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# The potential for supranationals to fulfil the role of a complementary source of risk-free, liquid investments in Australia

**By Samantha Swiss, Managing Editor, INSTO**

**December 2002**

**Submission to the Review of the Commonwealth Government Securities Market**

# About INSTO

INSTO is an Australian-based financial publishing and events business. The flagship INSTO magazine is published at the end of each quarter. In addition, INSTO publishes the weekly Australian Financial Markets Newsletter. Capital markets and technology-related events are held by INSTO throughout each year.

INSTO aims to provide the most comprehensive source of finance and capital markets information in the Australian market. Our mission through all products and services is to create the space where markets meet. In September 2002 INSTO set up an office in Europe, with the aim of broadening the depth of its editorial coverage by bringing in issues of international relevance to its publishing and event businesses.

In July 2002 INSTO was incorporated into Palamedia Ltd – the former My Money Group – which includes high-profile business and finance personality David Koch. Palamedia specialises in the production of business and finance content, which is supplied to a variety of audience segments through electronic, publishing and broadcast assets.

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# Executive Summary

• The Australian Treasury's discussion paper entitled *Review of the Commonwealth Government Securities Market*, released in October 2002, focuses on two possible alternatives for the various roles now fulfilled by commonwealth government securities (CGS) in the Australian market, in the event that a decision is taken to retire all government debt or continue to decline the issuance of CGS. These two alternatives are the corporate bond market and the interest rate swap market. This paper focuses on one sector within the corporate bond market which has received little coverage in terms of its potential to provide a complementary source of liquid and risk-free investment in the Australian market – supranationals.

• INSTO set out to determine to what extent supranational issuance can act as a complementary source of liquid and relatively risk-free investment in the Australian market. Eight supranational issuers were interviewed to gather information on their annual funding requirements, their level of appetite for obtaining funds in Australian dollars and how much of those Australian dollar-denominated funds they think it is possible to raise in the Kangaroo bond market, and what is preventing them from having a larger presence in Australia.

• The possibility for the supranationals to play a greater role in Australia as a complementary source of risk-free investment or as a benchmark in the pricing of other debt securities is limited if there is not greater issuance by institutions in this asset class in the Australian market.

• The supranationals with smaller funding requirements – like the Nordic Investment Bank, the Council of Europe Development Bank, The European Company for the Financing of Railroad Rolling Stock (EUROFIMA) and the European Bank for Reconstruction and Development – may use their status as flexible borrowers to establish yield curves in the Australian market. But to date, the only supranational in this group that has issued bonds in Australia is EUROFIMA.

• The bigger supranational borrowers – the International Bank for Reconstruction and Development (the World Bank), the European Investment Bank (EIB), the Inter-American Development Bank and the Asian Development Bank (ADB) – have all completed at least one transaction in Australia. The biggest global borrower in this group is the EIB, which has the strongest desire to issue benchmark bonds in Australia. The other borrowers in this group say they cannot commit to a regular presence in the Australian market, although the ADB is the largest supranational borrower in Australia.

• But there are still several obstacles to be overcome before supranationals – even the EIB – are encouraged to step up their issuance in Australia.

• The first obstacle is price – or funding levels. The supranationals say they will only issue more in the Australian market at the right price. Australian fixed income investors have so far been unwilling, say supranational borrowers, to price their securities in line with where the borrowers fund in other markets, or at least in line with Australian government and semi-government debt. This creates a catch-22 situation as domestic investors say they have not been encouraged to do so because there has not been sufficient issuance by the supranationals to warrant this – and therefore a liquidity risk premium is necessary when buying supranational paper.

• The second obstacle is the placement of supranationals within the UBS Warburg Composite Bond Index – the main benchmark used by domestic fixed income investors. In this index, supranationals are included in the corporate section (as distinct from the government and semi-government sections of the index). For most investors, this means that in comparing triple A credits, supranationals are viewed as expensive when viewed against other borrowers in the credit section of the index. The supranationals would like the index to be changed so they are placed either in a separate category of their own, or with the government or semi-governments.

• The third obstacle is the basis swap, which contracted substantially over 2002. As a result, the Australian market has not offered cost-effective funding for international borrowers who need to swap Australian dollars into other currencies. The main cause of the contraction of the basis swap is increased issuance in Australian dollars in offshore markets – particularly the Uridashi market in Japan, which is targeted to retail investors.

• Appendix 1 and Appendix 2 provide case studies of two agency borrowers that have visited the Australian bond market. Both Kreditanstalt fuer Wiederaufbau and Bank Nederlandse Gemeenten express their desire to have a greater presence in Australia, when market conditions improve. But like the supranational borrowers, one of the main impediments to further issuance in Australia is the unfavourable basis swap.

• Finally, supranationals say the winding down or elimination of a liquid commonwealth government securities market will make it more tricky – although not impossible – to issue in Australia.

• The conclusion is that for various reasons, supranationals are not ready to step up to the plate and assume the mantle of the government in providing to the Australian market a liquid, risk-free asset class. When it is considered that the commonwealth government has 11 benchmark lines with an average size of A$5 billion each, this point is brought into sharp focus. So if the Australian Treasury continues to decline its amount of issuance in the Australian market, or is one day in a position to buy back or wind down all its debt, unless the obstacles outlined in this report are overcome, the Australian financial markets will have to find another way to cope without the supply of risk-free liquid investments the CGS market now offers.

# The potential for supranationals to fulfil the role of a complementary source of risk-free, liquid investments in Australia

BY SAMANTHA SWISS, MANAGING EDITOR, INSTO

The Australian Treasury's discussion paper entitled *Review of the Commonwealth Government Securities Market* (the discussion paper), released in October 2002, focuses on two possible alternatives for the various roles now fulfilled by commonwealth government securities (CGS) in the Australian market, in the event that a decision is taken to retire all government debt or continue to decline the issuance of CGS. These two alternatives are the corporate bond market and the interest rate swap market. This paper focuses on one sector within the corporate bond market which has received little coverage as a complementary source of liquid, risk-free investment in the Australian market – supranationals.

When considering the corporate bond market as an alternative for pricing and referencing other financial products, most people's reaction is that the market as it now exists is not sufficiently deep or liquid to fulfil these roles. This attitude prevails even when it is taken into account that over recent years issuance of both commonwealth treasury and semi-government bonds has been declining, while the amount of corporate bonds on issue has increased (graph 1). According to Australian Office of Financial Management data for 31 October 2002, treasury bonds outstanding amount to A$48.5 billion (US$27.16 billion) (table 1), with total gross outstanding in CGS amounting to just over A$63.8 billion. According to the Reserve Bank of Australia (RBA), corporate bonds outstanding to the end of September 2002 totalled just under A$103 billion (graph 1). This consists of just over A$27 billion from financials, A$28 billion from non-financials, and A$47 billion in asset-backed securities. The RBA says this figure does not include more than A$87 billion outstanding from Kangaroo issuers.

INSTO set out to determine to what extent supranational issuance can act as a complementary source of liquid and relatively

**Table 1: Monthly Changes in Commonwealth Government Securities (CGS) Outstanding**

| Instrument | As at 30 Sep 02 Face Value A$'000 | October New Issuance Face Value A$'000 | October Redemptions Face Value A$'000 | As at 31 Oct 02 Face Value A$'000 |
|---|---|---|---|---|
| Treasury Bonds (a) | 51,745,649 | 402,000 (e) | 3,612,167 | 48,535,482 |
| Treasury Notes | 5,897,000 | 1,700,000 (f) | 4,896,000 | 2,701,000 |
| Treasury Indexed Bonds | 6,451,845 | - | - | 6,451,845 |
| Assumed debt (b) | 401,467 | - | - | 401,467 |
| Other (c) | 247,774 | - | 264 | 247,510 |
| Total A$ denominated CGS | 64,743,734 | 2,102,000 | 8,508,431 | 58,337,303 |
| Total foreign currency denominated CGS (d) | 352,566 | - | - | 342,377 |
| Total (a) | 65,096,301 | 2,102,000 | 8,508,431 | 58,679,680 |
| Gross outstanding debt | 70,233,381 | | | 63,816,760 |

(a) Excludes Commonwealth holdings

(b) Debt assumed by the Commonwealth from the Federal Airports Corporation and Snowy Mountains Hydro-Electric Authority

(c) Overdue CGS, State Domestic Raisings and State Tax Free Stock

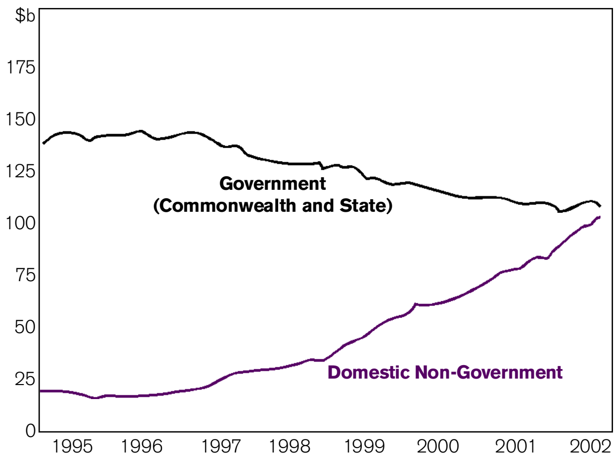
(d) Valued at end-month exchange rates

(e) Cash proceeds A$'000 421,020

(f) Cash proceeds A$'000 1,680,055

*Source: Australian Office of Financial Management, 31 October 2002*

**Graph 1: Domestic Bonds Outstanding (Monthly)**




Note: Total of A$102.883 billion outstanding in domestic non-government debt includes A$47.271 billion of asset-backed bonds, but excludes A$87.312 billion in outstanding Kangaroo bonds

*Source: Reserve Bank of Australia, September 2002*

risk-free investment in the Australian market. Eight supranational issuers were interviewed to gather information on their annual funding requirements, their level of appetite for obtaining funds in Australian dollars and how much of those Australian dollar-denominated funds they think it is possible to raise in the Kangaroo bond market, and what is preventing them from having a larger presence in Australia. Of all the supranationals canvassed for this paper, the European Investment Bank (EIB) has both the largest annual funding requirements and also the strongest desire to complete benchmark bond transactions in Australia.

However, at this stage it is unlikely that supranationals could be considered as a possible surrogate for CGS. Although at first glance their low-risk characteristics and potential volume of issuance seems to point in this direction, several obstacles remain before they will be encouraged to issue in the Australian market in greater volume. These hurdles range from the placement of supranationals in the main benchmark used by Australian fixed income investors and the ability of supranationals to achieve their global all-in cost of funding levels in the Australian market, to an unfavourable basis swap which during 2002 contracted significantly, thereby throwing cold water on the plans of many supranationals to raise funds in the Australian market.

## Supranationals as risk-free investments

As the discussion paper outlines in Chapter 3, one of the main advantages of having a liquid CGS market is the fact that it serves as a proxy for a risk-free asset and therefore assists in the pricing of other financial products. The discussion paper says: "The CGS market provides information about yields at different maturities. This may be important for pricing yields on other debt securities. The CGS yield is often considered a proxy for the risk-free rate of return in Australia, as yields are unlikely to be affected significantly by credit and liquidity risk." The discussion paper suggests two possible alternatives to the role CGS play in this regard – the interest rate swap curve and "the existing debt securities of organisations with similar risk characteristics" – in other words, the corporate debt market.

Supranationals are multilateral lending institutions which are typically set up and owned by sovereign states. The exception is the European Company for the Financing of Railroad Rolling Stock (EUROFIMA), which is owned by companies (European state railways), but as these companies are government owned, EUROFIMA is considered a supranational. According to a TD Securities report, *Supranational Borrowers and the Australian Capital Markets*, published in September 2002: "These organisations have the common task of fostering economic and social progress in developing countries by financing projects, supporting investment and generating capital. They also play a major role in the international capital markets by annually raising the large volume of funds required to finance their loans. Supranationals are distinct from bilateral agencies as they operate as more of a global collective of nations. Bilateral agencies represent only one country, and deal on a 'country-to-country' basis with developing nations."

There is no doubt that, apart from sovereign securities, supranationals offer the most risk-free asset class for investors. Standard & Poor's (S&P) says in a September 2002 report, *Supranationals Special Edition 2002*: "These institutions include some of the largest borrowers in international capital markets and, as a borrower class, have unsurpassed credit rating." In the report, S&P highlights the credit quality of supranationals by pointing out that in the year since its last supranational report, the rating agency has maintained the ratings and outlooks on all supranational institutions rated AAA/Stable/A-1+. The report continues: "The AAA/Stable/A-1+ ratings assigned to most supranationals reflect several factors. Most important is their strong financials, especially capitalisation, buttressed by the fact that they ordinarily do not pay taxes or dividends; the expectation that their loans will receive preferred treatment over those of other creditors in times of financial stress; and the expectation of other strong shareholder support, including the meeting of a call on their callable capital in the highly unlikely event that this should become necessary."

The TD Securities report adds: "(Supranationals') credits are so strong that normally there would not be any specific credit event that could generate upside or downside of their spreads disproportionately to other credits in the market….Supranational bonds continue to be regarded as the major

**Table 2: Index of Quality of Country Loan Portfolio**

| Year | Global Institutions | | Regional Institutions | | | | | Other Supranationals | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **IBRD** AAA | **IFC** AAA | **IADB** AAA | **ADB** AAA | **AFDB** AA+/AA- | **EBRD** AAA | **IIC** AA | **EIB** AAA | **EUROFIMA** AAA/AA+ | **CEB** AAA/AA+ | **NIB** AAA |
| 30.6.02 | 12.5 | 13.2 | 13.1 | 12.7 | 16.2 | 8.8 | 13.1 | 1.3 | 0.9 | 3.0 | 2.5 |
| 2001 | 12.5 | 13.2 | 13.0 | 10.1 | 16.2 | 9.2 | 13.1 | 1.3 | 0.9 | 3.1 | 2.3 |
| 2000 | 9.9 | 10.9 | 8.5 | 8.1 | 16.6 | 11.7 | 8.9 | 1.2 | 0.9 | 3.0 | 1.8 |
| 1999 | 12.1 | 11.2 | 8.4 | 9.0 | 16.9 | 17.5 | 8.5 | 1.2 | 0.9 | 4.4 | 1.9 |
| 1998 | 11.6 | 11.9 | 6.9 | 9.9 | 17.4 | 16.2 | 7.0 | 1.2 | 0.9 | 5.2 | 1.9 |
| 1997 | 9.4 | 10.1 | 6.9 | 5.0 | 17.7 | 8.4 | 6.6 | 1.2 | 0.9 | 6.1 | 1.3 |

IBRD=International Bank for Reconstruction and Development; IFC=International Finance Corporation; IADB=Inter-American Development Bank; ADB=Asian Development Bank; AFDB=African Development Bank; EBRD=European Bank for Reconstruction and Development; IIC=Inter-American Investment Corporation; EIB=European Investment Bank; EUROFIMA=The European Company for the Financing of Railroad Rolling Stock; CEB=Council of Europe Development Bank; NIB=Nordic Investment Bank

Data per end of 2001 except for IBRD & IFC, where data is for June 2002

Note: the lower the index, the lower the credit risk embedded in the institution

*Source: Standard & Poor's, Supranationals Special Edition 2002, September 2002*

**Table 3: Supranational Issuance in Australia**

| Issuer | Issue Size A$m | Coupon (per cent) | Launch Date | Maturity |
|---|---|---|---|---|
| Asian Development Bank | 1,000 | 5.375 | Sep 98 | 15 Sep 03 |
| Asian Development Bank | 500 | 5.25 | Apr 99 | 15 Sep 04 |
| IBRD* | 1,000 | 5.50 | Jun 99 | 14 May 03 |
| European Investment Bank | 400 | 6.00 | Sep 99 | 15 Jul 05 |
| European Investment Bank | 200 | 6.00 | Feb 01 | 15 Jul 05 |
| Inter-American Development Bank | 675 | 5.00 | Mar 01 | 15 Nov 06 |
| EUROFIMA | 300 | 5.00 | Apr 01 | 15 Apr 03 |
| Asian Development Bank | 500 | 6.25 | Jun 01 | 22 Jun 11 |
| EUROFIMA | 200 | 6.25 | Jul 01 | 22 Aug 11 |
| EUROFIMA | 100 | 6.50 | Aug 01 | 22 Aug 11 |
| EUROFIMA | 100 | 6.50 | Oct 01 | 22 Aug 11 |
| EUROFIMA | 100 | 6.50 | Feb 02 | 22 Aug 11 |
| EUROFIMA | 300 | 6.50 | Jul 02 | 22 Aug 11 |
| EUROFIMA | 200 | 6.50 | Jul 02 | 22 Aug 11 |

*includes two increases, in Oct 1999 and Jan 2000

IBRD=International Bank for reconstruction and development (The World Bank); EUROFIMA=The European Company for the Financing of Railroad Rolling Stock

*Source: TD Securities report, Supranational Borrowers and the Australian Capital Markets, 2 September 2002* benchmarks in the currencies in which they issue in volume."

In its supranational report, S&P offers an index of quality of loan and investment portfolio for various supranational institutions (table 2). According to S&P, this index is a summary measure of the embedded risk in an institution's loan and equity portfolios, and the higher the index, the higher the embedded credit risk in the portfolio. The average among the supranationals covered is 8.8. But certain supranationals, including ones that have issued in the Australian market, have extremely low indices, indicating very low credit risk. The least risky supranational is EUROFIMA, followed by the EIB, then Nordic Investment Bank (NIB).

The possibility for the supranationals to play a greater role in Australia as a complementary source of liquid and risk-free investment or as a benchmark in the pricing of other debt securities is limited if there is not greater issuance by institutions in this asset class in the Australian market.

Looking at current outstandings by the supranational borrowers in Australia, it seems that there has been limited commitment by these issuers to build benchmark curves in the domestic market (table 3). However, four supranationals have established Australian dollar medium-term note (MTN) programmes (table 4), and others have amended their euro MTN (EMTN) or global documentation to include the possibility of issuing in the Australian market. Some have also been through the process of applying to have their securities issued in the domestic market classified as eligible collateral for repurchase (repo) transactions by the RBA (table 5). These issuers are the Asian Development Bank (ADB), the EIB, EUROFIMA, the Inter-American Development Bank (IADB) and the International Bank for Reconstruction and Development (IBRD). The Council of Europe Development Bank (CEB) has also obtained agreement from the RBA to have any securities it issues in the Australian market in the future as repo eligible collateral. The supranationals point out that having their securities classified as eligible collateral for repo transactions adds to their liquidity in the Australian market.

The fact that these issuers have gone to the considerable expense – in terms of both time and money – to create these programmes and have their securities classified as eligible by the RBA for repo collateral, could be argued to show a level of commitment on their behalf to the Australian market.

In determining the potential for each supranational borrower to issue in benchmark, liquid transactions in the Australian market, it is necessary to look at their annual funding requirements (table 6).

**Table 4: Supranationals with A$ Domestic Programmes**

| Issuer | Size of programme | Date Established | Arranger(s) |
|---|---|---|---|
| European Investment Bank | A$3 billion | 1999 | RCB |
| Inter-American Devt. Bank | A$5 billion | 1999 | Westpac |
| Nordic Investment Bank | A$2 billion | 1999 | ML Australia |
| Council of Europe Devt. Bank | A$5 billion | 2001 | CBA |

Note: This table includes only the eight supranationals interviewed for this report. INSTO was unable to confirm with the European Bank for Reconstruction and Development whether it has established a programme in Australia. Neither the two biggest supranational issuers in Australia – the Asian Development Bank and the European Company for the Financing of Railroad Rolling Stock (EUROFIMA) – nor the World Bank have formal Australian dollar domestic programmes.

CBA=Commonwealth Bank of Australia; ML=Merrill Lynch; RBC=Royal Bank of Canada; Westpac=Westpac Banking Corporation

*Source: INSTO, 4 December 2002*

**Table 5: Supranational Securities Eligible as Collateral for RBA Repurchase Agreements**

| Issuer | Coupon | Maturity | Rating (S&P/Moody's) |
|---|---|---|---|
| Asian Development Bank | 5.375 | 15 Sep 03 | AAA/Aaa |
| Asian Development Bank | 5.25 | 15 Sep 04 | AAA/Aaa |
| Asian Development Bank | 6.25 | 15 Jun 11 | AAA/Aaa |
| European Investment Bank | 6.00 | 15 Jul 05 | AAA/Aaa |
| EUROFIMA | 5.00 | 30 Apr 03 | AAA/Aaa |
| EUROFIMA | 9.875 | 17 Jan 07 | AAA/Aaa |
| EUROFIMA | 6.50 | 22 Aug 11 | AAA/Aaa |
| Inter-American Devt. Bank | 5.00 | 15 Nov 06 | AAA/Aaa |
| IBRD | 5.50 | 14 May 03 | AAA/Aaa |

EUROFIMA=The European Company for the Financing of Railroad Rolling Stock; IBRD=International Bank for Reconstruction and Development (The World Bank)

*Source: Reserve Bank of Australia, November 2002*

**Table 6: Annual Funding Targets of Supranational Borrowers (billion)**

| Issuer | 2002 | 2003 |
|---|---|---|
| Asian Development Bank | US$5.8 | US$5-6 |
| European Investment Bank | euro38 | euro40 |
| EUROFIMA | CHF3 | CHF3.5 |
| Inter-American Devt. Bank | US$8 | US$7-9 |
| IBRD (World Bank) | US$15-20 | US$15-20 |
| Nordic Investment Bank | euro3.2 | euro3-3.5 |
| Council of Europe Devt. Bank | euro3.6 | euro3-3.5 |
| European Bank for Reconstruction & Devt. | euro2-3 | (figure not obtained) |

*Source: INSTO, 4 December 2002*

## The smaller supranationals: CEB, NIB, EUROFIMA, EBRD

### EUROFIMA

Of the smaller supranationals, EUROFIMA is the only one to have been active in the Australian market – in fact it is the second largest supranational borrower in Australia, behind the ADB. The supranational has two outstanding issues in the Australian market – a A$300 million five percent transaction maturing on 15 April 2003, and a total issue size of A$1 billion (including a first issue of A$200 million and five taps, all done in 2001/2002) with a coupon of 6.5 percent and maturing on 22 August 2011 (table 3). The issuer has been active in private and public issues in the Australian market since 1987, and has outstanding bond volumes in Australia in excess of A$1.6 billion. Since June 2000, the Australian dollar sector ranks fourth in terms of EUROFIMA's financing, behind the US dollar (29 per cent), the Swiss franc (23 per cent), and the euro (21 per cent). For EUROFIMA, a benchmark transaction is in the region of CHF2 billion.

EUROFIMA is the supranational with the lowest credit risk according to S&P (table 2). However, the fact that it is not the only source of funding for the European railways which comprise its membership – and therefore has to provide very competitive funding levels – means that the issuer is an arbitrage-driven borrower. In addition, EUROFIMA's funding requirements are not sufficient for the supranational to build a yield curve as a policy in any one currency – the issuer concentrates its efforts in arbitrage opportunities, generally in smaller markets.

### Council of Europe Development Bank

CEB established a Kangaroo programme in December 2001, which allows the issuer to raise up to A$5 billion in the domestic market. At the time the programme was established there was an opportunity to issue in Australia but the market moved away before a deal could be finalised. Most of CEB's transactions are swapped back into three-month Euribor, which means the issuer is largely dependent on an attractive basis swap in terms of its ability to issue in Australia. During 2002 CEB did raise funds in Australian dollars, all targeted at retail investors – through two transactions in the Eurobond market, and one A$70 million three-year Uridashi deal completed in mid-July. The Eurobond deals were issued off CEB's EMTN programme – a A$50 million increase of a A$100 million deal completed in 2001, which matures on 18 December 2012 and a five-year A$100 million deal maturing on 30 October 2007.

Even if the basis swap moved back out to levels that would attract the CEB to the Australian market it is unlikely that the organisation would be a benchmark issuer in the domestic market due to its smaller funding requirements (table 6). The only possibility that could exist for benchmark transactions in the Australian market from the CEB would be if the supranational exercised its well-known flexibility to bring a large deal in a niche market.

### Nordic Investment Bank

NIB has not yet issued in Australia, but it established a programme to issue up to A$2 billion in the Kangaroo market in 1999, with Merrill Lynch Australia as arranger.

Kari Kukka, vice president and head of funding at NIB, says the Australian market is of major interest to NIB and the supranational would still like to issue there. According to Kukka, when NIB set up the programme its idea was to approach the Australian market in a way similar to that in which the borrower has built a yield curve in the sterling market – through regular issuance of smaller deals in different maturities. He comments: "We completed an Australian roadshow in 1999 and we have been lined up to do a deal in Australia for a long time. Unfortunately, up to now, the funding level after swap has not been satisfactory." Kukka explains that the only currencies NIB is permitted to warehouse are US dollars, euros and the Nordic currencies. Therefore, the proceeds of transactions issued in any other currency have to be swapped into one of NIB's warehouse currencies.

NIB raised A$254 million in the Uridashi market in the year to 5 December 2002.

Like his counterparts at other supranationals, Kukka says another reason preventing NIB from having a greater presence in Australia is the fact that in the Australian market, triple A supranational credits are not being sufficiently distinguished from other triple A credits. He comments: "This is a pity because the funding price requirements of some non-supranational triple A credits are not on the same level as the borrowers in the supranational family."

## The bigger supranationals: IBRD, IADB, ADB, EIB

By far the biggest global borrower among the supranationals in this report is the EIB (with an annual funding requirement of euro38 billion in 2002, to step up to euro40 billion in 2003). This is followed by the IBRD (the World Bank) with annual funding requirements of between US$15 billion and US$20 billion; the IADB with a funding requirement of US$8 billion in 2002 and between US$7 billion and US$9 billion in 2003; and the ADB, with US$5.8 billion raised in 2002, projected to be between US$5 billion and US$6 billion in 2003. All four supranationals have issued at least one transaction in Australia.

### The World Bank

The IBRD has issued only one transaction in the domestic market – the A$1 billion 5.5 per cent deal completed in July 1999, which matures on 14 May 2003. The World Bank does not have a formal domestic Australian dollar programme. Says Doris Herrera-Pol, manager, capital markets operations at the World Bank: "We execute transactions as opportunities present themselves and whoever presents the best offer for an underwritten deal with a swap gets the mandate. And the best offer doesn't necessarily mean the lowest cost. For benchmark transactions we need to make sure that the bonds get priced at a level that clears the market so that investors will be happy with the bond's performance."

Herrera-Pol says the borrower's funding in Australian dollars is usually swapped into US dollars because most IBRD borrowers want US dollar loans and the bank's Articles of Agreement do not allow it to take on currency risk. She comments: "This means that for us to issue Australian dollars the bond proposals have to come together with a swap out of Australian dollars that has to be competitive vis-à-vis alternative ways to obtain US dollar funding. Our ability to reach our cost targets cannot be taken for granted but rather depends on market conditions. Therefore, we cannot commit ourselves to a regular Australian dollar issuance programme or a certain volume."

Herrera-Pol adds that the World Bank's borrowing history in Australian dollars gives testimony to the unpredictability of the borrower's capacity to issue in Australian dollars. She says: "In fiscal year 2003 that started on July 1, we have managed to raise US$2.5 billion equivalent in Australian dollars (by 2 December). But in the entire FY02 we were only able to raise US$1 billion in Australian dollars, and in FY01 we were not able to obtain any competitive funding at all in Australian dollars, while we raised only US$0.4 million equivalent in Australian dollars in FY00. Note also that the only bonds that were placed in the domestic market (partly because it was a global bond) were those we did in FY00. The other transactions have all been placed in Japan."

Despite the World Bank's relatively small activity in the Australian market to date, and its inability to commit to regular funding in Australian dollars, Herrera-Pol says: "We would be keen to explore ways in which our securities could be made more attractive or considered as a risk-free asset for domestic investors. This could help to improve our pricing and the availability and frequency of attractive funding-cum-swap opportunities for the bank in Australian dollars."

### Inter-American Development Bank

According to Hakan Lonaeus, chief of the capital markets division at the IADB, the supranational's funding target for 2003 will be at the higher end of the US$7 billion to US$9 billion range – funds raised by the IADB in 2002 totalled US$8 billion. The IADB has one outstanding deal in the Australian market, issued under its A$5 billion Kangaroo programme arranged by Westpac Banking Corporation (now branded Westpac Institutional Bank) and signed on 19 July 1999. The A$675 million 5.0 per cent transaction was completed in March 2001, with a maturity date of 15 November 2006. Lonaeus comments: "When we did the transaction in 1999, it was on a rare occasion when we could reach our funding targets by doing a deal in Australia, as a result of a favourable basis swap. At that time the market offered us good arbitrage possibilities. We had been looking at the Australian market for a long time before the deal and we have been looking at it since then, but we have not yet been able to replicate the same opportunities."

So, for Lonaeus as for many of his counterparts at supranational borrowers, a favourable basis swap is a crucial element in being able to issue in the Australian market (see below for more information on the basis swap). He says: "We have to swap all our transactions into the major currencies of our cash flows, which is dominated by US dollars. We would be happy to use the Australian market to a greater extent if it was cost-effective compared to the other markets we issue in. We like the Australian market as it provides us with diversification and it is always good to find new investors for our bonds. In addition, we know that if Australian investors become used to the IADB's name in Australian dollars, they may then turn to our bonds in other currencies. Unfortunately, the Australian market recently has been similar to the Euromarket, where the results haven't been sufficiently attractive for us to issue there – the diversification would come at too much of a cost with the way the basis swap has been lately."

### Asian Development Bank

The ADB is the biggest supranational issuer in Australia to date, with a total outstanding of A$2 billion in three transactions (table 3). The bank opened up the Kangaroo market in September 1998 with a A$1 billion 5.375 per cent transaction maturing on 15 September 2003. This was followed in April 1999 with a A$500 million 5.25 per cent deal maturing on 15 September 2004, and in June 2001 the ADB issued another A$500 million 6.25 per cent deal maturing on 22 June 2011. Although the issuer has established liquid transactions in three maturities in the Australian market, it does not have a formal programme for Kangaroo issuance. According to Juanito Limandibrata, assistant treasurer and head of the funding division at the ADB, the supranational conducts its transactions in Australia on a stand-alone basis. He comments: "We do not have a natural funding requirement in Australian dollars, so when we do a transaction in the Australian market the proceeds need to be swapped back into US dollars, the ADB's main operational currency. As a result, it is not easy to predict how much it is possible for the ADB to raise in the Australian market on an annual basis, as this will depend on whether the funding level will compare favourably with what we can achieve in the US dollar market. In 2002 the cost efficiency was not there and therefore we have not tapped the Australian bond market this year."

Limandibrata says although a good basis swap is one of the most important factors for the ADB in making a decision to tap the Australian bond market, other factors are also taken into account. He comments: "We have a policy to diversify our funding sources across markets and maturities. In the last transaction we did in Australia, for example, we were able to do a bond issue in a 10-year maturity on a cost-efficient basis, which is attractive for us in terms of matching the average life of our borrowings with our loans."

In responding to the criticism of many Australian fixed income investors that offshore borrowers tend to be opportunistic in their approach to the domestic market, Limandibrata says the ADB has proved that this is not entirely the case. "We have not been opportunistic relative to other supranationals in the Australian market," he comments. "With the exception of 2002 we have issued on a regular basis since our first deal in 1998. We have not been able to issue in 2002 because the market has not been cost-efficient throughout the year. Obviously we have certain thresholds with regard to our funding levels, but we balance that with our strategic objective to develop a presence in the Australian market. Based on the funding levels we achieved through our three Australian deals we have done so far, it is fair to say that our approach is not an opportunistic one."

On the question of whether supranationals could fulfil the role of surrogates to the commonwealth government, Limandibrata says with current market conditions that is unlikely. But he adds: "The commonwealth government outstandings are just over A$60 billion, roughly US$30 billion. I would say that the combined funding requirement of supranationals is over US$100 billion. So while it is unlikely that supranationals could replace CGS if cost efficiency remains as it is, if it improves we could very well become a government surrogate." Limandibrata stresses that most supranationals do not have a requirement for Australian dollars, so how much supranationals will issue in Australia will depend on cost efficiency. He comments: "If this cost efficiency becomes as competitive the US dollar market, supranational issuance may increase and, given our triple A rating and status, it may be possible over time for supranational borrowers to play a greater role in the Australian market as government bond surrogates."

### The European Investment Bank

Not only is the EIB the biggest supranational lender and borrower in the international markets, but it also scores the second-lowest ranking in S&P's credit quality index, meaning that it carries very low credit risk. The score of 1.3 by the EIB compares with an average of 8.8 for all supranational institutions. In addition, of all the supranational borrowers INSTO spoke to for this report, the EIB is the institution most committed to building a benchmark yield curve in the Australian market. Says Carlos Guille, head of funding for America, Asia and Pacific in the capital markets department at the EIB: "We are very keen to create a yield curve in Australian dollars, and we have the capacity to issue large benchmarks in the domestic market."

The EIB has a A$3 billion Kangaroo programme, established in 1999 with Royal Bank of Canada as arranger and an open dealer group based on reverse enquiry. The borrower debuted in the Australian market in 1999 with the Matilda programme for A$750 million, which was fully used. More recently, the EIB inaugurated its Kangaroo programme in September 1999 with a A$400 million 6.0 per cent transaction maturing on 15 July 2005. In February 2001 this transaction was tapped to increase it by A$200 million, taking the total size of the issue to A$600 million. The entire issue is deemed eligible as repo collateral by the RBA.

Says Guille: "The fact that we have established a Kangaroo programme, issued, increased the issue and been through the process of having our securities in Australia deemed eligible as repo collateral shows that we are committed to the Australian market. In 2003 our funding requirements will be in the range of euro40 billion, so we have both the size and critical mass to be in Australia with a regular presence. We think we have done everything we can to please Australian investors – and you don't do all of that for one transaction. You do it with an eye on your strategy for the future."

Guille points out that the EIB is the only supranational with very liquid benchmarks established in US dollars, euros and sterling, and he stresses that it is part of the EIB's strategy to build liquid benchmark curves in many different currencies. "We are not opportunistic borrowers," says Guille. "On the contrary, we are interested in developing other markets and having a regular presence there."

Guille says an attractive basis swap is not the only factor preventing the EIB from establishing a larger presence in Australia. However, he acknowledges that an unfavourable basis swap means that for the EIB to meet its all-in cost of funds, investors would have to be more flexible in pricing an EIB deal in the Australian market. Talking about strategic versus opportunistic issuance, Guille comments: "Australian investors seem to be very concerned that all supranational borrowers are opportunistic. We think the definition of opportunistic and strategic issuance is very subjective, and it's even more difficult to distinguish between the two in a small market like Australia." However, Zuriñe de Aguirre, capital markets officer for America, Asia and Pacific at the EIB, points out that during 2002 the EIB had strong demand to tap its existing Australian deal, to levels of between A$300 million and A$400 million. "We declined to do this," she comments, "because due to new tax rules in Europe, it would have penalised some of the original and potential future European investors in that transaction. This contradicts the argument that we are an opportunistic borrower, and shows that we do care about our investors."

Says Guille: "Our message to institutional investors around the globe is that we provide consistency, transparency and liquidity. Transparency is evidenced by the fact that our benchmark bonds are quoted on TradeWeb, Market Axess, Reuters, Bloomberg and MTS. Consistency is evidenced by our benchmark yield curves established in euro, sterling and US dollars, with many benchmark lines in both euros and US dollars issued in global format. The number of benchmarks we have in euros, US dollars and sterling also shows the liquidity of the EIB's transactions." By November 2002, the EIB had raised more than euro37 billion in 14 currencies, through in excess of 200 transactions.

A glance at the EIB's issuing activities confirms that it has a track record in building benchmark yield curves in different currencies. The EIB is the largest sole supranational benchmark issuer in US dollars, euro and sterling. In US dollars, the EIB has increased its new issue size to US$3 billion in 2002, from US$1 billion in 2000. Since January 2001 all new US dollar benchmark transactions have been in a global format, and in calendar year 2002, the EIB had completed three global issues of US$3 billion each, by the end of November. The EIB's US dollar benchmark curve consists of 12 outstanding lines with maturities ranging from April 2004 to May 2009, totalling US$28 billion. This includes US$17 billion of global bonds with an average issue size of US$3 billion each. In the euro denominated Euromarket, the EIB's benchmark bonds are euro-area reference notes (EARNs). There are 11 EARNs outstanding in maturities ranging from 2003 to 2012, resulting in the EIB having the most complete quasi-sovereign euro yield curve in this market. Total benchmark bonds outstanding in euros is around euro51 billion, of which euro21 billion is in global format. In the sterling market, the EIB is the benchmark non-gilt issuer with over £32 billion (US$50.2 billion) outstanding. Of this, £19.3 billion is outstanding in 13 benchmark lines in maturities ranging from December 2005 to April 2039.

Says Guille: "We have an average size of euro5 billion in our benchmark bonds in euros, and the whole euro curve is traded with similar bid-offer spreads as the most liquid European governments. In addition, in sterling, in some lines dealers inform us that we are even more liquid than gilts. So we have proved to be considered in some markets as alternatives or surrogates to government issuers."

Guille says the EIB has a wealth of experience in building benchmark curves in various currencies, and each market has to be approached in a different way depending on its conditions. He thinks the best approach for the EIB to build a yield curve in Australia may be similar to the EIB's experience in the sterling market, when the organisation matched the maturity profile of several gilts and built the benchmark liquidity by way of add-ons. He comments: "We recognise that bringing super-large sizes – up to A$5 billion to match the liquidity of the Australian government's 11 benchmark lines – in one go could be a problem. We would probably start with a minimum size of A$1 billion and then build it up when the market is ready. As you know, it is a very difficult compromise between liquidity and performance."

The EIB would be the strongest candidate among the supranational borrowers for providing a complementary source of risk-free liquidity in the Australian market. But there are still several obstacles to be overcome before supranationals – even the EIB – are encouraged to step up their issuance in Australia.

## First obstacle – price

Like all supranationals, the EIB will only issue more in the Australian market at the right price. Says Guille: "We cannot be priced in the Australian market at 15 basis points more expensive than, for example, our US dollar transactions." And therein lies the rub. Australian fixed income investors have so far not shown willingness, say supranational borrowers, to price their securities in line with where the borrowers fund in other markets, or at least in line with Australian government and semi-government debt.

However, the investors say they have not been encouraged to do so because there has not been sufficient issuance by the supranationals to warrant this. As one fixed income investor comments: "While supranational issuance remains at present levels, we definitely need to be paid a liquidity risk premium as compensation for investing in their bonds. We know that the supranationals would like to issue in this market at a level between the semi-governments and CGS, but we are not prepared to do that unless we see a commitment from them that they will be in the market more regularly with the aim of providing a curve. Why should we take that exposure for levels below semi-governments? What we need is a consistent supply of generic bonds if the supranationals want to fulfil the role of surrogates to the government bond market."

Warren Bird, head of fixed interest and foreign exchange at Colonial First State Investments, adds: "I think that investing with supranationals is, in a yield sense, a "gimme". For example, The World Bank is the best AAA in the world, probably safer than the Australian government given the level of support it gets from a large number of strong government borrowers. The thing is, though, that while supranationals are only occasional issuers of a couple of lines they will not have the degree of liquidity that is needed for better pricing. If they would undertake to step up to the plate and issue in large transactions, encourage trading, encourage a futures contract to be traded off their stock, and so on, then they would trade at CGS levels." Bird adds that the ADB and IADB issues, for example, are trading at a similar margin to semi-governments on smaller volumes of issues (table 7). He comments: "This says to me they are being priced fairly and if they had a few billion on issue in the lines they have in the market, they would trade below semis. In terms of liquidity, the ball is in their court."

A third fixed income investor comments: "I would be interested to see someone canvass the supranationals to see if they want to replace the government with a viable risk-free yield curve. Without CGS, I think the market will be prepared to pay up for risk-free assets. But will the market pay enough for supranationals to replace the government as a liquid risk-free curve?"

The ADB's Limandibrata understands investors' need for liquidity. He comments: "It is a bit of a catch-22 situation. What we need is a wider interest rate swap spread, which has been the case historically. If there was a wider spread, it may lead to bigger issuance volume from the supranationals. In the process, we would be able to offer investors better liquidity in our bonds. Given such liquidity, it is not difficult to achieve our targeted pricing, particularly as our bonds are already trading very closely in the secondary market against the semi-governments."

Guille and de Aguirre at the EIB say they are not so arrogant in their funding targets as to expect Australian investors to pay a price that would be flat to CGS – they acknowledge that investors will require some yield for buying their paper. However, says de Aguirre, a reasonable expectation would be "in line with government and semi-government securities – somewhere in between the two, considering that we have outperformed the semis in recent years". She adds: "What is predictable about our price range expectations in Australia is that we are not interested in targets below our average targets in other markets." Guille adds: "This is consistent with our strategy around the world. It would be unfair to penalise investors in one market at the expense of investors in another." According to de Aguirre, the EIB is not interested in coming back to Australia to do a small deal fighting for one or two basis points. She emphasises: "We want to be seen as a complementary source to the government as a quasi-sovereign issuer in the Australian market, and this needs to be reflected in the pricing levels. If this is accepted by domestic investors, we will issue a liquid benchmark transaction in Australia."

The IADB's Lonaeus says he is used to not getting the full benefit of his organisation's triple A rating in many markets, even those where government bonds are rated less than triple A. He comments: "It is very difficult to issue through the sovereign curve in any market and we understand that – the market is what the market is. If the choice for Australian investors is between the IADB or a triple A rated semi-government, it would be hard to tell what would be the better option for investors. However, it is always preferable for us to get fair triple A value in any market."

## Second obstacle – placement of supranationals within the UBS Warburg Composite Bond Index

For many supranational borrowers, part of the reason they say they are not being given a fair go in terms of pricing in the Australian market is that in the main benchmark used by Australian fixed income investors – the UBS Warburg Composite Bond Index – supranationals are included in the corporate section of the index. For most investors, this means that in comparing triple A credits, supranationals are viewed as expensive when viewed against other borrowers in the credit section of the index. Guille reflects the view of many supranational and agency borrowers INSTO spoke to while preparing this paper – that Australian fixed income investors are not sufficiently distinguishing between triple A and triple A paper. He comments: "Everybody knows that the true corporate sector offers investors better yield. But everyone also knows what can happen with these types of investments. Supranationals like the EIB are not in the same class as corporate borrowers – they are different both because of the size of the deals they can undertake and the credit quality they offer."

In the UBS Warburg Composite Bond Index, as at 2 December 2002, corporations comprise

**Table 7: Sample Rate Sheet: Supranationals vs Semi-Governments and Commonwealth Government Securities**

| Rating | Issue Amt ($m) | Issuer | Coupon (%) | Maturity | Yield (%) | Spread to CGS | Spread to Swap | CGS Benchmark | Initial Issue Details: Bond Issue Spread | Initial Issue Details: Swap Issue Spread | Initial Issue Details: First Issue Date |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Agency & supranational** | | | | | | | | | | | |
| AAA/Aaa | 300 | E'FIMA | 5.00 | 30 Apr 03 | 4.750 | 3.0 | -9 | Aug 03 | | 0.0 | Apr 01 |
| AAA/Aaa | 1,000 | IBRD | 5.50 | 14 May 03 | 4.750 | 3.0 | -9 | Aug 03 | 25 | -21.5 | Oct 99 |
| AAA/Aaa | 1,000 | ADB | 5.38 | 15 Sep 03 | 4.810 | 9.0 | -6 | Aug 03 | 39 | -13 | Sep 98 |
| AAA/Aaa | 500 | ADB | 5.25 | 15 Sep 04 | 4.975 | 7.0 | -9 | Sep 04 | 35 | -7 | May 99 |
| AAA/Aaa | 600 | EIB | 6.00 | 15 Jul 05 | 5.010 | 0.0 | -21 | Jul 05 | 37 | -22 | Feb 01 |
| AAA/Aaa | 675 | IADB | 5.00 | 15 Nov 06 | 5.405 | 23.0 | -3 | Nov 06 | 47 | -5 | Mar 01 |
| AAA/Aaa | 500 | ADB | 6.25 | 15 Jun 11 | 5.865 | 23.0 | 2 | Jun 11 | 47 | -2 | Jun 01 |
| AAA/Aaa | 1,000 | E'FIMA | 6.50 | 22 Aug 11 | 5.950 | 31.5 | 10 | Jun 11 | 52 | | Jul 01 |
| **Government** | | | | | | | | | | | |
| AAA/Aaa | 5,712 | CGS | 9.00 | 15 Sep 04 | 4.905 | | -16 | | | | |
| AAA/Aaa | 5,502 | CGS | 7.50 | 15 Jul 05 | 5.010 | | -21 | | | | |
| AAA/Aaa | 6,103 | CGS | 6.75 | 15 Nov 06 | 5.175 | | -26 | | | | |
| AAA/Aaa | 3,907 | CGS | 10.00 | 15 Oct 07 | 5.290 | | -27 | | | | |
| AAA/Aaa | 4,494 | CGS | 8.75 | 15 Aug 08 | 5.415 | | -22 | | | | |
| AAA/Aaa | 5,709 | CGS | 7.50 | 15 Sep 09 | 5.530 | | -22 | | | | |
| AAA/Aaa | 5,797 | CGS | 5.75 | 15 Jun 11 | 5.635 | | -22 | | | | |
| AAA/Aaa | 4,800 | CGS | 6.50 | 15 May 13 | 5.715 | | -23 | | | | |
| AAA/Aaa | 800 | CGS | 6.25 | 15 Apr 15 | 5.815 | | -16 | | | | |
| **Semi-government** | | | | | | | | | | | |
| AAA/Aaa | 2,951 | NSWTC | 7.00 | 01 Apr 04 | 4.905 | 0.0 | -5 | Sep 04 | | | |
| AAA/Aaa | 2,609 | NSWTC | 6.50 | 01 May 06 | 5.275 | 10.0 | -7 | Nov 06 | | | |
| AAA/Aaa | 3,181 | NSWTC | 7.00 | 01 Dec 10 | 5.820 | 18.5 | 1 | Jun 11 | | | |
| AAA/Aaa | 1,720 | NSWTC | 6.00 | 01 May 12 | 5.900 | 26.5 | 0 | Jun 11 | | | |
| AAA/Aaa | 2,388 | QTC | 6.50 | 14 Jun 05 | 5.125 | 11.5 | -8 | Jul 05 | | | |
| AAA/Aaa | 2,007 | QTC | 6.00 | 14 Jun 11 | 5.835 | 20.0 | -2 | Jun 11 | | | |
| AAA/Aaa | 1,037 | WATC | 10.00 | 15 Jul 05 | 5.155 | 14.5 | -6 | Jul 05 | | | |
| AAA/Aaa | 926 | WATC | 7.00 | 15 Apr 11 | 5.870 | 23.5 | 4 | Jun 11 | | | |
| AAA/Aaa | 1,048 | TCV | 5.25 | 15 Nov 04 | 5.005 | 10.0 | -9 | Sep 04 | | | |
| AAA/Aaa | 1,306 | TCV | 6.00 | 15 Nov 06 | 5.330 | 15.5 | -10 | Nov 06 | | | |
| AAA/Aaa | 1,459 | TCV | 5.50 | 15 Sep 10 | 5.780 | 14.5 | -4 | Jun 11 | | | |
| AAA/Aaa | 1,046 | TCV | 6.25 | 15 Oct 12 | 5.905 | 27.0 | -2 | Jun 11 | | | |
| AA+/Aa2 | 700 | SAFA | 6.50 | 15 Aug 05 | 5.195 | 18.5 | -4 | Jul 05 | | | |
| AA/Aa2 | 676 | TAS | 9.00 | 15 Nov 04 | 5.085 | 18.0 | -1 | Sep 04 | | | |
| AA/Aa2 | 655 | TAS | 7.00 | 15 Jul 05 | 5.200 | 19.0 | -2 | Jul 05 | | | |

CGS=commonwealth government securities; E'FIMA=European Company for the Financing of Railroad Rolling Stock; IBRD=International Bank for Reconstruction and Development; ADB=Asian Development Bank; EIB=European Investment Bank; NSWTC=New South Wales Treasury Corporation; QTC=Queensland Treasury Corporation; WATC=Western Australia Treasury Corporation; TCV=Treasury Corporation of Victoria; SAFA=South Australian Government Financing Authority; TAS=Tasmanian Public Finance Corporation

*Source: National Australia Bank, 4 December 2002*

31 percent, semi-governments 36.88 percent and commonwealth securities 32.12 percent. Within the corporate section, 26 percent of bonds outstanding come from sovereigns/supranationals (as defined by UBS Warburg – note that some agency borrowers are included within UBS Warburg's definition of "sovereign/supranational", while at least one agency borrower – BNG – is classified as a "bank" within this index). Supranationals comprise 8.0 per cent of the entire index.

Supranationals argue that it would lead to better pricing results – and therefore more liquidity from this sector of the market – if they were included with the governments or semi-governments, or cited in a category of their own. As the IADB's Lonaeus says: "We generally think that to the extent that we have any effect on indices, we prefer to be on our own or with government bonds, rather than in the corporate section. If we are put together with corporations, we become the most expensive corporate bonds available, whereas if we are in with governments or on our own, we become more attractive for investors." He adds that in the US market the IADB has been partly successful in arguing that it should be classified as part of the agency market. Comments Lonaeus: "Most of the investment banks have moved the trading of our bonds from the corporate to the agency desk, which has a similar effect to changing the composition of the index. I think if supranationals are in their own category or placed with government or semi-government issuers, it would strengthen demand for their paper and the tendency would be to improve pricing."

The EIB's Guille concurs. He comments: "We have done quite a lot of work to be placed correctly in the UBS Warburg Composite Bond Index. We believe the question of the index is very important as it would broaden our investor universe." He adds: "If we were priced in line with government and semi-government paper in Australia, investors would benefit from a pick up in yield, which at the absolutely low levels they are used to receiving for government paper would make a substantial difference to their portfolios."

Limandibrata at the ADB says the possibility of a change in the index with regard to the placement of supranationals may increase if a decision is taken by the commonwealth government to continue to decline or buy back its debt. He comments: "Of course we would like to see our bonds in a different category within the index. This will require a change in the mandates of most institutional investors. To facilitate this change, we should be prepared to spend more time and effort with investors to update them on our credit strength and funding strategy. I suspect that if the government's plans to further reduce its debt are materialised, this change become's inevitable."

The issue of where to place supranationals in the index is not new. For example, it was discussed in some detail in in a feature published in INSTO magazine in October 2001 (*Measuring Up*, page 30). And Rebecca Mills, associate director in indices research at UBS Warburg, comments: "The question of the supras being transferred to the government index has been raised a number of times. It has become more topical recently with the dwindling supply of CGS. As a result, we recently conducted a market survey to gauge investors' views on supras being in the credit index. The majority of clients responded that it is appropriate for supranationals to be included in the credit portion of the index and in cases of doubt we should refer to the global precedent. All global indices clearly state in their inclusion criteria that their government indices contain domestic government issues only."

Furthermore, says Mills, when USB Warburg questioned investors as to whether the supranationals being included in the credit index makes any difference to their investment approach, the response was that it makes no difference and that most mandates explicitly separate commonwealth and state debt from other debt.

She continues: "As for the issue regarding the retirement of commonwealth debt, I have spoken to several clients on this issue in relation to the ramifications for the Composite Bond Index. In looking at this issue it is important to look at what the purpose of an index is. In the case of the Composite Bond Index, its purpose is to track fixed rate CGS, semi-government and corporate bonds issued into the Australian debt market. If the commonwealth bonds on issue were to reduce in size, the Composite Bond Index should reflect that. If, due to the lack of risk-free assets to invest in, mandates change so that clients can invest in say larger portions of semi-government and specifically supranational debt, we would be happy to consider setting up a new index to reflect the pool of assets which some clients are now investing in."

Further, Mills points out that the issue of changing an index or creating a new index to better reflect the times is not determined by UBS Warburg, but its clients. She comments: "It is important not to forget that UBS Warburg calculates and publishes over 150 debt market indices every day. These indices represent all asset classes available to investors and can be cut and diced in numerous ways. Fund managers and asset consultants have access to all these indices, their pricing parameters, analytics, historical levels, rules for inclusion and methodology. We are happy to recommend to clients which index fits their investment profile, but at the end of the day it is up to the fund manager and the asset consultant to decide which benchmark best meets their investment criteria."

It may well be that international indices reserve the government section of their indices for domestic government debt only, but some investment banks separate supranational and agency debt from corporate debt by having them as separate categories within their indices. The Salomon Smith Barney US Broad Investment Grade (BIG) Index, for example, is divided into three main asset classes. These are government/government sponsored, collateralised and corporate. The government/government-sponsored section is divided into domestic and foreign sovereign and sovereign-guaranteed, and government sponsored/regional government. The latter includes agency, supranational, other government-sponsored, regional and regional government-guaranteed debt. As the EIB's Guille points out: "This index is an example where supranationals are placed in the non-risk part of the index. It is only Lehman Brothers and UBS Warburg in Australia where supranationals are not placed in the right part of the index, and we are now working with Lehman Brothers as they are not very consistent. For example, in US dollars they treat Freddie Mac as a government issuer, but in euros they treat it as a credit. There are obvious inconsistencies within the Lehman Brothers indices and we are trying to move our position within those."

The Lehman Global Aggregate Index has three main categories and is similar to the UBS Composite Bond Index in terms of where it places supranational issuers. The three sections in the Lehman index are government, credit and collateralised. The government sector includes Treasuries – government bonds issued in the domestic currency of the government issuing – and agencies. The credit section is divided into corporate and non-corporate. Non-corporate includes sovereign, supranational, local agency and local authority issues.

## Third obstacle – the basis swap

During the course of 2002 the basis swap contracted substantially. As a result, the Australian market has not offered cost-effective funding for international borrowers who need to swap Australian dollars into other currencies. The main reason posited for the contraction of the basis swap is increased issuance in Australian dollars in offshore markets – particularly the so-called Uridashi market in Japan. Uridashis are bonds targeted to Japanese retail investors.

The year 2002 was the year of the Australian dollar Uridashi market, with some massive transactions by a variety of issuers. It is estimated that between A$9 billion and A$10 billion was raised in this market by the beginning of December 2002. However, it must also be taken into account that many of the larger Uridashi transactions were deep discount bonds, meaning that, in the words of one Australian investment banker: "The true level of issuance was around 60 per cent of the announced level."

Apart from Commonwealth Bank of Australia's A$1.4 billion transaction and other activity by Australian issuers in the Uridashi market, most transactions by international borrowers would have ended up with the proceeds being swapped by the issuers into the currencies of their home or lending markets. The EIB raised A$1.285 billion in one single transaction and A$2.245 billion in the Uridashi market during the year. By 5 December the IADB had completed five Australian dollar Uridashi deals, totaling almost A$1.2 billion. The World Bank completed a few Uridashi deals by the beginning of December 2002, totalling the equivalent of US$2.5 billion. The largest of these deals was a A$1.2 billion deep discount bond. The ADB's biggest Australian dollar Uridashi deal in 2002 was a A$1.5 billion deep discount bond. By 5 December the ADB had raised 20 per cent of the US$2.8 billion issued in private placements during 2002 in the Australian dollar Uridashi market, according to Limandibrata.

The amount of Australian dollar issuance in the Uridashi market certainly reflects an appetite for Australian dollar investors to provide much-valued diversity for borrowers.

But the problem for the Australian market is that when the Australian dollar proceeds are swapped back into other currencies – principally US dollars and euros – these relatively big swap transactions have a negative effect on the basis swap – the spread between the Australian bank bill swap rate (BBSW) and either the US dollar-Libor or Euribor rates.

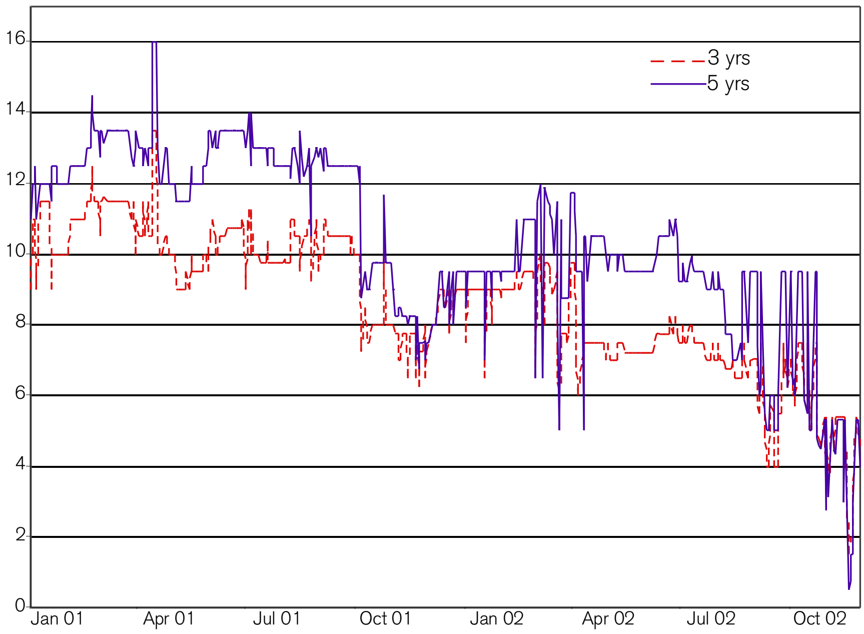
The impact of this on the basis swap has been substantial. On 21 December 2001, the basis swap (A$BBSW/US dollar-Libor) was 8.4 basis points mid-rate in three-year, nine basis points mid-rate in five-year, and 9.5 basis points mid-rate in 10-year. By the end of October 2002 this basis swap was three basis points across all three maturities. On 14 November 2002 it was 0.5 in three-year, flat (zero) in five-year, and -1.5 in 10-year. By the end of November this basis swap had widened slightly, to 5.0 in three-year, 5.5 in five-year and 2.0 in 10-year. But these levels are still substantially below where they were in 2001 (graph 2) – and previously.

A contracting basis swap has led to a marked decline in Kangaroo bond issuance. According to INSTO data, new issuance from the Kangaroo sector totaled A$5.9 billion in 1999, A$3.52 billion in 2000, and A$7.3 billion in 2001. By 1 December 2002, a mere A$2.75 billion was raised by eight Kangaroo borrowers in 12 transactions. The record A$7.3 billion in the Kangaroo sector in 2001 was raised by 18 borrowers in 32 transactions.

Supranationals recognise the double-edged sword created by their issuance in the Uridashi market in Australian dollars, in terms of the negative impact this has had on their potential to raise funds in the Australian market. Says the IADB's Lonaeus: "In 2001 and 2002 5.0 per cent of our funding programme has been raised in Australian dollars, before swaps. And with the exception of one deal, all of this has been raised in Japan. This can be a self-limiting process because most of the Japanese issues are swapped out of Australian dollars, which affects the basis swap and therefore makes issuing in the Australian market much more difficult."

But Limandibrata at the ADB adds: "I think the effect of supranational issuance on the basis swap would be there regardless of how much is issued in the Australian dollar Uridashi market. For example, if supranationals are to tap the Australian bond market more, they will still have to swap most of the proceeds back to either US dollars or euros, which would also cause the basis swap to move. What we need is a wider interest rate swap spread in the Australian market so we are not so dependent on the basis swap. This is the case in most other developed markets, with the exception of Japan."

**Graph 2: Basis Swap A$BBSW/US$ Libor**




*Source: National Australia Bank, 4 December 2002*

## Fourth obstacle – a declining government bond market

Many supranational borrowers say it may affect their ability to issue in the domestic market if there is not a liquid CGS curve. Says Lonaeus: "We issue in very few markets where there is not a liquid government bond market. The most similar position I can recall was when the US government announced a decline in Treasury issuance. This resulted in a widening of supranational spreads. So I'm not sure that a shortage of issuance by the Australian government would help us."

According to Guille at the EIB, if the Australian government buys back all of its bonds, it will affect the derivative markets and therefore the EIB's ability to swap its issues from fixed to floating rate, or between currencies. But he adds: "It would create a difficulty, not an impediment. In other markets where the government bond markets are not so liquid we have still managed to create a presence. The alternative in these situations is to be imaginative – for example, to use correlation with other governments."

The ADB's Limandibrata says a declining government bond market shouldn't impact the secondary market activity of the borrower's bonds in Australia. He comments: "We have three outstanding bonds which trade in the secondary market with quite good liquidity, with the result that we would be able to use that as a reference point in the event of a decrease or disappearance of CGS. In addition, we have established relative pricing against semi-government bonds, so there wouldn't be a huge impact from a pricing point of view." Regarding the ability to swap the proceeds of the ADB's Australian bond issues into other currencies, however, Limandibrata says a liquid interest rate swap market is important. He comments: "To ensure such liquidity, swap market participants need to hedge their market risks on a cost-efficient basis. At the moment this hedging facility is available in the form of a liquid commonwealth government bond market and liquid futures markets. So in the absence of these markets, Australia will need to come up with a suitable alternative."

## Conclusion

It is clear from the supranationals canvassed for this report that while they may provide an alternative source of low-risk liquidity in the Australian market, the supranationals are not ready to step up to the plate and assume the mantle of the government in providing to the Australian market a liquid, risk-free asset class. Even the EIB, which has the biggest annual funding programme and has most clearly expressed the desire to enter Australia with benchmark transactions, is clear on this point. Says Guille: "There are many features of government bonds that supranationals can replicate – for example, being seen as a safe haven in times of economic turmoil, being considered as low-risk long-term investment vehicles, and even providing benchmark interest rates for pricing other securities if a yield curve is built. But the EIB should be seen as complementary, not alternative, to the government markets. We can play a role in developing a market, but we don't think we should substitute governments."

When it is considered that the commonwealth government has 11 benchmark lines with an average size of A$5 billion each, this point is brought into sharp focus. So if the Australian treasury continues to decline its amount of issuance in the Australian market, or is one day in a position to buy back or wind down all its debt, unless the obstacles outlined in this report are overcome, the Australian financial markets will have to find another way to cope without the supply of risk-free liquid investments the CGS market now offers. **insto**

# Appendix 1

## Case study of an agency borrower: KfW

Bilateral agency borrowers have also visited the Australian bond market. In calendar year 2002 to 4 December there were three transactions in the Australian market from three agency issuers (table 8), compared with only two transactions from one supranational – EUROFIMA over the year.

Considering their usually high (triple A) credit ratings and the fact that they are backed by either implicit or implied sovereign guarantees, and in most cases their big volume funding requirements, agencies may also offer liquid, high quality securities for Australian investors.

Kreditanstalt fuer Wiederaufbau (KfW) – the leading non-government borrower in Europe – is the second largest agency borrower in the Australian market, behind Fannie Mae (table 8).

KfW gives impetus to economic, social and ecological development on a global scale. The Federal Republic of Germany owns 80 per cent of KfW's capital and the German federal states hold the remaining 20 per cent. With a direct guarantee of the federal government as well as the additional security of *anstaltslast* (maintenance obligation)* AAA/Aaa rated KfW is Germany's leading promotional bank and plays an active role in the business areas of investment finance, export and project finance, financial cooperation with developing countries and also advisory and other services.

According to Dr. Frank Czichowski, head of capital markets at KfW, the agency's annual funding requirements rose in the last five years to euro52 billion in 2002 (to 5 December) from euro32 billion five years ago. He comments: "Half of our funding is raised by KfW's euro benchmark programme and our US dollar programme, while the other half is raised by targeted issues and private placements."

KfW International Finance, KfW's subsidiary for financing in the international capital markets, has completed two transactions in the Australian market (table 8), bringing a total volume of A$600 million 6.25 per cent bonds maturing on 15 July 2005. The issuer has established a note programme for Australian dollars, with a volume of A$3 billion. Comments Czichowski: "So far we have had good experiences in the Australian market and we are satisfied with the distribution of our securities. Cooperation with banks and investors has been excellent, and we hope to continue this process in the future." He adds that KfW has great potential in the Australian market if the government continues to decrease its bond issuance, or decides to buy back or wind down all its outstanding debt. "Both the Australian market and KfW definitely have a larger absorption capacity for KfW bonds denominated in Australian dollars. KfW's prime quality is based on the high quality of its balance sheet and the fact that all liabilities are guaranteed by the Federal Republic of Germany. In addition to our constant AAA/Aaa rating, the government guarantee makes KfW bonds zero per cent risk weighted assets. This, in turn, makes KfW bonds a prime substitute for government bonds. It should therefore be possible for our securities to become a surrogate for government issues, much the way it has happened in Europe with KfW euro benchmark bonds," he comments. Czichowski adds that KfW has observed over the last few years a convergence of the yield of KfW and government bonds in the euro and US dollar markets. He says: "We would be delighted to see the same development in the Australian market."

Czichowski says the Australian market is important for KfW because it offers the borrower investor diversification, which is of high strategic value to KfW. He says: "We will issue in the Australian market provided we can achieve – on a hedged basis – refinancing levels comparable to our main markets." According to Czichowski, because most of KfW's lending is in euros and US dollars, the swap rate is an important consideration for the issuer.

Regarding the placement of KfW in the corporate section of the UBS Warburg Composite Bond Index – the main benchmark used by Australian fixed income investors, Czichowski echoes the views of the other supranational and agency borrowers interviewed for this paper – that it would be preferable for KfW to be in a supranational/agency category rather than in the corporate part of the index. He comments: "The low credit risk and high quality of KfW bonds should be considered in an index. Because of the triple A rating of Germany, I don't think KfW is placed adequately in the corporate index."

*According to an INSTO/TD Securities report, *German Frequent Borrowers and the Australian Capital Markets*, published in 2002, *anstaltslast* literally translates as 'institutional obligation'. Under this principle of German law, the owners of a public law institution or their proxies have a legal obligation to keep that institution financially viable and in the event of financial difficulties enable it by financial contribution or in some other appropriate manner to perform its obligations when due. This principle is the primary protection available to creditors and is preventative by its very nature. It follows, therefore, that under this principle the institution will in the majority of circumstances be able to meet its debts as and when they fall due.

**Table 8: Agency Outstandings in the Australian Market**

| Issuer | Credit Rating (S&P/Moody's) | Date of Issue | Issue Size (A$m) | Coupon (per cent) | Maturity |
|---|---|---|---|---|---|
| Fannie Mae | AAA/Aaa | Aug 97 | 1,000 | 6.375 | 15 Aug 07 |
| KfW | AAA/Aaa | Jul 99 | 600 | 6.25 | 15 Jul 05 |
| KfW | AAA/Aaa | Feb 01 | 100 | 6.25 | 15 Jul 05 |
| Kommunalbanken | AAA/Aaa | Jun 01 | 200 | 6.00 | 20 Jun 06 |
| Dexia | AAA/Aaa | Feb 02 | 350 | 6.00 | 15 Oct 07 |
| BNG | AAA/Aaa | Jun 02 | 200 | 6.25 | 18 Jun 07 |
| Rentenbank | AAA/Aaa | Jul 02 | 300 | 6.00 | 15 Sep 09 |

BNG=Bank Nederlandse Gemeenten; Dexia=Dexia Municipal Agency; KfW=Kreditanstalt fuer Wiederaufbau; Rentenbank=Landwirtschaftliche Rentenbank

*Source: INSTO, 4 December 2002*

# Appendix 2

## Case study of an agency borrower: BNG

Bart van Dooren, head of capital markets at Dutch agency Bank Nederlandse Gemeenten (BNG), reflects many of the views expressed by the borrowers outlined in this paper. BNG debuted in the Australian market in June 2002, with a A$200 million (US$112 million) 6.25 per cent transaction maturing on 18 June 2007.

BNG's supervisor is the Dutch central bank, and the institution is limited to financing the Dutch public sector. Although BNG does not have a formal guarantee from the Dutch government, 87 per cent of its assets are fully guaranteed by the Dutch state. According to van Dooren, BNG has a very high BIS ratio – around 26/27 at the end of November 2002 – so giving the agency a guarantee on the liability side would be effectively doubling up the guarantee on the asset side. van Dooren comments: "In our history we have never had a write off of loans, and all three rating agencies have given us the highest bank financial strength rating, as well as confirmed our triple A rating with a stable outlook."

According to van Dooren, BNG's funding programme over the last couple of years has been relatively stable, between euro10 billion (US$10 billion) and euro12 billion. Although BNG issues in multiple currencies, because its balance sheet on the asset side is in euros, the issuer swaps all its bond proceeds back to euros. BNG has focused its benchmark borrowings to build yield curves in euros and US dollars. Says van Dooren: "We try to distinguish ourselves from our peers in the international markets by bringing benchmark transactions which are larger than 1 billion – between 1 billion and 1.5 billion in either euros or US dollars."

Of the euro11.7 billion raised by BNG to the end of November 2002, 2.5 per cent was issued in Australian dollars in five transactions. In addition to the Kangaroo bond, BNG completed two Australian dollar Eurobonds and two Australian dollar Uridashi transactions. van Dooren says BNG's plans to issue further in Australia will depend on market conditions – a better basis swap and less volatility so Australian investors are encouraged to look at deals from issuers headquartered beyond their borders. This will be linked to the issuance behaviour of domestic companies, says van Dooren. He comments: "The triple As of this world don't offer the greatest yield, which makes it difficult for Kangaroo borrowers which are compared with domestic Australian issuers. However, if there is more offshore issuance by Australian borrowers and if the government and semi-governments continue to decrease their bond borrowings, there must be more room for supranationals and agencies in the Australian market. I would guess that if the government bond market continues to decline, we would aim to achieve between 5.0 and 10 per cent of our annual funding programme in the Kangaroo market."

However, van Dooren says the potential demise of the government bond market will not have a positive effect on new transactions. "Swap rates will definitely be influenced by the liquidity of government bonds," he comments, "so hedging tools may be difficult to find. The total impact will depend on to what extent domestic banks will be willing to deliver liquidity to hedging tools."

van Dooren is also quick to recognise that a Kangaroo issuer's capacity to issue in the Australian market depends to some extent on the attitude of the borrower. "We think keeping up a regular dialogue with institutional investors is very important, and when we do issue we're not concerned with squeezing out every last basis point. We like to leave at least one basis point on the table for investors, to ensure that our bonds perform well on the secondary market," he says.

Finally, van Dooren is very keen for the Reserve Bank of Australia (RBA) to change its criteria for securities eligible as repo collateral, to include issuers such as BNG and other agencies. He comments: "Having repo eligibility is like a supermarket – it gives greater liquidity to the securities on issue. We have seen this with our rated bonds which are eligible as repo collateral with the European and Swiss central banks." According to van Dooren, BNG's board prepared a letter to the RBA at the beginning of 2002, outlining why BNG's securities should be considered as eligible for repo collateral. "However, we heard before we sent the letter that another agency, Kreditanstalt fuer Wiederaufbau, had received a negative response from the RBA with regard to a similar request, so we didn't pursue the matter," he says.

# Appendix 3

## Purpose of supranationals and rating agency comments

### EUROFIMA

The European Company for the Financing of Railroad Rolling Stock (EUROFIMA) is a joint-stock company established in 1956 and owned by the national railways of 24 continental European countries. Railways wholly owned by triple A rated sovereign governments hold nearly two thirds of shares. Member governments are either directly liable for, or guarantee, the obligations incurred by their respective national railways under EUROFIMA financing contracts. Under the terms of EUROFIMA's founding convention, member governments must also either be directly liable for, or guarantee, their national railways' obligations as EUROFIMA shareholders. The supranational's mission is to further the development of rail transport in Europe by financing purchases of rolling stock. A Standard's & Poor's (S&P) supranational report published in September 2002 states: "The quality of EUROFIMA's asset base and associated collateral, along with a consistently solid financial performance, have allowed EUROFIMA to operate successfully despite higher balance-sheet leverage than most other multilateral lending institutions." The ratings agency adds that EUROFIMA has never experienced a loan loss or invoked a government guarantee.

### Council of Europe Development Bank

The CEB's mission is to provide loans in member countries for social purposes. Its mandate was broadened in 1997 to include job creation, urban development, and social projects to improve social cohesion among its member states.

According to the S&P supranational report, CEB's AAA/Stable rating reflects strong membership support, excellent asset and capital quality, and conservative financial policies, including reinforced lending guidelines. CEB is the only financially autonomous institution created by the Council of Europe – a 44-member organisation created in 1949 to promote democracy in European countries. CEB is subject to the Council of Europe's authority, but it has its own full legal status and independent funding capabilities. The report states that although CEB's gearing and leverage policies are still more generous than those of other multilateral lending institutions – after they were strengthened significantly since the fifth capital increase accorded to the bank in 2001, limiting lending to 2.5 times total capitalisation and borrowing to 4.0 times capitalisation – capital adequacy is also protected by the excellent quality of CEB's assets and callable capital. S&P points out: "CEB has never suffered a loan loss, reflecting its counterparties' high creditworthiness."

### Nordic Investment Bank

NIB was founded in 1976 with the aim of strengthening and developing Nordic cooperation and promoting growth in the five Nordic countries by means of financing long-term projects in both the private and public sectors. NIB also aims to foster integration and economic development in emerging markets outside the Nordic region. According to a 13 November 2002 Moody's Investors Service (Moody's) research report, NIB requires non-member countries to sign cooperation agreements in which those governments acknowledge the bank's preferred creditor status on par with other multilateral institutions, which has helped to protect asset quality during recent times of financial stress in emerging markets. Ninety-nine percent of NIB's capital is held by countries rated AA+ or better.

According to the S&P supranational report, NIB's increase in authorised capital to euro4 billion (US$4 billion) in January 1999 – of which euro30 million has been directly paid in by members – is indicative of the continued strength and depth of the unerring support of its member governments. The ratings agency adds: "Statutory and policy controls are prudent, while financial performance has been stable. Ordinary loans and guarantees are limited to 250 per cent of the bank's authorised capital. Lending under the bank's other programmes is subject to well-defined and conservative limits. Loans and guarantees are geared below the statutory limit."

### European Bank for Reconstruction and Development

The EBRD's mandate is to foster the transition to market economies of the central and eastern European and Commonwealth of Independent States countries, by promoting private and entrepreneurial activities. It began operation in 1991 and by the end of 2001, the EBRD's shareholders included 60 countries as well as the European Union (EU) and the European Investment Bank. According to a 12 November 2002 Moody's research report, member nations that represent 84 per cent of capital are rated Aaa or Aa, while a number of other members are rated investment grade. The report states: "At year-end 2001 total paid-in capital amounted to euro5.2 billion. The EBRD's capital levels are prudent. There is a 1:1 gearing level which limits the total amount of outstanding loans, share investments and guarantees to a maximum of 100 per cent of its subscribed capital, reserves and net income. The EBRD's Aaa rating is also underpinned by its preferred creditor status and by the fact that all its transactions are excluded from foreign exchange controls."

### The International Bank for Reconstruction and Development (The World Bank)

The IBRD is part of the World Bank, which is owned by 184 countries. Its purpose is to reduce poverty by promoting sustainable economic development by providing loans, guarantees and related assistance for projects and programmes in its developing member countries. The IBRD is the largest constituent of the World Bank Group, which also includes the International Development Association, the Multilateral Investment Guarantee Agency, and the International Finance Corporation.

According to a 13 November 2002 research report from Moody's, the World Bank's Aaa rating is based on the bank's solid capital structure, its preferred creditor status, financial policies that greatly reduce the bank's exposure to financial risk while achieving adequate profitability, and strong support from Aaa/Aa member countries. The Moody's report states: "The bank is very strong in terms of Moody's capital adequacy measures. Despite financial turmoil in several large borrowing countries during the past several fiscal years, the bank's convertible currency paid-in capital, total reserves, and callable capital of Aaa/Aa countries continued to comfortably exceed what Moody's regards as the bank's true risk assets – loans to countries rated below investment grade." The report continues: "The bank's financial strength, in addition to support from Aaa/Aa shareholders, gives it unique access to world markets – permitting it to undertake financial innovations that reduce the cost of borrowed funds." Commenting on the stable outlook for the bank's rating, Moody's says the value of the World Bank's preferred creditor status has recently been demonstrated in Argentina, which so far has continued to make payments. The rating agency concludes: "Should this situation change, however, Moody's believes the bank could withstand the impact without affecting its ability to meet its obligations."

## The Inter-American Development Bank

The IADB's purpose is to accelerate economic and social development in Latin American and Caribbean countries, with an emphasis on poverty reduction and social equity, modernisation and sector reform, economic integration, and the environment. According to a 13 November 2002 Moody's research report, the supranational's Aaa rating for its long-term debt reflects the IADB's conservative capital structure imposed by the bank's charter, which limits loans outstanding to total capital plus reserves. The report states: "Although the IADB lends only in Latin America and the Caribbean, its loan portfolio has performed well because of the bank's preferred creditor status in its borrowing countries. The bank has always generated a profit."

The rating is also supported by the IADB's strong capital base and support from its highly rated shareholders, says Moody's, which adds that sound financial management is a very important factor for the IADB's rating. The report states: "The IADB is successfully balancing its development assistance mandate and the rapidly changing demands from its borrowing member countries with sound financial management. The bank is considering adding a special lending window aimed at providing emergency financial assistance to member countries during financial crises. The current capital base can support that window in addition to project and policy-based lending." The Moody's analysts conclude that the Aaa rating outlook remains stable for the IADB, given its ample capital base, its owners' credit quality and support, and the IADB's preferred creditor status with the countries to which it lends.

## The Asian Development Bank

The ADB was founded in 1966 with the aim of providing loans and equity investments that promote the economic and social advancement of its member states in the Asia Pacific region and to encourage public and private sector investment for development purposes. The bank is owned by regional (63.7 per cent) and non-regional (36.3 per cent) members. Its largest shareholders are Japan and the US, each with 15.9 per cent of the capital and 13 per cent of the voting power. According to a 13 November 2002 Moody's research report, under the terms of its charter the ADB's commitment for loans, guarantees and equity investments cannot exceed subscribed capital, reserves and surplus. The bank also limits new borrowings to no more than 95 per cent of the callable capital pledged by member countries with convertible currencies. The report states: "The bank has operated within those restrictions and has never resorted to a capital call." And the Moody's analysts add: "With negligible non-accruals on its public sector loans and minimal exposure to the private sector, the ADB maintains a loan portfolio performance equal to the best in its peer group of multilateral development banks…The ADB's strong member support and healthy financial condition ensure a stable near-term outlook, even with continued economic difficulties in some of the bank's major borrowing countries. Rising pressures on the bank's capital base may, however, pose challenges on the bank's financial intermediation capacity over the medium term."

## The European Investment Bank

Owned by the 15 member states of the European Union (EU), the AAA/Aaa/AAA rated EIB has been the EU's financing arm since 1958. The EIB's mission is to promote EU policies by financing capital investment furthering European integration. The bank provides loans and guarantees to public and private sector borrowers for capital investment projects, mainly in infrastructure, industry, energy, and the environment. It also lends to EU candidate countries to support their accession process and to other non-EU countries in accordance with the EU's cooperation and development policies.

According to a S&P research report published on 4 December 2002, membership support of the EIB is strong, as demonstrated by the bank's record of regular and timely capital increases and the key financing role assigned to the EIB in the EU's plans for economic integration and enlargement of the EU. On 1 January 2003, EIB's subscribed capital will increase to euro150 billion from euro100 billion, while paid-in capital will increase to euro7.5 billion from euro6 billion, reducing the paid-in capital ratio to 5.0 per cent from 6.0 percent, according to S&P. The ratings agency states: "This is the eighth increase, following an increase to euro100 billion in 1999, and it will allow EIB to continue with moderate growth of its lending activities in European Union members and to strengthen its operation in accession countries in 2003 to 2008."

The EIB's strong capital base is also evidenced by the fact that just over 75 per cent of the EIB's shareholders are AAA rated, while 98.7 per cent of shareholders are rated AA or better. Included in the assessment of the EIB's asset quality is the fact that 84 per cent of EIB loans are backed by a formal guarantee, while over 50 per cent of loans are either lent directly to or guaranteed by member states and public institutions of the European Union. The EIB also has conservative risk management policies – evidenced by its gearing ratio of 250 per cent, the fact that it is prohibited by its statutes from taking on foreign exchange risks, and the fact that liquidity is maintained at between 25 per cent and 40 per cent of projected net annual cash flow.

S&P points out that the EIB operates with a relatively low proportion of paid-in capital compared with other multilateral lending institutions: "Paid-in capital as a percentage of total shareholders' adjusted equity was 26 per cent in 2001, one of the lowest ratios among multilateral lending institutions (MLIs)…EIB's capital quality, as measured by the proportion of callable capital from AAA rated countries, is higher than that of all other supranationals apart from EUROFIMA, at 65.3 per cent at year-end 2001. Moreover, all shareholders are of investment grade creditworthiness, and all but one are rated AA or higher."

Commenting on the EIB's strong asset quality, the S&P report says the bank has suffered only minimal losses on loans that it has issued or guaranteed, although one loan in arrears on a project within the EU was restructured owing to serious cash flow difficulties in the early 1990s. The report states: "Only rarely has the EIB had to draw on guarantees for loans to be repaid, and almost all cases involved non-EU countries. Non-accrual loans as a percentage of gross disbursed loans have been almost zero in the past few years. In general, EIB's asset-quality ratios have consistently been among the best of all rated supranationals since 1995."

## Statutory and policy controls of supranationals

According to a report published by TD Securities on 2 September 2002, entitled *Supranational Borrowers and the Australian Capital Markets*, the supranationals all have individual statutory and policy controls designed to control credit and market risk exposure and to ensure sufficient liquidity (table 9). These controls fall into three categories.

First is gearing and leverage. The report states: "Gearing restrictions limit outstanding loans relative to capital and reserves, and, consequently, emphasise the quality of MLIs' assets and capital. Asset quality depends on the underlying structure of the loan portfolios and their repayment records. Quality of capital mainly reflects the paid-in share of subscribed capital and the callable capital of the more creditworthy member countries. The quality of callable capital is an important gauge of the ability of member states to meet a capital call in the unlikely event MLIs cannot service their debt."

Second is asset and liability management. According to the TD Securities report, liquidity management plays a particularly crucial role in this regard, in safeguarding financial flexibility – notably when adverse market conditions constrain the MLIs' access to long-term funds. "Liquidity also helps to ensure timely repayment to MLIs' bondholders in the event that a capital call is delayed due to political resistance within the institution or from shareholder governments. Lacking a natural deposit base, MLIs must maintain sufficient liquid assets to meet a portion of future cash requirements," states the report.

Third is lending. The report states: "The supranationals have each focused on their own measures for managing credit risk. Prudential controls on loan concentrations, requirements of government and other quality guarantees, and preferred creditor status have contributed to the MLIs' generally excellent loan repayment record."

**Table 9: Five-year Comparable Data for Select Supranationals**

| | IBRD | IADB | ADB | EBRD | EIB | CEB | NIB | EUROFIMA |
|---|---|---|---|---|---|---|---|---|
| **Size (US$m)** | | | | | | | | |
| *Gross disbursed loans and equity investments (US$m)* | | | | | | | | |
| 2001 | 121,589 | 44,951 | 28,947 | 7,991 | 163,693 | 7,678 | 8,872 | 14,849 |
| 2000 | 118,866 | 41,872 | 28,496 | 6,986 | 157,021 | 7,950 | 8,642 | 15,836 |
| 1999 | 120,104 | 38,552 | 28,617 | 6,977 | 154,062 | 7,877 | 8,895 | 17,024 |
| 1998 | 117,228 | 32,635 | 24,997 | 6,735 | 155,261 | 7,568 | 8,831 | 20,108 |
| 1997 | 106,576 | 27,301 | 19,051 | 5,038 | 131,701 | 6,535 | 7,927 | 19,700 |
| **Gearing (%)** | | | | | | | | |
| *Disbursed loans net of loan-loss reserves and equity investments net of reserves for impairment of value/shareholder's equity adjusted + AAA callable capital* | | | | | | | | |
| 2001 | 122.0 | 91.9 | 129.7 | 66.7 | 219.1 | 354.2 | 323.2 | 1,102.7 |
| 2000 | 125.0 | 79.5 | 98.4 | 52.1 | 213.4 | 488.5 | 438.2 | 1,160.6 |
| 1999 | 111.7 | 74.5 | 96.9 | 50.9 | 197.3 | 471.8 | 439.7 | 1,235.5 |
| 1998 | 110.4 | 68.1 | 84.6 | 43.6 | 245.3 | 412.7 | 452.1 | 1,268.9 |
| 1997 | 101.9 | 61.5 | 68.1 | 36.9 | 221.2 | 398.1 | 450.8 | 1,340.2 |
| **Leverage (%)** | | | | | | | | |
| *Gross debt/shareholder's equity adjusted + AAA callable capital* | | | | | | | | |
| 2001 | 114.5 | 91.2 | 111.8 | 122.4 | 211.5 | 491.1 | 374.3 | 1,182.1 |
| 2000 | 116.2 | 83.1 | 88.0 | 115.8 | 205.5 | 719.9 | 536.9 | 1,237.7 |
| 1999 | 105.7 | 78.8 | 89.4 | 106.6 | 190.7 | 669.0 | 563.0 | 1,307.4 |
| 1998 | 112.4 | 69.8 | 80.8 | 84.1 | 228.5 | 623.8 | 541.3 | 1,334.7 |
| 1997 | 102.1 | 63.5 | 62.8 | 63.3 | 205.1 | 565.3 | 491.7 | 1,389.7 |
| *Gross debt net of liquid assets/shareholders' equity adjusted + AAA callable capital* | | | | | | | | |
| 2001 | 87.0 | 71.4 | 74.3 | 30.3 | 190.7 | 373.9 | 254.7 | 1,075.9 |
| 2000 | 89.5 | 60.3 | 61.7 | 13.6 | 184.9 | 482.4 | 351.8 | 1,130.6 |
| 1999 | 81.7 | 57.1 | 61.3 | 16.3 | 169.8 | 481.5 | 377.1 | 1,207.1 |
| 1998 | 82.9 | 51.6 | 53.1 | 13.0 | 204.6 | 451.8 | 365.2 | 1,238.7 |
| 1997 | 75.8 | 45.5 | 37.3 | 7.2 | 182.0 | 407.3 | 344.3 | 1,311.1 |
| **Liquidity (US$m)** | | | | | | | | |
| *Liquid assets/gross debt* | | | | | | | | |
| 2001 | 24.0 | 21.7 | 33.5 | 75.3 | 9.8 | 23.9 | 32.0 | 9.0 |
| 2000 | 23.0 | 27.4 | 29.9 | 88.2 | 10.0 | 33.0 | 34.5 | 8.6 |
| 1999 | 22.7 | 27.6 | 31.5 | 84.7 | 11.0 | 28.0 | 33.0 | 7.7 |
| 1998 | 26.3 | 26.1 | 34.3 | 84.5 | 10.4 | 27.6 | 32.5 | 7.2 |
| 1997 | 25.7 | 28.3 | 40.7 | 88.7 | 11.2 | 27.9 | 30.0 | 5.7 |

Fiscal years ending 31 December, except for IBRD whose fiscal year ends 30 June of the following year

IBRD=International Bank for Reconstruction and Development; IADB=Inter-American Development Bank; ADB=Asian Development Bank; EBRD=European Bank for Reconstruction and Development; EIB=European Investment Bank; CEB=Council of Europe Development Bank; NIB=Nordic Investment Bank; EUROFIMA=The European Company for the Financing of Railroad Rolling Stock

*Source: Standard & Poor's, Supranationals Special Edition 2002, September 2002*