AOFM Opening Statement – Senate Estimates, 28 October 2020

The pandemic impact has been extraordinary for a number of reasons, not the least from the AOFM's perspective because it brought with it extreme stress in global funding markets.

The funding market dislocation in March this year materially constrained AOFM's issuance capability for several weeks. High-quality government bond markets globally were the last to close in the disruption and therefore were subject to large volume selling. The domestic and investment bank trading arms, which sit between us and global funding markets, absorbed this selling. Very quickly they reached volume and risk limits, reducing their ability to bid for meaningful volumes at AOFM bond tenders.

The AOFM has long had in place a plan for a crisis in which funding market access is lost temporarily. This plan had two elements – one was holding sufficient liquidity in the cash portfolio to cover around four weeks of forecast Government outlays – the other was to maintain the Treasury Notes market. Treasury Notes are short-term cash instruments with expected increased demand during periods of extreme market stress. Both mechanisms allowed continued access to sufficient short-term cash flow needs during and immediately following the market dislocation.

AOFM borrowing operations are referred to as primary market activity. Secondary market activity is where banks as intermediaries buy from and sell to investors. The AOFM uses two primary market approaches; both are common to sovereign issuer operations. Most AOFM issuance overtime has been achieved through competitive tenders, where issuance volume is set in advance and banks bid competitively for bonds, in essence taking a risk they will find buyers, and market valuations for that stock won't move against them in the interim.

Syndication is where bonds are placed directly with investors - allowing for much higher volume transactions. This is most often used for establishing new bond lines. Syndications are attractive to investors who are able to access large volumes at a point in time and with confidence regarding price. The process is technically complex and the AOFM appoints banks to run them under its instruction. The risks associated with tenders and syndications are readily identifiable by AOFM but the relative costs of the two approaches are difficult to determine – syndications involve direct costs whereas establishing new bond lines over multiple tenders involves indirect costs. The AOFM has established a relatively high number of new bond lines since April. This has been driven by risk considerations and the need for new lines to accommodate the scale of the Budget financing tasks. Furthermore, the rate at which financing has been required has been unprecedented.

The largest previous issuance program was $106B in 2016-17 and compared with the $90B required in the last quarter of last fiscal year alone, this highlights how little experience there has been on which to base expectations at each decision point since March. Even during WWII, when the overall scale of debt accumulation (as a percentage of GDP) was larger than currently forecast the rate of fiscal responses did not match recent experience.

From late March until recently, managing the cash portfolio has required: determining the profile of outlays as new fiscal programs were to be implemented; understanding deterioration in the underlying Budget position; and considering how funding markets would absorb high rates of AOFM issuance. The objective was to rebuild a strong cash position to be well placed to deal with the uncertain outlook. As of yesterday around 54 per cent of the $240B Treasury Bond issuance program for this year has been completed as a reflection of that aim. Market conditions have been consistently favourable since late April and demand from offshore investors has been supported by slightly higher yields here relative to overseas competing markets.

Turning to the AOFM's establishment of the Structured Finance Support Fund, the fundamental aim is to keep public securitisation markets open. Detail describing the three approaches adopted by the AOFM to achieve this aim are available in the recently published AOFM Annual Report. However, by way of summary the Committee can note the following. One approach has involved public securitisation market support using the SFSF to invest directly in new primary issuance. The SFSF has also been used to invest in some secondary market securities, whereby the proceeds of those transactions are used by investors in support of new primary market issuance.

Securitisation market conditions have steadily improved in recent months to the point where the need for AOFM support has diminished noticeably. To illustrate this point, all $1.4B of SFSF investments in public markets occurred between late March and the beginning of July. In fact, of the 26 primary market transactions totaling $16.5B that AOFM has agreed to support since the last week of March, the last 15 transactions have been executed without calling on the AOFM commitment to invest.

In a second approach the AOFM has so far agreed to make revolving warehouse investments of over $2.2B, which has helped to maintain around $15B of private sector funding to more than 30 smaller lenders. This market also appears to be improving over recent months, with a number of investors indicating a renewed willingness to invest in these facilities.

Under the third approach, the AOFM has worked with industry through the Australian Securitisation Forum to establish a special purpose vehicle to provide lending to non-ADIs against capitalised interest on loans in Covid-19 related hardship. As well as providing secured funding to eligible lenders its availability alone has underpinned confidence in the broader non-ADI securitisation market.

ENDS