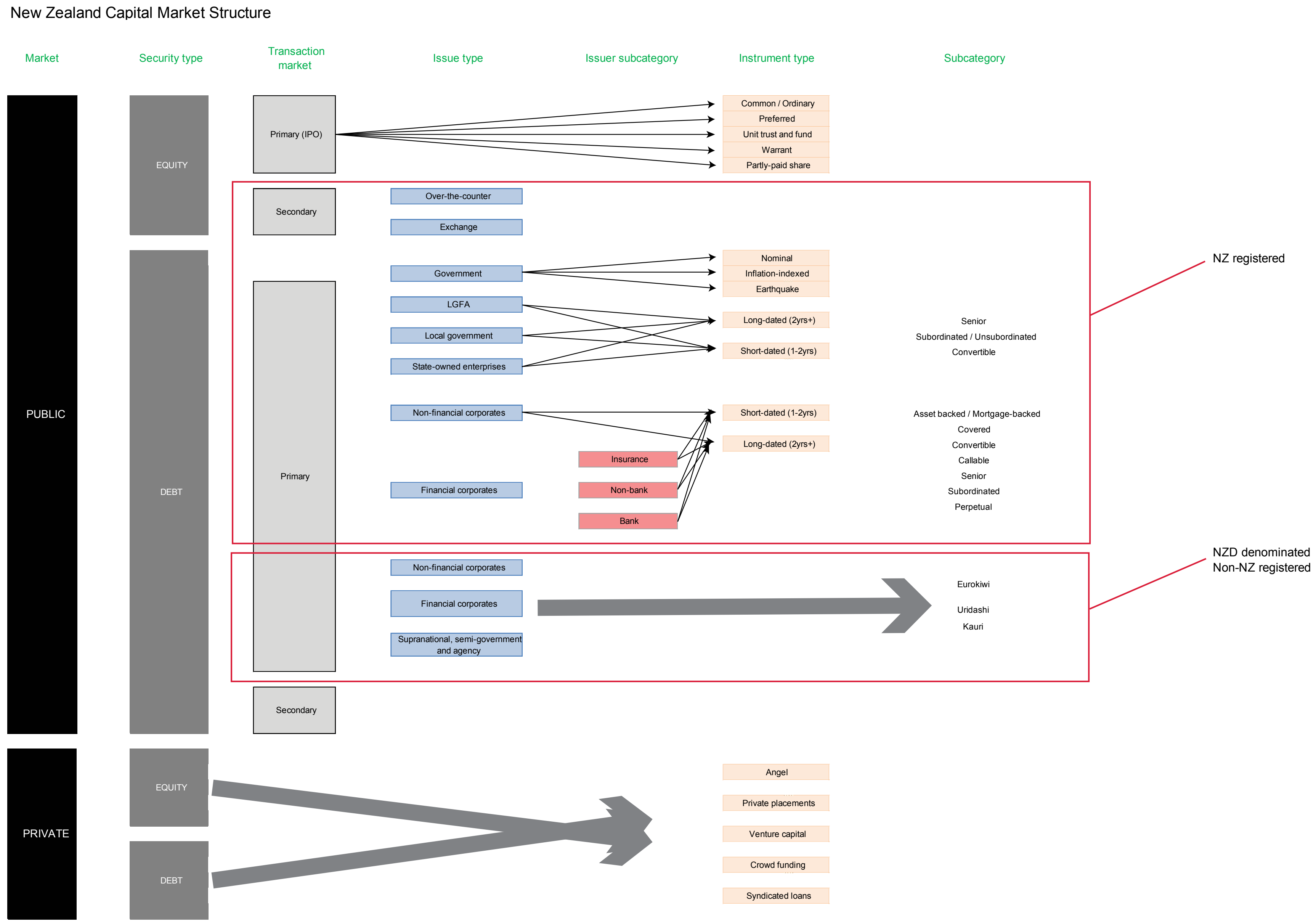
5.1. *Equity markets*

Both public and private equity markets operate in New Zealand. The public equity market operates through an exchange – the NZX – where shares in listed companies can be bought and sold. A share is a residual claim on a firm's future profits and represents a fraction of the ownership of the firm. The private equity market refers to equity financing for firms that is not publicly traded on an exchange.

10 Data on bond issuance have been provided by a number of domestic and international institutions, data providers such as KangaNews, Thomson Reuters and Bloomberg, and other publicly available sources. This information was cross-checked with summary data from the domestic registries.

11 See Watson and Vucetich (2013) for further details. Note that since 2012, the majority of covered bond issuance has been into offshore markets.

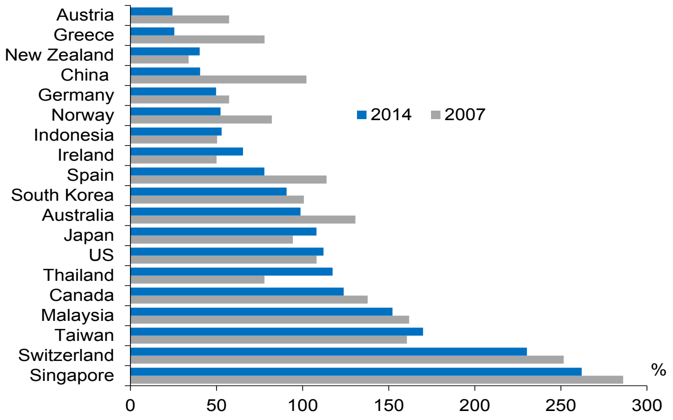
Figure 2
A stylised representation of the structure of capital markets in New Zealand



Public markets

New Zealand's listed equity market is small by international standards. Stock market capitalisation is 40 percent of GDP, less than half that of Australia but similar to that of China and Germany (figure 3). However, given New Zealand's low national savings rate, a high proportion of large New Zealand companies being wholly-owned offshore, and a relatively low capital-intensive economy, a small listed equity market is perhaps not surprising.

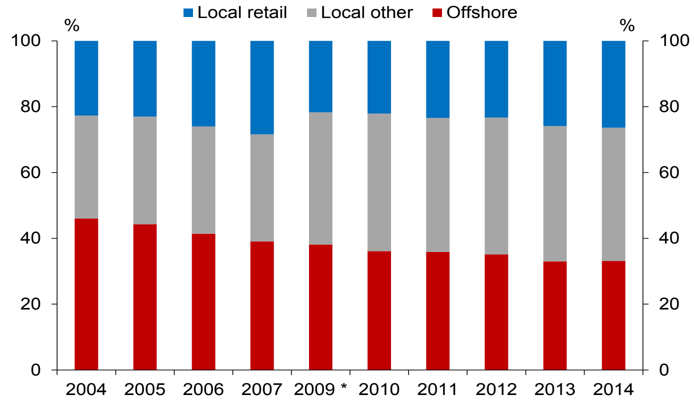
Figure 3
Stock market capitalisation
(percent of GDP)



Sources: World Bank, World Federation of Exchanges members.

Primary issuance in the New Zealand share market has increased over the past two years, from an average rate of 5.4 initial public offerings (IPOs) per year from 2003 and 2007 (inclusive) to an average of 10 in 2013 and 2014 (Henry, Aitken, and Koreman-Smit, 2015). There has been a greater proportion of domestic investors (domestic holders excluding government) owning shares at the point of an IPO, rising from 54 percent in 2004 to 67 percent in 2014 (figure 4). Part of the recent surge followed the partial privatisation of a number of government-owned utility companies.

Figure 4
Ownership of New Zealand primary listings
(percent of total, June years)



Source: Henry, Aitken, and Koreman-Smit (2015).

Note: March years to 2009, June years thereafter.

Over the past decade, domestic institutional holdings of primary listings increased nine percentage points to just over 40 percent of ownership. The emergence of the KiwiSaver scheme in New Zealand may explain some of the uptick in recent years, although as Henry, Aitken, and Koreman-Smit (2015) point out, domestic institutional ownership still remains low compared with many other countries, including Australia. Activity in the secondary market has also increased, with the number of transactions on the NZX 50 increasing from 319,000 in 2010 to 862,000 in 2014 and the number of shares traded rising from 2 billion in 2010 to 3.4 billion in 2014. In general, greater turnover increases market liquidity.

In recent years, a number of innovations and changes have occurred that may have assisted in both the growth and increased turnover of the domestic equity market. The FMC Act is designed to support the capital market regulatory environment and simplify issuance by smaller firms (see box B in section 6). The partial privatisation of SOEs has likely raised the national and international awareness of the domestic stock market, at least for a time. Tax changes in 2010 may have encouraged the share of new investment going into non-financial investments (e.g. property) to have fallen at the margin. And as noted above, the KiwiSaver scheme has contributed to an increase in the demand for domestic equity in portfolio holdings. Finally, timing may well have played a part. Historically low interest rates and an upward sloping yield curve may have encouraged investment into capital markets (both bond and equity), and the appreciation and outperformance of the share market since 2012 may have increased the public's awareness via the media and news articles.

Private markets

In New Zealand's private equity market, the sources of funding are wide-ranging, including family, friends and other small investors (via peer-to-peer and crowd-funding), high net worth individuals, institutional investors (via boutique private equity-focussed firms), and venture capital networks. Firms that receive private equity funding range from start-up companies (funded by venture and angel capital) through to well-established unlisted firms looking to expand their operations.[12]

Since these are private markets, data on the size and functioning of the varied sources of private equity are less readily available compared to their public counterparts. However, the New Zealand Private Equity & Venture Capital Association (NZVCA) does provide some useful information that allows insights into how this market operates in New Zealand. According to the NZVCA's 2014 New Zealand Private Equity and Venture Capital Monitor (2014), disclosed investments and divestments (buying into and selling out of a firm) tend to be lumpy and variable over time. Total activity in 2013 amounted to $1.1 billion, which was the fourth largest year of activity in the past decade, while 2006 and 2007 were notable years with totals of $1.4 and $1.5 billion, respectively. According to NZVCA (2014b) and NZVCA data, the greatest number of investment transactions occurs in the venture capital (VC) sector, focussing on start-up firms and seed-funding. However, the value of private equity transactions (excluding VC) are much higher, with around 80 percent of total reported activity in the past decade occurring in the non-VC segment of private equity (i.e. enabling existing firms to source capital for expansion or restructuring). These figures are consistent with discussions with industry contacts that highlight how important the established private equity market is for New Zealand's capital market.

While New Zealand's stable political, legal, and governance frameworks provide an attractive landscape for private capital investing (Groh, Liechtenstein, and Lieser, 2014), the relatively small size of the market and comparatively small funds requested have been identified as limiting offshore investment here (Smith, 2012). Quantifying the size of this market is, by definition, quite difficult, but anecdotes suggest that private equity plays a critical role facilitating the growth and functioning of small-to-medium New Zealand firms. Boutique wealth management and merchant banks frequently broker transactions between counterparties. For example, in 2012 a number of investors pooled resources and in 2013 purchased Bell Tea, a well-known New Zealand private company. The purchase was made by Pencarrow IV Fund, a private equity manager. Other investors into this sector of the market tend to be large pension funds, such as Kiwisaver funds and the New Zealand Superannuation Fund (NZSF), offshore and domestic fund managers, and wealthy individuals. For example, the ACC was a co-investor in the Bell Tea acquisition.

12 Venture capital refers to the funding for less mature companies, and typically for the application of a new technology and new products that do not have a proven track record or stable revenue streams. Angel investment provides funding for similar reasons, often from high net worth individuals, and typically fills the gap between funding from family and friends, and formal venture capital. Technically, private equity encompasses venture and angel capital as well as investment in established firms, but colloquially, private equity in New Zealand tends to refer to transactions excluding venture and angel investments.

5.2. Bond markets

Box A outlines a selection of types of bonds that can be issued in the primary market. New Zealand's public debt markets, like those in most advanced economies, are dominated by the issuance of government bonds.

The domestic public bond market – overview

Issuers of bonds in New Zealand can be separated into a number of categories, as shown earlier in figure 2. These include central government, local government,[13] SOEs,[14] financial companies (such as banks, finance companies, and insurance companies), and non-financial corporates. Non-resident entities also issue bonds into the New Zealand market – these are known as Kauri bonds (see Reid, 2014 for more details).

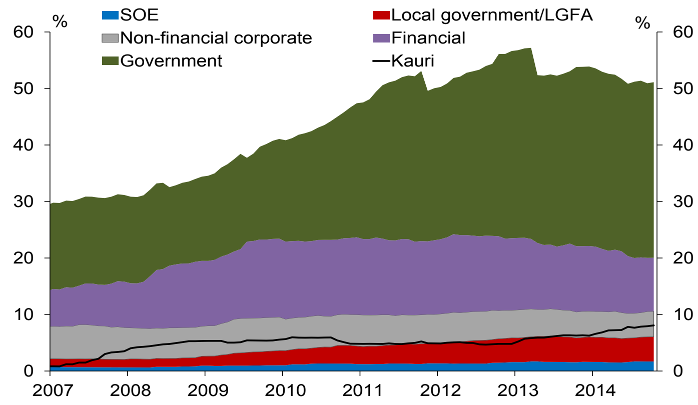
As of October 2014 about $121 billion of outstanding bonds had been issued by New Zealand resident entities into the local public debt market, which amounted to just over 50 percent of GDP (figure 5).[15] The majority of resident-issued debt ($73.5 billion) was in the form of central government bonds. In addition, there were $19.1 billion of Kauri bonds outstanding that had been issued in New Zealand by non-resident entities.

13 In 2011, the LGFA was set up to provide lower funding costs and more diversified funding sources (including foreign currency) for New Zealand local authorities. Local councils can, and still do, issue individually.

14 Including enterprises now part-privatised but still majority-owned by the government.

15 This figure refers to the market of issue where the bonds were first registered, not to the current domiciled holdings of these bonds, which may be offshore.

Figure 5
Bonds outstanding in the New Zealand market
(percent of GDP)



Source: See footnote 10.

Note: Amount as at issued price, not current market price.

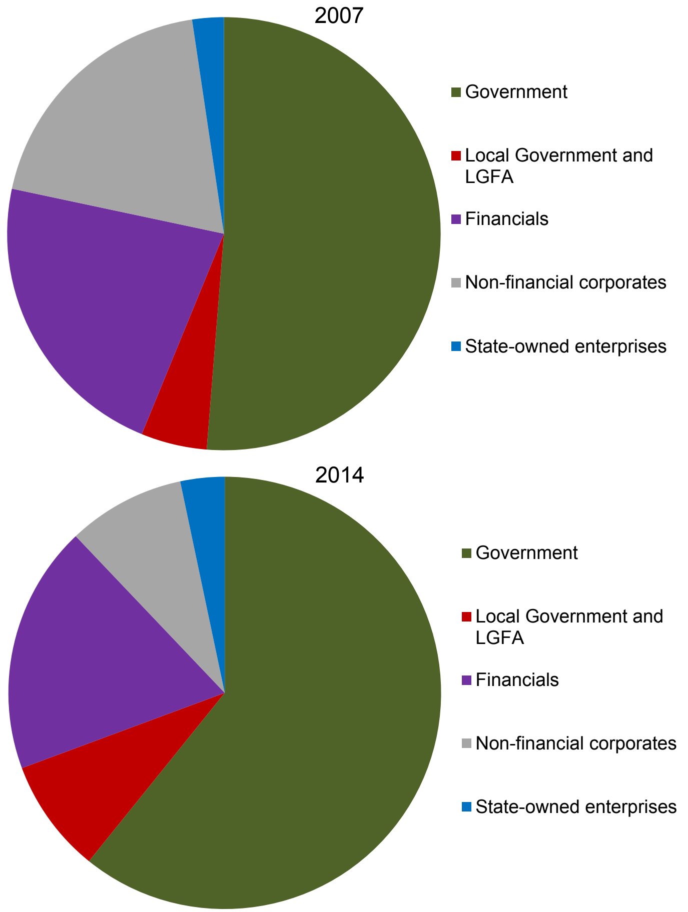
The total amount of bonds outstanding in the local market (excluding Kauris) has more than doubled since 2007 in nominal terms, rising from just over $50 billion (30 percent of GDP) at the start of 2007 to $121 billion. More than two-thirds of this rise is due to an increase in central government debt, while nearly 20 percent of the increase represents bond issuance by banks. The increase in government bond issuance is linked to the shift from fiscal surpluses to deficits during the Global Financial Crisis (GFC), and further issuance following the Christchurch earthquakes.

New Zealand banks increased their issuance of long-term debt sharply in the immediate post-GFC period. This followed from a number of changes in the global environment, including the risk of a negative credit rating from international rating agencies stemming from a reliance on short-term funding, a lack of global liquidity, and a cessation of some wholesale funding markets during the depth of the GFC (increasing the risk of a failure to roll over upcoming funding needs). In addition, New Zealand registered banks are now required by the Reserve Bank to raise a greater proportion of funding that is likely to remain in place for at least one year, as part of the prudential liquidity policy introduced in 2009.[16] The Reserve Bank's prudential liquidity policy was implemented to reduce the risk posed to New Zealand's banking system by an overreliance on short-term wholesale market funding.

As at October 2014, the New Zealand (central) government sector had issued 61 percent of New Zealand's bonds outstanding (figure 6). By comparison, the share of the local government sector was 8.5 percent, with 18.5 percent issued by banks or other financial institutions and 9 percent by non-financial corporates. SOEs comprise the remaining 3 percent. This breakdown has changed markedly since 2007; as previously noted, central government debt makes up a much larger share today, while the proportion of non-financial corporate bonds has fallen from 19 percent to its current level of 9 percent of the total. Although the nominal amount of bonds outstanding has increased for all sectors, non-financial corporate bonds have decreased as a share of GDP, falling from 5.7 percent to 4.5 percent currently (possibly reflecting weaker overall demand for business credit in the past five years). Note that figure 6 does not include bonds issued by New Zealand entities in offshore markets; if included, the share of government bonds would decrease.

To give some context to the overall size of the domestic bond market, Laeven (2014) reports that total private-sector domestic debt securities (i.e. excluding government and local government) for high-income economies averaged 33 percent of GDP in 2010. By comparison, the equivalent figure for New Zealand was around 20 percent of GDP in 2010. Furthermore, as a funding source for New Zealand non-financial firms (i.e. SOEs and non-financial corporates), debt outstanding (as at October 2014) was $14.6 billion. By contrast, credit provided to non-financial firms (including the rural sector) by the banking system amounted to $137 billion as at September 2014.[17] In addition, many large New Zealand companies are wholly owned foreign firms. These firms will often have some funding (debt) provided by the offshore parent, thereby

Figure 6
New Zealand resident bonds outstanding by sector
(share of total bonds outstanding)



Source: See footnote 10.

16 See Richardson, Nield, and Hoskin (2009).

17 Note, lending by the banking system to the business sector includes lending that might be undertaken in conjunction with other lenders (syndicated loans), including private capital market investors. Unfortunately it is not possible to separately identify syndicated lending from the bank lending data.

Box A

What is a bond?

A bond is a security issued by a borrower into the wholesale or retail market (or both). New Zealand bonds are registered with either Computershare or Link Market Services and settled through NZClear. Ownership and related transactions are recorded by the registry. Historically, 'bearer bonds' were issued, which means that no records are held against the bond and possession was retained by the holder of the original ownership slip.

The borrower, or issuer of the bond, receives cash in exchange for a debt owed over a specified duration (maturity), and regular payments (coupon) are set, usually at six monthly intervals. The size of each issue and the minimum parcel size of each bond can vary depending on the market the bond is issued into (wholesale versus retail) and the size of the total borrowings. Principal is repaid in full at the maturity of the bond. This principal amount is called the 'at par' value of the bond, or the original borrowings.

There are many different types of bonds. Some of the most common types are described below:

- Senior/subordinated: The seniority of a bond refers to its ranking over other creditors during a credit event or default – a senior bond takes priority over other bonds and equity holdings. Conversely, a subordinated bond is one that has a lower priority claim on a company's assets than its senior counterpart.

- Secured: A secured bond is a bond that is secured by an underlying asset/s owned by the firm. This asset may or may not provide a stream of income. The asset that secures the bond remains on the borrower's balance sheet. In a credit event or liquidation, this asset is segregated from other claims on the business and is used to repay the secured bond holders.

- Unsecured: An unsecured bond is one which is not backed by a specific asset. The coupon repayments and principal are a claim on the company's future profits. Because of its unsecured nature, the firm's credit risk is important in the valuation of the bond. In the event of insolvency, bond holders have a claim against the remaining assets of the firm, once secured creditors are paid. During a credit event, senior unsecured bondholders are repaid before subordinated (unsecured) bondholders but after secured bondholders.

- Asset-backed: An asset-backed security (ABS) is a specific type of secured bond. The assets provide a stream of income that delivers the bond's cash flow (coupon) and principal repayments. For example, these assets may be automobile loans, credit card debt, or residential mortgages (in which case the ABS is also known as a residential mortgage-backed security). These assets are securitised, that is, they are pooled and held off-balance sheet in a separate company (called a Special Purpose Vehicle). While the bond holder has a preferential claim over the pooled assets, in the event of insolvency the value of the underlying assets (the loans and the cash flow from them) may also change over time.

- Covered: A covered bond is another specific type of secured bond. In contrast to an ABS, collateral in the form of income-earning assets are pledged to the bond and the composition of the assets may be adjusted over time to ensure that the bond's credit rating remains unchanged and the coupon repayments unaffected. Also in contrast to an ABS, these assets remain on the issuer's balance sheet. Consequently, in the event of a default or insolvency the investor has dual recourse – a secured claim on a specific pool of the issuer's assets and an unsecured claim on the issuer.

- Callable: A callable bond is a security with an embedded call option. This allows the issuer to 'recall' the bond for cash prior to maturity, if pre-defined conditions are met (usually between a future date and maturity). The callability of the bond is offset by an enhanced yield, to compensate the investor for the uncertainty created by the call option.

- Convertible: A convertible bond is a fixed-rate security that may become equity of the firm, if pre-defined conditions are met (usually within a specified period of time, where the conversion rate is set). While a convertible bond has an embedded option with some equity features, it is not considered equity until or unless the security is converted and the bond is redeemed.

- Perpetual: A perpetual bond is one that has no maturity date, although many perpetual bonds have a callable element to them.

further reducing the total of corporate bonds reported, as a proportion of overall debt funding.

How and why are bonds issued?

There is no definitive way in which a bond is 'usually' issued in New Zealand. Bank and non-financial corporate issues have historically been into the wholesale market, to obtain sufficient funding allocations. On these occasions, large domestic fund managers, insurance companies, and other large institutions have tended to purchase the bonds. However, during the GFC, corporate (financial and non-financial) bonds were issued directly into the retail market, due to the constrained wholesale markets. At this time, non-financial corporate bonds were more expensively priced (for the issuer) than an equivalent bond issued by a financial institution – a reflection of the perception of relative risk at that time. Anecdotally, lower-rated (that is, below investment grade or unrated) non-financial companies tend to issue into the public (retail) market, with the overwhelming majority going to New Zealand resident investors. Issues frequently occur via syndication with one or many banks and brokers.

Domestic issuance by smaller institutions tends to be directly in response to funding needs, or requirements to roll over (re-issue) existing funding. By comparison, larger firms tend to have more scope to decide whether to issue, and when, and can take advantage of conditions opportunistically. For example, the decision by a large corporate to issue debt may be dictated by future expected funding needs (not just current funding requirements), by the current level of interest rates and the shape of the yield curve (how interest rates are expected to change over time), and by credit spreads.[18] The relative cost of issuing into the debt versus the equity market can also drive the funding decision for larger firms.

18 Of course, in any event, the terms of funding can be switched into a floating (or fixed) rate, using the derivatives market (swaps).

Primary issuance

Primary issuance in the New Zealand market (excluding central and local government) is dominated by a small number of highly rated entities. The largest four banks (all rated AA- by Standard and Poor's), as well as Rabobank New Zealand and Kiwibank, account for more than 40 percent of New Zealand's domestic issuance. Other large issuers include utility firms (for example, the partly privatised power companies) and well-known corporates such as Fonterra and Auckland International Airport. The type of issuance by these firms is dominated by senior unsecured bonds (roughly 80 percent), with the remainder spread across various other types of bond issuance (see box A for more details on different types of bond issued in the New Zealand market).

Secondary market trading

After the primary issue, bonds can be freely traded. Given that the majority of these transactions occur OTC, there is little public information on the holdings of New Zealand debt issued. The Reserve Bank reports on the current holdings of bonds issued by central government, with 65.8 percent held by non-residents in January 2015. The market for government bonds is relatively liquid for institutional investors (domestic and offshore), with price-makers quoting prices continuously.[19] The Reserve Bank publishes an estimate of New Zealand Government bond turnover on a weekly basis, the majority of which is driven by repurchase (repo) agreements.[20] In 2014, the average monthly turnover for repo transactions was $63.3 billion while there were about $10.2 billion of non-repo transactions per month.

In general, there is very little secondary trading of all other corporate bonds. Brokers are unlikely to actively (continuously) quote corporate bond prices, but rather bonds are quoted and traded on an on-demand basis via phone or trading platforms such as Bloomberg ALLQ and Yieldbroker. Purchases tend to be held to maturity, in particular by retail investors and asset fund and pension fund managers. Anecdotally, the secondary market for LGFA bonds is becoming more liquid over time, as the quantity of bonds outstanding increases. Average monthly turnover of LGFA bonds settled through the NZClear system rose from $230 million in 2012 to $383 million in 2014. The NZX has recently established the New Zealand Debt Market (NZDX), a platform where bonds can be listed and prices quoted are 'live' (that is, they show the current price at which brokers are willing to buy and sell bonds). This market is new and turnover remains low. Over the past two years, the average daily turnover was 0.01 percent of the outstanding face value of bonds listed on the NZDX.

New Zealand resident issuance into the global bond market

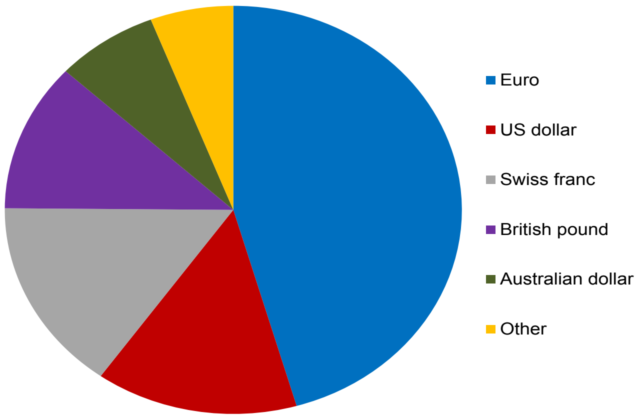
New Zealand firms can also fund in offshore markets. In the vast majority of cases, these bonds are issued in foreign currencies.[21] As at October 2014, NZ$33 billion of foreign currency bonds issued by New Zealand resident entities were outstanding in offshore public markets, with three-quarters of this issuance in euros, US dollars, and Swiss francs (figure 7). Banks were the largest issuers of foreign currency bonds, accounting for around 80 percent of issuance in offshore public debt markets, while other issuers include large corporates, SOEs, and Auckland Council. In 2010, New Zealand firm issuance into the offshore market equated to 9.1 percent of GDP (13.3 percent currently). By comparison, the average

19 The interbank price-makers in the New Zealand market currently include ANZ, ASB, BNZ, Deutsche Bank, Kiwibank, and Westpac.

20 See Cook (2012) for more information about repurchase agreements and the repo market.

21 Note that offshore NZD issuance is also possible but New Zealand firms appear to be able to achieve a cheaper overall cost of borrowing by issuing in a foreign currency and hedging this funding back into NZD.

Figure 7
Breakdown of foreign currency issuance by currency
(percent of total)



Source: See footnote 10.

offshore private sector bond issuance for high-income economies was 33.5 percent of GDP in 2010 (Laeven, 2014).[22]

Offshore bonds are issued to diversify the issuer's investor base and to take advantage of lower funding costs in other markets. Foreign currency bonds may also be issued to meet certain funding needs; for example, market participants note that it is difficult for domestic issuers to issue into the domestic market for terms beyond seven years. The size of a firm's balance sheet, and therefore its funding requirements, is also a driver for issuing bonds offshore – at times the largest local firms are unable to issue a bond of the amount they need into the domestic market.[23]

The demand for bonds from offshore investors also influences the market that New Zealand institutions issue into. For example, New Zealand banks may have overseas funding programme commitments (typically in Europe or the US), under which they agree to provide a minimum issuance size on a regular basis. Swiss investors have traditionally had strict credit rating restrictions, thereby excluding all but the highest rated New Zealand banks. Finally, the offshore market provides a greater pool of investors and funding with a wider range of investing requirements, and, at times, a cheaper source of longer-term funding to meet a local firm's needs.

Table 1 summarises the characteristics of bonds issued by New Zealand entities. The average bond duration at the time of issuance is 5.8 years, which includes both onshore and offshore issues by New Zealand entities (excluding central government issues), with an average size of $83 million. These figures, especially average issuance size, are skewed lower by small amounts often issued by local councils. If the local government sector is excluded, the average issue size of private-sector bonds rises to $144 million. Table 1 also highlights the significant differences in the characteristics of bonds issued onshore versus offshore – bonds issued offshore tend to be for longer terms and for larger amounts.

Table 1
Characteristics of bonds issued by New Zealand resident entities since 2004

	Onshore	Onshore (private sector)	Offshore	Total
Average size ($ million)	70	144	314	83
Average tenor (years)	5.5	5.7	8.6	5.7

22 The New Zealand figures contains bonds issued in offshore public debt markets only, and so understates the true value of offshore bond issuance by New Zealand firms (including private placements).

23 There is also evidence that some firms use their parent to issue into the offshore market, and this is channelled to the subsidiary internally. In this respect, the 'true' offshore issuance by New Zealand domestic firms may be under-reported.

Box B
Supporting domestic capital market development – recent policy initiatives

Over the past several years there has been a wide range of regulatory and policy changes designed to support the development of both public and private capital markets in New Zealand.[24] The focus on reducing the cost of raising capital for New Zealand firms, while building local and international investor confidence in New Zealand's debt and equity markets, stems from a taskforce established in 2008 (which included representation from the Reserve Bank) to assess both the constraints and the opportunities for growing New Zealand's capital markets. The final report of the taskforce made a number of recommendations to address the following areas of concern (CMD Taskforce, 2009):

- the over-reliance of small businesses on bank funding;
- a public equity market that is small by international standards;
- a corporate debt market that offers a limited range of quality services; and
- other factors such as information poorly tailored to investor needs, a lack of trust of financial advisers, and a limited degree of financial literacy among the public at large.

Most of the taskforce's recommendations have been, or are in the process of being, implemented. In relation to public capital markets,the partial privatisation of SOEs has broadened the range of high-quality equity offerings for retail investors.[25] Listings on the NZX in 2013 were the highest in a decade, although 60 percent of the capital raised in that year was due to the share offer programme. Such listings may act to create a 'virtuous circle' of public market activity which will encourage further listings, and greater domestic and international investor interest in the New Zealand stock exchange.

The recently enacted FMC Act provides a framework to develop 'alternative' public exchanges (separate from the main board of the NZX), with simpler listing rules and lower disclosure requirements, in order to reduce compliance costs for small businesses thinking about raising capital through public listings. One example of this is the 'stepping stone' market called the NXT, created last year, offering a cheaper source of funding and lower compliance costs for high-growth companies. The NXT was approved by the Financial Markets Authority (FMA). The FMA also worked with the NZX and dairy co-operative Fonterra to develop the Fonterra Shareholders' Fund (FSF) which is a unit trust listed on the NZX and is a vehicle for investors to gain exposure to the New Zealand dairy industry. The FSF is part of Fonterra's Trading Among Farmers scheme, which also includes the Fonterra Shareholders Market (FSM) – a private market operated by the NZX that enables farmers who are part of the co-operative to trade shares among themselves.

More generally, the FMC Act is designed to support investor confidence across both public and private capital markets, while streamlining capital-raising for businesses in both these markets. The Act provides more capital-raising opportunities for firms by increasing the set of exemptions for debt and equity offers to certain investors. For example, disclosure requirements have been reduced for capital-raising from experienced investors and investors that already have an established relationship

24 See New Zealand Government (2013 and 2014).

25 On the public debt side, the development of the LGFA has helped to broaden the range of high-quality debt offerings available to domestic and offshore investors.

with a firm. So too have the requirements around small offers of debt and equity.

The avenues available for small to medium-sized enterprises (SMEs) to raise funding have also been enhanced through crowd funding and peer-to-peer lending. In July last year, the FMA issued its first crowd funding licences under the Act. Firms issuing securities through crowd-funding do not have to disclose as much as companies raising equity, for example, on the NZX. It is also easier now for small businesses to raise funds from employees, via share offer schemes. Several initiatives also support businesses at the very early stage of development. These include support for the New Zealand Venture Investment Fund, and changes to the Government's incubator programme.

Private debt markets

In addition to public markets, both banks and some non-financial corporates also make use of private debt markets. In recent history, the US private market – not presented in the above data – has been a major source of cost-effective long-dated funding for some New Zealand corporates looking to issue in relatively small volumes. Due to its nature, we are unlikely to have a full picture of the private placement market; however, our dataset indicates that for non-bank issuers, offshore private placements are at least as large as offshore public bond issuance. As in New Zealand, there are costs involved with publicly issuing bonds in foreign markets, such as reporting requirements and registration costs. Issuing bonds via private placements can avoid (some of) these costs, and might explain the high proportion of private issuance by non-bank issuers.

6. Where to from here?

New Zealand's equity and bond markets have grown in size and depth in recent years. Despite this, the size of New Zealand's capital markets remains small and underdeveloped by international standards, while the banking system continues to dominate funding for New Zealand firms.

On the one hand, the relatively small size of New Zealand's capital markets might simply reflect the small size of the economy: some economies simply lack scale to support a flourishing capital market. Laeven (2014) argues that, "in an increasingly globalised world, not every country needs to develop a fully-fledged physical capital market at home. The optimal balance between local capital market development and integration in global capital markets will depend on country circumstances, such as economic size and stage of development" (p. 19). As noted in this article, larger New Zealand corporates already have access to global markets – both public debt markets and private placements.

On the other hand, many believe that further development of both equity and bond markets in New Zealand would help to underpin economic growth (CMD Taskforce, 2009). Indeed, capital market activity over the past few years has been heavily influenced by a wide range of continuing regulatory and policy initiatives to support New Zealand's equity and bond markets (see box B).

Looking ahead, the growth of KiwiSaver scheme funds and the recent partial privatisation of SOEs could add further depth and liquidity to the domestic equity market, and in turn increase international interest and participation. In addition, the development of an alternative public growth market, introduced last year by the NZX, could help to encourage more SMEs to raise funds via public listing (by offering lower compliance costs). Other policy and regulatory initiatives summarised in box B, including formalising crowd funding via crowd funding licences issued by the FMA, could further serve to reduce capital-raising costs for small firms. That said, most of the regulatory initiatives are very recent, and at this point, it is difficult to assess how much difference these changes will make over the longer term.

7. Conclusion

This article offers a primer on New Zealand's capital markets. It describes why capital markets are important, the different instruments and participants, and how these entities interact in the New Zealand context. The article gives estimates of the size and composition of the non-government bond market and how it has changed over the past seven years. Finally, the paper summarises regulatory and policy initiatives since the publication of a report from the Capital Markets Taskforce in 2009, and how these might benefit local capital markets in coming years.

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