<table>
<thead>
<tr>
<th>Sub-Sovereigns, Supras &amp; Agencies</th>
<th>Covered Bonds</th>
<th>Senior Unsecured Bank Bonds</th>
<th>Corporate Bonds &amp; SSD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IDABank</strong></td>
<td><strong>Prima Banka</strong></td>
<td><strong>DKB</strong></td>
<td><strong>BayWa</strong></td>
</tr>
<tr>
<td>€1.25 billion Inaugural EUR Bond</td>
<td>€500 million Inaugural Covered Bond</td>
<td>€500 million Blue Social Covered Bond</td>
<td>€500 million Inaugural Green Bond</td>
</tr>
<tr>
<td>0.000%</td>
<td>0.010%</td>
<td>0.010%</td>
<td>3.125%</td>
</tr>
<tr>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
</tr>
<tr>
<td><strong>KFW</strong></td>
<td><strong>Lloyds Bank</strong></td>
<td><strong>ARKEA</strong></td>
<td><strong>Siemens</strong></td>
</tr>
<tr>
<td>€1 billion Green Bond Tap</td>
<td>€1 billion Mortgage Covered Bond</td>
<td>€500 million Senior Non-Preferred</td>
<td>€3 billion</td>
</tr>
<tr>
<td>0.010%</td>
<td>0.125%</td>
<td>1.625%</td>
<td>0.375%</td>
</tr>
<tr>
<td>2019/2027</td>
<td>2019/2026</td>
<td>2019/2026</td>
<td>2019/2029</td>
</tr>
<tr>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
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<tr>
<td><strong>European Investment Bank</strong></td>
<td><strong>mymoneybank</strong></td>
<td></td>
<td><strong>Fraport</strong></td>
</tr>
<tr>
<td>€500 million Climate Awareness Bond</td>
<td>€500 million Mortgage Covered Bond</td>
<td></td>
<td>€330 million Schuldscheindarlehen</td>
</tr>
<tr>
<td>1.000%</td>
<td>0.050%</td>
<td></td>
<td>2019</td>
</tr>
<tr>
<td>2019/2042</td>
<td>2019/2029</td>
<td></td>
<td>6y/8y/10y/15y</td>
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<tr>
<td>Joint Bookrunner</td>
<td>Joint Bookrunner</td>
<td></td>
<td>Joint Arranger</td>
</tr>
</tbody>
</table>

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* S&P: AA-(negative)/Moody’s: Aa1(negative)/Fitch: AA-(stable)
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The most active player in EUR Bonds

EMEA Bookrunner Ranking, 2012 – 2018¹

<table>
<thead>
<tr>
<th>Year</th>
<th>Bookrunner</th>
<th>2012 – 18</th>
<th>(no. of deals)</th>
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<tr>
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<td>Bookrunner</td>
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<td>2015</td>
<td>Bookrunner</td>
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<td>2014</td>
<td>Bookrunner</td>
<td>401</td>
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</tr>
<tr>
<td>2013</td>
<td>Bookrunner</td>
<td>336</td>
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<tr>
<td>2016</td>
<td>Bookrunner</td>
<td>322</td>
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</tr>
<tr>
<td>2012</td>
<td>Bookrunner</td>
<td>268</td>
<td></td>
</tr>
</tbody>
</table>

¹Source: Dealogic; cumulative data (2012 – 18 ranking) 1 Jan 2012 – 31 Dec 2018; annual rankings 1 Jan – 31 Dec

Best in class Transaction Banking

Euromoney Trade Finance 2019: Market Leader in CEE and 10 countries³

²Source: Euromoney; www.euromoney.com/research-and-awards.html
³Source: Euromoney; www.euromoney.com/research-and-awards.html

cib.unicredit.eu

Banking that matters.
Between heaven and hell: capital markets get 2020 vision

Equities are at record highs, rates at record lows; the US is quarrelling, China is slowing. As 2020 begins, participants are divided on which way markets will move. Toby Fildes picks 10 themes

How low can you really go?
Capital markets go into 2020 in positive mood. The ECB has got their back, having restarted quantitative easing, and rates are set to stay low or get even lower over the next year. It should, therefore, be a vintage year for borrowers of all stripes as far as absolute cost of funds is concerned. So low that we might have to find a new name for high yield bonds. Many mid-grade names, having had a cracking year, are now borrowing at rates their developed market peers used only to dream of.

Fragile and febrile
But don’t be fooled into thinking markets will be easy. Volatility, as September’s spike in repo rates showed, has not been abolished, just because central banks are floating the market with bond purchases again. In fact, markets seem more fragile than ever — and the fractures are less easily explained. Some point the finger at a generalised lack of liquidity, which may have been exacerbated by central banks sucking up lakes of bonds. Nasty surprises are becoming increasingly normal.

Markets at a crossroads
Financial markets are poised uncannily between heaven and hell — or at least, limbo. The US stockmarket is at a record high, after its strongest year since 2013 (as of early December). But at the same time, markets are stalked by fears of a global downturn. The world’s two biggest markets are at open economic war, with disruptive effects the world over. Donald Trump may ramp up his rhetoric as he seeks re-election in November. Some of the air has gone out of even Europe’s limp recovery. But at the same time, markets are stalked by the slowing Chinese economy.

Transition bond conundrum
A great leap forward for the sustainable finance bond market or a backward step? Since Marfrig’s trailblazer in the summer, transition bonds have split the market down the middle. To many they are a necessary innovation — allowing non-green companies cleaning up their acts to access specialised investors to finance their transitions. Others decry them as greenwashing. The Green Bond Principles are likely to pass down their guidance soon. Meanwhile, sustainability-linked bond structures have arrived. Expect the mechanism to spread in 2020 — though not all green bond enthusiasts are wild about them.

Life after Brexit
Europe is under new management — a new president of the Commission, a new head of the European Central Bank. They should bring new energy and focus to a bloc that has been distracted by Brexit and hamstrung by persistently low-growth. Ursula von der Leyen’s European Green Deal and Christine Lagarde’s view that climate change is “mission-critical” are new and ambitious ideas. But they also have a golden chance to reinvigorate the EU’s slow-moving Capital Markets Union project, and it is quite clear European policymakers want to accelerate it. With the bloc’s largest capital market leaving the Union (probably at the end of January), and a dislocated banking system out-fought by Wall Street banks, CMU has never been more urgent.

Private pleasure, public pain
Private capital markets mean many things to many people in Europe. Leveraged direct lending, off-market equity investing, alternative credit, Schuldscheine, US private placements. It’s sometimes confusing but what all these markets have in common is a great performance post-crisis, in terms of expansion and returns. Preqin says Europe-based private debt assets have grown from €24bn in 2008 to €135bn in 2018; direct lending is now the fastest growing asset class in European credit, according to Deloitte. Proponents argue all these products are here to stay — and will grow as genuine rivals to public bonds, syndicated and bilateral bank loans and equity capital markets. Some even argue that credit funds might soften economic downturns because they are incentivised to keep the debt taps flowing in tough economic times. But behind the optimism is the nagging worry that these products have only flourished because of ultra-low interest rates and the desperation for yield and allocation, and that they are major contributors to the dangerously large corporate debt bubble.

Libor alarm bells
The Libor alarm is set for January 2021. But will the capital markets force regulators to hit the snooze button? When Andrew Bailey, chief executive of the Financial Conduct Authority, tolled the death knell for the benchmark in 2017 there seemed plenty of time to come up with a new set of reference rates and get them working seamlessly. Instead, the closer the deadline comes, the more horrendously complicated — perhaps even impossible — such a swap appears. Now, after two years of developing Sonia, Estr and Sofr, there are increasingly loud calls for Libor to be saved.

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After Aramco: get real on price
Forget Aramco. That was always going to end in tears. Even Wall Street’s hype machine was bound to come unstuck when serving a government too proud to compromise on price. But the lesson is that all IPO sellers are going to struggle to sell deals at inflated valuations. Investors have shown they are willing to buy sales of stock in listed companies, but will not gamble on new names without hefty discounts. More issuers might shun the IPO process altogether, finding it too cumbersome and fragile, and go for direct listings or demergers instead.

TLAC/MREL clouds lift
It’s not just Father Christmas who delivers at this time of year. The Single Resolution Board has caught the festive mood, and will finally be letting European banks know their targets for bail-in capital, which include subordination requirements. Depending on how these targets are calibrated, banks might have lots of capital to issue — as much as €330bn over the next three years.

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The GlobalCapital debt capital markets survey: banks expect to make money and hire

Markets go into 2020 fretting about a global recession and an escalation of trade tensions between the US and China, according to 25 heads of debt capital markets in the EMEA market, in Toby Fildes’ annual outlook survey. Respondents are mildly pessimistic on spreads and fees in the primary markets as well. But on the plus side, bankers are feeling hopeful about sustainability-themed bonds and almost unanimously believe issuance will top $270bn.
With our bonds, you are on the safe side.

As a long-standing borrower, Rentenbank has been a reliable and particularly attractive partner for safety-conscious investors. With the three most important rating agencies awarding us a triple-A rating, Rentenbank is one of the safest development banks in the world. Since we raise our funding with continued success in the international financial markets, we can quite simply say: the bull is closer to us than the bear.
EDITOR’S OVERVIEW
Debt capital markets poll

Which products are you most optimistic/pessimistic about for 2020 in terms of volume?

Pessimistic

Optimistic

Leveraged loans
Investment grade loans
MTNs
Private debt (e.g. US PPs, Schuldscheine, Euro PPs)
Sustainability-linked loans
Hybrid/subordinated debt
SRI/green bonds

Which sectors or client groups are you most optimistic about for 2020 in terms of volume?

Which banks do you expect to increase or decrease market share in EMEA DCM the most in 2020?

How many bank mergers can we expect to see in 2020 that will involve a top 25 bookrunner bank?
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16-17 June 2020, London

Global Borrowers & Investors Forum
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EDITOR'S OVERVIEW
Debt capital markets poll

Do you expect your business to make more or less money in 2020 than in 2019?

Do you expect your managing directors and directors to be paid more or less in 2020 than in 2019?

Will the US introduce a round of quantitative easing in 2020?

Do you expect the European Central Bank to expand its QE programme in 2020?

Jerome Powell will keep his powder dry

Christine Lagarde will save this option for a rainier day

Very targeted at specific bond asset classes

Significantly, but sticking to the same assets as previously

A little
EDITOR’S OVERVIEW
Debt capital markets poll

Will bonds with coupons that can change according to sustainability metrics replace traditional sustainable bonds based on use of proceeds?

Which sectors of the market will have the most exciting technological developments?

How do you expect the Fed Funds target rate to change by the end of 2020?

How do you expect the ECB’s deposit rate to change by the end of 2020?
EDITOR’S OVERVIEW
Debt capital markets poll

Which financial centres will be the main winners from Brexit?

Overall, will there be more or fewer people working for you by the end of 2020?

What will be the impact of the US election on debt capital markets in 2020?

What will be the impact of Brexit on debt capital markets in 2020?
What are your upside wildcards for 2020?

Green, social and sustainability bond issuance will hit about $270bn in 2019. Predict the 2020 figure.

The transition from Libor and Euribor to risk-free rates — How well prepared is the DCM market?

Which of the following risks to DCM in 2020 are the most likely, and would have the most severe impact?
As US banks’ shadow lengthens, Europeans plan their fight back

Each year brings another retreat for European investment banks, as their seemingly invincible US competitors edge further into the European market. While the Europeans are far from capitulating, the pressure is relentless. As Jasper Cox reports, they are trying to redefine success by concentrating on the markets and segments where they are strongest.

The pain keeps on coming for European investment banks. US competitors have cemented their dominance for the foreseeable future and Europeans are trying to fight for smaller victories.

First in 2019 it was Société Générale, announcing cuts to trading. Then Deutsche Bank slashed its equities business after its failed merger with Commerzbank. As the year wore on, it was the turn of HSBC and UBS to restructure investment banking All the while, the US banks continued to look magisterial — even if they are not immune to a spot of austerity.

As the charts on this page show, the top five US banks have substantially outperformed the top seven Europeans in global investment banking revenue over the past eight years.

“We’ve seen the American banks pick up market share and become more dominant, and the response from the European banks is not to invest and win that market share back, the response is: ‘Let’s get more attrition, let’s cut down even more,’” says an analyst of European investment banks. “That’s the message for this year.”

Not everyone has crouched into a defensive position of rationalisation and cost-cutting. Barclays has fought back against activist investor Edward Bramson’s assault on its investment bank, while BNP Paribas snapped up Deutsche’s unwanted equities platform. But in general, Europeans are in defensive mode, trying to protect what they have rather than carrying the fight to Bank of America, Citigroup, Goldman Sachs, JP Morgan and Morgan Stanley.

“The fight for wholesale investment banking, really large scale investment banking in Europe, was lost a long time ago,” says Andrea Vismara, chief executive of the Equita Group, an independent Italian investment bank in Milan. “All of this is happening faster than we could have expected it to happen, but the trend was very clear.”

How have Europe’s investment banks found themselves bobbing along in mid-table? And how should they adapt?

Structural advantages

The primary reason for the dominance of the US banks is the strength of the US domestic market, helped by the country’s GDP growth outpowering the EU’s in recent years.

Some argue another factor is that Europe has so far failed to complete its Capital Markets Union, which in theory would dismantle barriers to capital flows and allow institutional debt markets to provide more capital instead of banks. This would favour big investment banking operations.

At the moment, many banking activities remain localised, and the lack of progress on the CMU holds up consolidation between banks, which would benefit investment banks that now fight over scraps of business. One of the US banks’ advantages is the large market shares the top five banks enjoy in their home market.

But progress on CMU has been tricky, and banks are not holding their breath for it to be completed. Bond underwriting appears to exemplify the effect of having numerous competitors. “Standard bond fees are lower in Europe because of market dynamics,” says Frazer Ross, head of investment grade debt capital markets syndicate for Europe, the Middle East and Africa at Deutsche Bank in London. “US banks have clearly historically done a better job fighting fee compression in their home market than European banks have in theirs.”

The US is already in effect a large capital markets union, giving its domestic banks a big helping hand. In markets like corporate debt and securitisation, the US is simply larger.

The playing field is more even in rates and foreign exchange. But the revenue pool for the biggest houses in fixed income, currencies and commodities trading (FICC) has shrunk more than it has for equities and for origination and advisory work in recent years (see chart).

Low rates and low volatility, induced by central banks, are one cause. US banks have also pulled ahead in equities trading. The analyst points to their investments in technology and success in attracting hedge fund clients.

Meanwhile, the US banks’ persistence in maintaining operations in different regions of the world, covering a wide range of products, creates a self-perpetuating advantage.

<table>
<thead>
<tr>
<th>Revenues for the top 12 global investment banks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Origination and advisory revenue</strong></td>
</tr>
<tr>
<td>European banks</td>
</tr>
<tr>
<td>FY18 ($BN)</td>
</tr>
<tr>
<td>FY11 ($BN)</td>
</tr>
<tr>
<td>Source: CRISIL Coalition</td>
</tr>
</tbody>
</table>
Natixis, a reference bank for Green & Sustainable business

The environment and climate have landed at the heart of the global agenda, and the financial industry is feeling the full force of the shockwaves. The UN Sustainable Development Goals and the Paris Agreement, both of which came into force in 2015, are real game changers. Natixis, a founding signatory of the UN Principles for Responsible Banking in September 2019, has made green & sustainable finance a key pillar of its strategy.

A dedicated cross asset and global Green Hub, at the core of the CIB

In July 2017, Natixis launched its Green & Sustainable Hub (GSH) within the CIB. The GSH’s objectives are threefold: Firstly, it steers product innovation to generate and develop green & sustainable revenues. Secondly, it enhances syndication and distribution bases and brings a green & sustainable dimension to the bank’s “originate to distribute” business model. Lastly, it guarantees that the ecological and social transitions remain at the heart of the CIB’s value proposition.

From an organizational perspective, the GSH is unique. Its partnership model combines the expertise of a 14-person team, consisting of seasoned ESG/SRI/financial experts within the core of the CIB, with the all-round breadth of the CIB. Supported by its innovative Center of Expertise and by an extensive network of “Green Captains” - the GSH’s ambassadors, core business partners and enhancers - the GSH has a truly global cross-asset coverage.

The CIB’s initial focus on renewable energy financing and SRI/ESG research has gradually broadened out to include everything from financing solutions - green bonds, loans, securitization - to advisory and climate-related and sustainability investment solutions, all steered by the GSH.

In line with this belief, Natixis has pioneered many firsts in the green & sustainable market since 2018: green mortgage-backed securities (85 Broad Street, New York), green mortgage loan (Duo Towers, Paris), green repack note (Green OAT), green EMTN program (Société du Grand Paris), green syndicated loan (Séché Environnement), first green margin loan (Ivanhoe Cambridge), green capital call (Icawood), green notes that are equity-linked to a climate index (ECOSE / Groupama Insurance Retail campaign).

Naturally, the Hub contributes to market evolutions through its heavy involvement in global, regional and national multi-stakeholder initiatives (such as the ICMA Green Bond Principles). It also works with regulatory bodies such as the EU Commission and the French Financial Markets Authority.

The Green Weighting Factor: an innovative tool to drive the climate and environmental transition

In 2019, Natixis became the first bank worldwide to operationally launch a Green Weighting Factor (GWF). This initiative, which benefited from the full backing of its senior management and more than 18 months of internal development, built on its existing expertise in the green finance sector. It is operationally co-led by the GSH and Natixis’ ESR team.

The GWF is an in-house mechanism that links analytical capital allocation to the sustainability of each financing. It aims to incentivize financings that support the transition towards a low-carbon economy and to penalize those financings with a strongly negative impact on the climate and the environment. Hence the GWF adjusts the expected profitability of each transaction in line with its impact on the environment. This tool will be instrumental in steering the transition strategy of Natixis, which aims to meet the objectives set out by the Paris Agreement, as well as those of its clients.

Natixis will leverage the GWF to fully integrate the climate and sustainability issues into its strategic dialogue with its clients.

What the future holds

Faced with the urgency of climate change, Natixis is convinced that green & sustainable finance will fail in its overarching mission if highly-emitting industries are left on the sidelines. Carving a place in this market for CO2-intensive companies that are committed to transitioning is, therefore, of the utmost importance.

The GSH is working to devise a clear, robust, science-based definition of transitioning that takes account of geographical gaps, establishes a boundary between “doing better” and “doing enough” and helps it to create bespoke financing products for its clients.

To support economic resilience, Natixis’ plan is clear: it will continue to integrate ESG criteria into its risk assessments and scale up its green & sustainable businesses. It will also accompany borrowers, issuers and investors in their own transitional and sustainable initiatives, with its GWF as a key monitoring tool.
in the form of better diversification. European banks have been retreating home, where the market has been tougher of late.

Some also point to the effect of regulation. Europe’s rulemakers have pushed MiFID II and greater capital requirements on to banks in recent years (although European banks did have more need for the capital).

Under the administration of president Donald Trump, US regulators have made louder pro-industry noises, including moves towards slimming down the Volcker Rule.

Regardless of which region’s banks face the tougher rules, regulation in itself favours big incumbents by putting up a barrier to entry.

Finally, Europe’s negative rates — which do not look likely to let up any time soon — add pressure to lending as well as fixed income trading activities.

**How to cut**

With little prospect of the structural problems that beset them being eased any time soon, European houses are working out how to respond, in an age when shareholders are not so keen on grand expansion plans.

One answer is to regard the investment bank as a support mechanism for other parts of the business, like wealth management or serving corporate clients more broadly. Another is for banks to focus on what they do best, perhaps even partnering with outside companies for some products.

Firms may well retain mergers and acquisitions bankers, because they can take advantage of lending relationships to get a seat at the table for this activity, which also does not soak up capital.

But advisory work could change from a technological perspective. Banks that use big data may gain an edge in offering insight. And rather than waiting for clients to come to them about M&A opportunities, the savviest banks can seek out opportunities for clients in advance, according to Matt Long, head of capital markets in Europe at Accenture in London.

Equity capital markets is another way European banks can use existing relationships, and this can also be a strategic line of business.

“When you’ve got the ECM capabilities, you can have a strategic dialogue with your clients, you can talk to CEOs,” says Pierre Palmieri, head of global finance and advisory at Société Générale in Paris. “And then, when you talk to CEOs, you can come with ideas that will have a positive impact on other areas of activity.”

But Deutsche’s decision to retreat from secondary market sales and trading in equities has raised questions about the viability of this business for many in Europe, and about what it brings to a bank.

“Equities is a market that in Europe nobody knows who’s going to take care of,” says Vismara at Equita. Bankers tend to think that Deutsche’s decision will harm its remaining ECM franchise, although the bank boasted in its third quarter results of having completed, priced or won more than 50 equity origination mandates since July.

“How do you do ECM if you do not have the secondary activities?” asks Vismara. “If you execute an IPO for a company without having secondary activities, and without having reputable research, it means that you’re only using your relationships, which means that you’ll probably do it mostly for your home companies, so German companies, because you know all the investors. And yes, of course, that is feasible, but it doesn’t mean that you’re a player in the equities market.”

What about the impact on other lines of business?

“The impact of DB withdrawing from equities trading on the DCM business is very low,” says Ross at Deutsche. “What DCM clients appreciate is our focus on and commitment to capital markets.”

Working out the damage to the sum of the parts is the crucial issue when banks weigh up whether to cut business lines.

Shutting businesses down cannot be done lightly, not least because it is expensive to turn off infrastructure.

“It takes a huge amount of investment just to chisel away,” says Long at Accenture. “You’ve got huge pipes that you can’t just suddenly downsize, just because the volume of what you’re flowing through them has significantly reduced.”

This is particularly the case when technology and operations are intertwined with businesses outside the investment bank.

**Not all bleak**

Still, encouraging results for Barclays and BNP Paribas this year suggest Europe still has room for at least a couple of big, home-grown investment banks. And Deutsche’s retrenchment could help them.

“It is positive for Barclays,” says John Cronin, financials analyst at brokerage Goodbody in Dublin. “But I wouldn’t make any assumptions about where those clients who might migrate from Deutsche would go, it’s so relationship-dependent. I think it’s positive for the remaining incumbents. But equally, the US banks will be fighting hard for that business.”

For other banks, the answer appears to be playing to their strengths. This could include being pickier about clients.

“We need to be relevant to our clients. But also the clients need to be relevant to us,” says Palmieri. “There’s capital selectivity at the client level.”

Natixis is an example of a bank with a sharp focus, in its case on sectors like energy and natural resources, infrastructure and aviation.

“The game today is to be relevant,” says Marc Vincent, head of corporate
and investment banking at Natixis in Paris. “We are not a CIB offering everything to everyone. I don’t think we can compete on size, and therefore the flow business is not for us.”

Getting granular
UniCredit stresses that its investment bank is important in servicing smaller companies. “We have to be close to both the real economy and our clients in their everyday life,” says Richard Burton, CEO of corporate and investment banking at UniCredit in Milan. “This is a very important distinction between a big global bank and a pan-European bank like ours. A big global bank doesn’t have the same presence deep into the country, the closeness to mid-size corporates and an understanding of their day-to-day capital needs.”

Opportunities still exist in some areas, such as investment products. Vincent at Natixis says low rates are opening avenues here, while Palmieri at SG points to the ageing population as creating demand.

European banks still have advantages.
The region remains poised between the American and Asian time zones. Those in the industry — and not just bankers at European firms — say European companies want Europe’s banks to continue to serve them. Politicians probably wish this as well, so that they can keep more control over the sector. The German government was said to be keen on a Deutsche-Commerzbank merger. This factor might in the end help win the banks some relief from tighter regulation or progress on CMU.

But for any serious challenge to the US hegemony, the conditions are not there in the medium term. For most banks, finding profitable niches is the way to keep the show on the road. GC

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**Europeans’ sustainability lead**

IN SEPTEMBER, the United Nations launched the Principles for Responsible Banking. Some 130 banks holding $74tr of assets signed up.

The main European investment banks were almost all present, except for HSBC and UniCredit. But in the US, of the five large investment banks, only Citigroup has signed.

While joining the Principles does not necessarily mean a bank is more sustainable, this is one area where European banks hold their heads high. It is not that US banks are neglecting environmental and social issues, but they cannot claim to be ahead of European peers; indeed, some would say they have some catching up to do. The PRB commit banks to shaping their business around the goals of the Paris Agreement on Climate Change and the UN’s Sustainable Development Goals.

Toni Ballabriga, who is global head of responsible business at BBVA in Madrid and has been involved from the initial drafting stages of the PRB, highlights two features of the Principles.

First, signatories must conduct an impact assessment to examine their own impacts on the societies, economies and environments where they operate — negative impacts as well as positive ones. Second, they must set targets for improving their impacts.

“It is a pity that some big banks didn’t join the initiative at this time,” says Ballabriga. “I would think there will be more banks joining the initiative.”

**Change in investment banking**

Sustainability has for a while been important for a subset of capital markets issuers and investors, and investment banks are familiar with products like green bonds. But as sustainability concerns seep into all sectors and are taken up by all investors, investment banks’ relationships with clients look set to change.

“Sustainable finance has become a strategic topic for companies, and we see this more and more in our discussions with clients, including at the CEO level.”

Investment banks hope to work on sustainability issues with carbon-intensive companies as well, even though some argue that the climate problem is so urgent that these firms should be blacklisted altogether.

“All the clients, not only renewable clients, even the oil and gas clients, we can accompany them through the energy transition,” says Palmieri. SG has committed to raising €120bn of financing for the energy transition between 2019 and 2023.

Natixis this year announced a new internal capital model for its CIB, which will weight green activities more favourably and disadvantage brown ones. Regulators may make a similar adjustment to actual capital requirements.

But Vincent at Natixis rejects the idea of a total boycott of brown: “Deciding to ban financing is not the appropriate answer to a problem.”

**Sustainable advantage?**

The European banks that embrace sustainability fastest and most deeply may well reap a commercial advantage. And this advantage could extend beyond Europe, as sustainability becomes more important in different regions around the world.

“The sooner you start this journey, the more capabilities you will have and the more experience to develop solutions that help your clients to make the transition,” says Ballabriga. “We think that is a clear advantage to be a first mover on sustainability. We see that sustainability is a big opportunity for European banks to mobilise not only Europe but also other countries.”
The benchmark is dead: long live the benchmark

The transition from one set of interest rate benchmarks to another is conceptually simple. But it is also unprecedented and has deeper consequences than many realised when Libor’s abolition was announced in 2017. With contracts worth hundreds of trillions of dollars referencing the disgraced benchmark, even small errors will have vast repercussions. PPI mis-selling? You ain’t seen nothing yet. Richard Kemmish reports

"If you keep 6s unchanged today, I will f-ing do one humongous deal with you… Like a 50,000-buck deal, whatever.”

So gabbled a Libor trader in a chat room exchange referenced in a US court case.

The writing was on the wall as soon as the discussions were made public. Resignations, fines and prison sentences were inevitable, as was the end of a benchmark seen to be so susceptible to manipulation.

Andrew Bailey, CEO of the UK’s Financial Conduct Authority, finally tolled its death knell when he announced in 2017 that banks would no longer be required to contribute reference rates to the Libor calculation after 2021.

But to abolish one set of benchmarks is easier than to propose another, and the five years given for the transition was always going to be a challenging deadline, perhaps too challenging.

“While central authorities have been considering replacement rates for Libor for some time, firms have mobilised their programmes comparatively recently,” according to Nassim Daneshzadeh, partner at PwC, who is advising clients on their transition plans.

What are we changing to?

We can’t even agree on names. Most market participants by now at least know the names of the new benchmarks for the biggest three currencies — Sofr, Sonia and €str (and if you had to google to check which benchmark is for which currency, you are part of the problem). But these are just the big three, do you know which currency will be using Saron or Tona? Answers at the end of this article.

But this is about much more than just remembering names. With the Libor family there was a commonality of methodology and an understanding of what the rates actually meant — real reference rates for term unsecured lending between banks. That commonality is no more: dollars and Swiss francs will reference secured overnight rates; sterling, euros and yen have to make do with unsecured rates. Central banks will calculate some rates, exchanges will calculate others; sterling overnight rates are compounded, Sofr rates use an arithmetic average overnight rate. But perhaps the biggest problem is that the new rates are not even a like-for-like replacement. Libor is forward looking and available for various terms — anything from overnight to one year. It was designed as a term rate to make cash-flow management easier. Backward looking rates, in contrast, are definitively only ever known at the end of the time period that they relate to. The fact that they are overnight adds another level of complexity when you want to use them to fix a bond coupon for the next three months. Converting overnight rates to term rates relies on a derivatives market and, according to Ann Battle, assistant general counsel at ISDA, “there needs to be sufficient volume in the derivatives markets to be able to generate forward long-term rates from derivatives transactions in the overnight rates. No one can predict when sufficient volume will exist.”

She goes on to say: “A big focus of ISDA in the next year will be to assist the market in trading the alternatives.”

The three largest benchmarks are all developing at very different speeds. Sonia has been in existence since 1997 so, as Daneshzadeh says, “it is an existing rate and is getting increasing traction in the derivative markets and in some cash markets” but Sofr “as a new rate is developing more slowly and that may become an issue for a 2021 deadline”.

Even though €str was first published only this year, the euro market can afford to be more relaxed. Eonia, which will continue beyond 2021, is already frequently used in contracts and is an overnight rather than a term rate, easing the pressure on firms to transition.

What’s a bank to do?

Even if we can all remember the new names and agree on some market conventions, there is still a lot of wood to chop. Replies to a ‘Dear CEO’ letter from the FCA and the Bank of England published in
The stripes in the graph show the average annual temperature increase in Germany from 1881 to 2018. Sustainable investments help to achieve the UN’s SDGs. #showyourstripes @nrwbank

www.nrwbank.com/greenbond
Libor and Euribor replacement

June highlighted some of the problems individual banks face. They included finding and quantifying a firm’s exposure to the old benchmark, making plans to address the risks involved in a transition, addressing prudential and conduct risks in the transition and engaging with their peers in the development of the replacement benchmarks.

Even something as simple as identifying and quantifying exposure to Libor isn’t trivial. How do you find all the Libor exposures in hundreds of thousands of loan contracts, not just in their main reference interest rates but as fall-back rates, or penalty interest rate references? Once the exposures are found, can they be quantified? Are alternative reference rates already contained in the legal documents? Are they hedged?

And Libor exposure isn’t always found in the obvious places such as loan contracts. Risk calculation software, collateral valuation rules, even staff performance measures sometimes have the doomed benchmark lurking in them somewhere.

It all adds up to a vast logistical exercise to replace Libor. According to Daneshzadeh at PwC, “some of the largest global banks already have 100-plus staff working on the project. By the time they move to implementation, this could increase 10-fold.”

The risks of getting it wrong

The bond market is a highly visible aspect of the transition but the biggest risks lie elsewhere. In the US mortgage market – one never shy of litigation – mortgages are still being originated with Libor reference rates. “They shouldn’t but they are, and that could lead to big litigation problems in the future,” says Oonagh McDonald, a consultant who has called for a reprieve for Libor and who has written a book Holding Bankers to Account about the history of the scandal.

Similarly, it is difficult to rewrite water-tight contracts with companies that rely on a term structure of benchmark rates when there is not even an agreed methodology to create those term rates.

Some contracts might even have to revert to fixed rates as they do not contain proper fall-back clauses, according to Paul Richards, head of market practice and regulatory policy at the International Capital Markets Association, writing in the industry group’s quarterly report (The transition to risk-free rates in the bond market, July 2019).

“Permanent discontinuation of Libor does not appear to have been considered when these contracts were originally written, so there is a risk of market disruption if nothing is done to pre-empt fall-backs to a fixed rate.”

If the entire objective of Libor reform is to protect the innocent, could the very process create new risks for them? The Bank of England has already highlighted the risk of conduct issues during transition. Does a bulk transfer of retail mortgage contracts, for example, from Libor to a new rate raise questions of fairness, conflict of interest and information asymmetry?

“In the case of conduct regulation, it is important that the change of benchmark does not give rise to mis-selling or other conduct risks,” says Richards at ICMA.

Tax losses and capital gains

Then there are the accounting and taxation aspects. A material change to a debt instrument or a derivative could in some jurisdictions trigger a tax loss for the investor or, more often, given the recent downward path in interest rates, a capital gain.

Or, from an issuer’s point of view, there is a real risk that switching both the bond that they have issued and the swap that they used to hedge it could be deemed to be a material change, which would trigger a loss of hedge accounting. Given the (frequently unrecognised) importance of hedge accounting to the entire bond new issue market, the P&L swings could be enormous. Most expect the accounting standards boards to come to the rescue; if they rule that the benchmark transition is not a material change to the contract, and therefore an accounting event, tax authorities will follow. But those rulings will depend on the nature of the transition — and time is running out.
for them.
If the process of transitioning to the new rates revives the manipulation concerns that started the whole process, so does the most radical proposal so far: not doing it.

Replace or reform?
Despite the traders’ chat rooms and their colourful evidence of manipulation, and despite the manifest flaws in the entire Libor structure, not everyone agrees that Libor has to go, or “at the very least, banks should be pressing for an extension,” according to McDonald.
The problem of legacy contracts could be addressed by a stay of execution. “A potentially complementary option would be for the FCA... to allow the continued publication of Libor for legacy products... when the usage of Libor is restricted for new transactions,” according to Richards. But Battle says that “market participants have shown some concern about a ‘non-representative’ rate possibly being published.”
It is not as if regulators have been sitting on their hands since the scandal first erupted. In 2012 the UK government commissioned a report from Martin Wheatley into the crisis which concluded that Libor needed substantial reforms but, crucially, that it should continue to be published. The reforms were comprehensive and, in the opinion of many, perfectly adequate to restore the benchmark’s integrity and, crucially, reputation. As McDonald points out, “the press always refer to Libor as a scandal-ridden benchmark, but that view is at least six years out of date”.
The changes to the disclosure rules, with individual bank submissions now being kept confidential for three months, reduce the manipulation risk — if you don’t know who helped you manipulate the fixing, who are you going to give that 50,000-buck deal to?
The three month embargo also removes one of the other problems seen in Libor fixings. The whole scandal first came to light because of rumours that a bank was struggling to borrow in the inter-bank market at the height of the financial crisis. Willem Buiter, a former member of the Bank of England’s Monetary Policy Committee, famously quipped that Libor was “the rate at which banks don’t lend to each other”. If no one can see the individual submissions, no one knows if any of their peers are struggling to access interbank funding.

Criminal offence
Other reforms included taking the administration of Libor away from the British Bankers’ Association and making it a regulated activity for the first time, making manipulation of the benchmark a criminal offence, shifting the emphasis to actual transactions rather than indicative prices and abolishing the three month embargo also.

“It is important that the change of benchmark does not give rise to mis-selling or other conduct risk”
Paul Richards, ICMA

Less liquid currencies and maturities that were more amenable to foul play.
The reforms should also be seen in the context of much wider changes to bank compliance which would have captured some of the more egregious examples of Libor-rigging. Looking at the colourful language used in some of the traders’ chat rooms, the adjectives alone would now see the culprits summoned to the compliance department, let alone the behaviour they described.
But the reforms were insufficient. When he announced the death of Libor, Bailey said that the problem was no longer about the method but about the thing being measured.
“The market for unsecured wholesale term lending to banks is no longer sufficiently active,” he said. And if the market is illiquid “... how can even the best run benchmark measure it?”
The use of secured rates — from the repo market — is supposed to improve the quality of the data but, as McDonald points out, “repo rates are frequently very volatile, as we saw last September — this hardly accords with the principles set for the new benchmarks”.
The FCA has highlighted that not enough banks fully appreciate this and instead consider Libor replacement to be a voluntary, if belated, response to the well-documented abuses. As they said in response to a consultation earlier this year, “Some responses demonstrated limited understanding of the inherent weaknesses in Libor, instead attributing the need to transition solely to historic compliance issues... a small number of responses still presented transition from Libor as a choice rather than a necessity”.
The dollar repo spike in September may have been a one-off — or it may not. But with trillions of dollars referencing the new benchmark and with time fast running out to iron out such glitches, let alone input the resultant benchmarks into millions of contracts and thousands of IT systems, the possibility of a stay of execution for Libor beyond 2021 has to be very real.
The chat rooms where the problem started may have been almost comically cress and frequently obscene, but finding the right antidote? Far more complex than most people realised. GC

Saron: Swiss Average Rate Overnight Tona: Tokyo Overnight Rate Average

Richard Kemmish is a guest contributor

Brexit will run on and on, as EU cities specialise

After leaving the EU, the UK will face continuous and infinite choices over how aligned to remain for financial services. Meanwhile, London looks set to continue to leak activity to EU hubs, several of which are developing their own specialisms. Jasper Cox reports

Boris Johnson’s adviser Dominic Cummings is fond of the concept of “different branches of history” — how a series of pivotal moments determined the course we travelled on and where we ended up.

Superficially, one might imagine that if and when the withdrawal agreement that the UK prime minister has negotiated with the European Union is enacted, the mist will clear for the UK’s finance sector.

But, as Cummings might put it, many branches will lie in store for the UK’s capital markets, which will each lead them in a different direction.

How EU member states react to the new circumstances will have a strong influence — especially, how successful they can be in their revised determination to complete Capital Markets Union. So will the commercial decisions of financial firms.

One of the most important forks in the road will be whether the UK stays in the Single Market. This looks unlikely, but by now if you still take anything involving Brexit as a certainty you have not been paying attention. Single Market membership would give firms continued access to EU markets through so-called passporting.

But if the UK leaves the Single Market, the decision tree blooms outwards, with various trade-offs and no clear end.

The UK could seek equivalence (with the EU recognising that the UK’s regime is equivalent to its own), or attempt to include financial services in a free trade agreement, or simply use World Trade Organisation rules.

Meanwhile, any UK decision to sign an agreement with another jurisdiction outside the EU could close off the possibility of closer European alignment. And the reverse applies: hugging close to the EU could hinder the UK’s ability to set different rules and strike deals with other countries, although trade deals tend not to involve much in the way of financial services anyway.

If the UK were to change its regulations on a particular issue, the EU would be likely to see this as a competitive threat and respond by toughening its rules, for example by requiring that more business serving EU clients take place on EU soil.

Rule-takers or rule-makers?

If those are the options for the government, what are they likely to hear from the regulator and the industry?

For its part, the Bank of England does not want to be a rule-taker.

The cynical view is that it is simply keen to hang on to its powers. It may also be a case of a politically aware organisation trying to sail with the prevailing winds. “[Governor Mark] Carney’s just very good and clever at picking up on political desires,” says John Cronin, financial analyst at brokerage Goodbody in Dublin.

But there is also logic to the Bank’s preference. “I absolutely have sympathy with what they’re saying,” says Kate Sumpter, a partner in Allen & Overy’s financial services regulatory practice in London. “They would prefer to be in a position to write their own rules if they are not in a position to influence them. While we have been a rule-taker as part of the EU, we’ve also had a very loud voice at the table, particularly in the financial services space.

Nicolas Véron, senior fellow at think tank Bruegel in Brussels and at the Peterson Institute for International Economics in Washington, has less sympathy, in part because he thinks the EU would be unlikely to enact legislation particularly and specifically harmful to the UK.

As for the finance industry, it has had to prepare for a No Deal Brexit, but favours closer alignment with the EU. A close relationship would “give them the optionality to make a business-driven decision as to whether they maintain their two entities [or] collapse one entity into another,” says Vishal Vedi, a partner in risk advisory at Deloitte in London.

But strength of feeling over this may have waned because UK firms are already set up for a hard Brexit, with entities in EU countries able to conduct business there.

Some may think that if the UK aligns closely with Europe, this would obstruct their UK arms from opening up access to other markets.

So while the downside of a hard Brexit may now be limited, the downside of a soft one remains.

Meanwhile, the equivalence regime could get swept up by other political priorities and blown off course.

In June, negotiations between the EU and Switzerland over issues including legal jurisdiction and citizens’ rights deteriorated so much that the bloc let Swiss financial equivalence expire. The episode demon-
strated the instability of this type of arrangement.

Still, Cronin thinks the EU will not rock the boat. “EU capital markets are best placed to progress and evolve to the extent that they remain open to and integrated with Britain, and I suspect that’s the view the EU has formed on this too,” he says.

One idea on the UK side has been an enhanced equivalence agreement, focused on making sure the outcome of rules rather than the rules themselves are aligned.

This would give the UK more flexibility and “is something the UK regulatory bodies are much more comfortable with,” says Vedi. This special equivalence regime could also involve a facility to protect against sudden withdrawal.

But the EU may not be accommodating “Given the level of trust and political relationships between the UK and the EU right now, it’s very hard to see the EU offering equivalence on a purely technical, purely outcome-based approach,” says William Wright, managing director of think tank New Financial in London.

The only offer may be a stricter “line-by-line” equivalence. “That’s when the UK could be faced with quite a difficult choice,” says David Strachan, head of the Europe, Middle East and Africa centre for regulatory strategy at Deloitte in London.

How much capital markets business moves from London to the EU is likely to increase over time, regardless of the outcome of Brexit.

“Many firms that have set up operations in the EU as part of Brexit contingency plans have made various commitments to the EU about bolstering their presence on the Continent over the next year or two,” says Sumpter. “The European regulators accepted that it was not going to be physically possible to put in place a certain degree of changes in the time available. But they have expected firms to move to a longer-term position over a time horizon.”

Even if UK firms retain passporting, what has been lost to London is unlikely to come back in the foreseeable future. Apart from their commitments to the EU, companies could fear political uncertainty in the UK, or find it inconvenient to wind back past relocations.

Bumpy journey

But what could affect the scale of relocation is the bumpiness of the political journey.

“Let’s say there’s an agreement that the UK will leave the single market in five years’ time, and this date is set in stone, and there are five years to prepare — that’s a very different scenario from the kind of drama we’ve had so far,” says Véron.

The transfer of activities may not be visible as job relocations. Investments and hires may be concentrated in the services space “I think it could inject a little more urgency into this process, trying to iron out the remaining creases — and there are lots of them — in the single market, in banking and finance,” says Wright.

For the EU, this could certainly be a silver lining to the cloud of losing its biggest capital market. For the UK finding a compromise between staying close to the EU and deepening relationships elsewhere looks difficult. GC
Masters of the universe — central banks’ grip on markets tightens

Since the global financial crisis, central banks have accumulated powers over regulation and supervision of markets as well as over monetary policy. In 2019 politicians began to erode that with interventions that have raised questions over who should control markets. By Phil Thornton

The independence of central banks came under unprecedented attack this year, as politicians embarked on populist policies that hurt their economies or refused to take measures to give them a much-needed boost.

Sometimes the political interference is blatant, as exemplified by US President Donald Trump’s repeated calls on the Federal Reserve to cut interest rates and his tweets threatening to remove its chairman, Jerome Powell.

He is not alone. Turkey’s president, Recep Tayyip Erdogan, has set out a novel theory that rate cuts lower inflation. His calls for lower interest rates even amid runaway inflation appeared to have been picked up by the central bank, which cut rates by 250bp in October.

On the other side of the world, Indian central bank chief Urjit Patel resigned after a public row with Prime Minister Narendra Modi’s government, to be replaced by Shaktikanta Das (who has since cut rates by 50bp).

Indeed, according to the International Monetary Fund, central banks representing about 70% of world GDP loosened monetary policy between April and October 2019.

Then there are indirect interventions that hurt growth and force central banks to make even greater use of monetary policy, whether that is the trade war launched by Trump against China or the pressure on Germany to provide a fiscal stimulus for the eurozone economy.

Tobias Adrian, financial counsellor at the International Monetary Fund in Washington DC, says even if central bankers do not respond to political pressure in the decisions they take, it changes the markets’ perception. “The public might have the perception that the central bank is in the hands of the politicians and at that point, trust can erode. That’s a real danger here.”

Power bank

This erosion comes after 10 years of central banks accumulating more power and responsibility following the financial crisis. It fell to them to keep economic growth alive. The net result of this accumulation of power is that central banks have cemented their position as the masters of the universe with their quantitative easing policies and near-zero interest rates coming as they have been handed greater supervisory and regulatory powers. This means they have built up a very significant influence over financial markets.

“IT is true that central banks have taken control of financial markets,” says Padhraic Garvey, head of global debt and rates strategy and regional head of research, Americas, at ING in New York. “Since the financial crisis, there has been greater control taken by central banks, which makes sense against a backdrop where central banks hold a massive chunk of government bond paper — whether that is the Fed, the Bank of Japan or the European Central Bank,” he says.

Central banks now hold vast stakes in many advanced economy sovereign markets. Major central banks’ holdings of domestic sovereign bonds range from 20% of outstanding domestic paper by the US Fed, to more than 30% in the UK and almost 45% in Japan, according to the Bank of International Settlements.

A BIS study of banks’ unconventional operations found that while the immediate impact eased severe market strains created by the financial crises, there had been several negative side-effects. These included a scarcity of bonds available for investors to purchase, squeezed tightening in some markets, higher levels of bank reserves and fewer market operators actively trading in some areas.

Risk-free space

Garvey says central banks have contributed huge excess demand for sovereign paper that has left trillions of dollars earning negative yields. “When you are looking at the risk-free rates space, I would argue that that is quite deviant from the contemporaneous macro circumstances,” he says.
With central bank rates close to — or below — zero in many economies, investors have embarked on a search for yield, taking advantage of the huge quantity of liquidity in the financial markets. Equity markets and bond prices are at historic highs.

This has created a paradox: levels of volatility such as the Vix index have fallen close to record lows even as analysts fret about the potential for asset prices bubbles to burst.

This concern has been compounded by the fact that central banks have been given greater supervisory powers. The Bank of England and the European Central Bank gained supervisory powers in the wake of the global financial crisis, while the Federal Reserve cemented its position as the primary supervisor of the nation’s banking companies.

“We are heading through a period of regime change, which has been a combination of central banks doing their own thing in terms of QE and ultra-low rates together with these rules and regulations that the banks and market participants have got to abide by,” Garvey says.

“Does that combination lead to greater volatility? Well, yes. Have we seen it? No. In terms of measures of implied volatility, the traditional market measures are starkly low and will remain starkly low: “Having said that, is there a greater risk that we are going to have some outsized moves in markets.”

The fear is that this cocktail of masses of liquidity, ultra-low rates and a search for yield will manifest itself in the form of a financial crisis, whether through an asset bubble bursting or a so-called “flash crash”, where markets plunge precipitously at wholly unexpected moments before rebounding.

The crash in the prices of complex securities based on illiquid collateral of subprime mortgages in the US in 2007 and 2008 forced policymakers to intervene by supporting markets and in some cases rescuing the financial institutions involved.

The first of 2019’s flash crashes came within three days of the new year, when the yen spiked suddenly against the dollar. It jumped 8% in the space of seven minutes against the Australian dollar and 10% against the Turkish lira. The second was in February, when the Swiss franc gyrated wildly, with an unexplained and brief jump against the euro and dollar.

In its April global financial stability review, the IMF said increased instances of flash crashes in recent years, even in the most liquid markets, had raised concerns about the fragility of market liquidity. It said there was a “liquidity strained event” in the sovereign bond market — its term for a lack of buyers and sellers — once a day in early 2019, up from about three a week in 2018.

The IMF has developed a monitoring tool that can help its analysts gauge whether liquidity conditions are becoming strained. Fabio Natalucci, deputy director of the monetary and capital markets department at the IMF in Washington DC, says that while it is currently looking at equity and sovereign debt markets, there are plans to extend it to more illiquid markets such as credit and complex securities, although data availability may be an issue.

“It is not to forecast liquidity events but to get a sense of whether the conditions are set for making the system more susceptible to some kind of shocks in terms of a liquidity amplifier,” he says. “Financial conditions are extraordinarily easy now, especially in the US and Europe, and there are a number of triggers that could generate a sudden sharp tightening of financial conditions and that could be amplified by a lack of liquidity.”

Regulation and reform

According to the IMF, tighter leverage and capital requirements for banks have arguably increased the cost of providing capital market services and changed dealers’ incentives to make markets — leading, for example, to some dealers cutting services to less profitable clients.

On the supply side, expanding central bank holdings of safe and liquid assets resulted, by design, in the reduction of the free float of securities available for investors. On the demand side, monetary policies nudged investors to reach for yield through exposure to duration and credit risk in less liquid assets, it said.

Adrian says increased financial regulation may have had unintended consequences in terms of making episodes of illiquidity more likely.

However, he insists the benefits of greater financial stability for tighter regulations outweigh the lower levels of balance sheet capacity. “The risk that a number of large institutions might go bankrupt is much lower than it was in 2008, but on the other hand smaller liquidity events might become more frequent.”

With interest rates forecast to stay lower for longer and the ECB still injecting liquidity, analysts believe markets will remain under the control of central banks for some time.

Garvey says the resolution will have to come through rising inflation that will allow banks to raise interest rates and withdraw liquidity, although he says the outlook is “remarkably benign” in Europe and the US.

“We have this great difficulty generating inflation,” he says. “If there were to be a generation of inflation in the eurozone, that would be the clearest route to exiting the negative rate environment,” he says.

The IMF’s Adrian says central banks need to ensure their policy frameworks are fit for purpose, pointing to the Fed and ECB as two banks that are rethinking them.

Holger Schmieding, chief economist at Berenberg, says there is not much else central banks can do. “They didn’t mess it up and they can’t do much about it. They can react to the symptoms, but they can’t solve the underlying political issues and the underlying nervousness of business, households and especially financial markets.”

I’m watching you: Donald Trump and his Federal Reserve chair Jerome Powell

Capital markets tech reaches tipping point

As it spawns innovations everywhere from new issues to collateral management, is blockchain the technological key to digitising capital markets? And if it is, will that be through public versions such as Ethereum or private confidential networks? Or is this focus on distributed ledgers missing the point and the real need just to automate antiquated manual and bilateral processes? Julian Lewis reports

We are working with technology that is evolving every day,” says Charlie Berman, co-founder and CEO at agora, a digital capital markets technfin. “Its capabilities are several stages more advanced now even than last years’ and that rapid evolution will continue. Anybody that doesn’t recognise that things could be done much better might find that they are disrupted. But, increasingly, organisations that do understand technology see the potential for much more efficient processes and exciting real-world products. We are going to see radical changes and do things never done before.”

“The likely trajectory is that dealers will operate vertically integrated and automated platforms, which could rely on utility services.”

One possible model for future developments is the ‘Platform of Platforms’ anticipated by another UK-based fintech, Nivaura. In this, no single platform will dominate as Amazon does in retail or Google in search. Instead, multiple inter-connected dealer platforms using standard legal frameworks will operate alongside each other and sometimes collaborate (as on syndicated transactions).

“The likely trajectory is that dealers will operate vertically integrated and automated platforms, which could rely on utility services,” forecasts Avtar Sehra, CEO and chief product officer at Nivaura. “These platforms will help them connect their issuer and investor clients. Using these platforms, dealers will be able to focus on the value-add activities such as advisory and provision of specialist analytics and services such as structuring more complex hedging products.”

He expects open communication standards to drive growth in this direction — “where being open and connected is not the competitive advantage, but the norm, and the advantage will come from the additional services that dealers can pin on to their core platforms to provide added value for their clients and to other dealers across the market.

“Over the next five years the capital markets will consider this as the beginning of a new and standard industry-wide operating model,” Sehra asserts.

Berman at agora is similarly bullish. A 35-year veteran of international capital markets, he argues that the markets’ last period of significant change came in the late 1980s and early 1990s with the emergence of significant computing power through desktop PCs. This period saw the critical emergence of swaps, as well as the development of new products and formats such as the global bond.

“What’s different now is that the technology is finally there to provide a lot of the things we knew we wanted,” Berman says.

Capital markets players have broadened their thinking around the impact of digitalisation lately, believes Raja Palaniappan, CEO at Origin Markets. “Four to five years ago people were loath even to acknowledge the issue,” he says. “Macroeconomic pressures are not absent from this discussion, especially for dealers, but one of the positives of the past couple of years has been the increasing acknowledgement and genuine recognition that this is not just a cost-saving but also a way to enhance the customer experience.”

This is significantly improved by being digitised, Palaniappan argues — citing the widespread adoption of retail banking apps. “More and more people are thinking about the metrics of judging the whole experience. We are just at the beginning of that.”

Ancillary business

These considerations are particularly relevant to less profitable businesses such as CP and MTNs, where a number of fintechs have focused. Banks offer these products to reinforce client relationships and help win more lucrative ancillary business.

“By definition, banks are there as a service. They want to run that service as efficiently as possible, but also to make it rewarding for customers,” says Palaniappan.

The products may benefit too. For example, the instant DvP enabled by blockchain would enable sales...
of commercial paper with intraday maturities, notes Michael Spitz, CEO at Main Incubator, Commerzbank’s R&D unit.

In turn, this raises challenging questions about existing terms and definitions such as ‘day count’ and ‘accrued interest’.

“They wouldn’t work any more and would need to be redefined,” he says.

Digital capital markets could also attract new issuers, Palaniappan argues. “If the process is easier and cheaper, that could open the market wider.”

Although Origin does not offer a bookbuilding tool, it sees scope in the medium term to grow investors’ connections to the primary market. This could be in the form of a reverse enquiry portal, since the current process is highly manual (enquiry via phone or chat, sales person entering details into Origin or a similar system).

Perfect use case

As this example shows, the host of highly manual processes still used across capital markets — and often performed by expensive front-office talent — highlights the need for change. In particular, fintechs point to the frequent need in current workflows for documents to be reconciled by sight after multiple amendments or reconciled between multiple databases.

“It’s just madness. There is so much scope for mistake and error,” judges one fintech player.

Main Incubator cites reconciliation tasks as the area blockchain is most suited to and points to potential applications in capital markets, as well as trade finance, ‘programmable currencies’ and identity.

“DCM is a perfect use case for this technology,” agora’s Berman contends. “You have complex, confidential bilateral discussions between banks and issuers that at some point turn into multilateral conversations that are still confidential. Then you form a syndicate, exchange and manage information flows and finally reach terms.”

Equally, artificial intelligence (AI) could be used to predict the composition of order books, notes Spitz at Main Incubator.

Baulking at blockchain

Berman argues that private confidential distributed ledger technology will prove more valuable for markets than the public blockchain — where much of the landmark activity to date has occurred (see page 28).

“The power of a private confidential network is that you can ensure that everyone who needs the information is seeing it, but no one that you don’t want, and it needs to be fast, scalable and secure,” he says.

Even so, some fintechs play down the need for blockchain solutions in capital markets — either in general or as an immediate priority. “It’s not the most important thing,” argues Origin’s Palaniappan. “Market participants don’t have a trust issue between themselves. Right now everyone has their own database. Blockchain moves to everyone sharing and not being able to edit. If at some point the capital markets and immediate relevance, and is agnostic as how to transactions are settled.”

Adoption is key, agrees Main Incubator’s Spitz. “Not the entire universe is on there. If only a fraction of counterparties are using it, it doesn’t make a lot of sense,” he asserts, noting that with only limited volume of debt market activity conducted on blockchain currently participants may need to wait longer for widespread adoption.

“But once it has real benefits for clients, they will come,” he adds, citing the sale to MEAG, the asset manager of Munich Re and Ergo, of a tokenised KfW note that delivers ‘accrued interest’.

“Over the next five years the capital markets will consider this as the beginning of a new and standard industry-wide operating model”

Avtar Sehra, Nivaura

The likely trajectory is that dealers will operate integrated and automated platforms

have had a lot of press around our ongoing blockchain and tokenisation efforts, but we recognise that not all of the market is primed to work with those technologies,” notes Duncan Phillips, chief commercial officer at Nivaura.

“Nivaura’s core focus is on workflow technology that has widespread

“Over the next five years the capital markets will consider this as the beginning of a new and standard industry-wide operating model”

Avtar Sehra, Nivaura

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“But once it has real benefits for clients, they will come,” he adds, citing the sale to MEAG, the asset manager of Munich Re and Ergo, of a tokenised KfW note that delivers ‘accrued interest’. “If there is the option to custodise a security cheaper, one client after another will do it.”

Nuts and bolts

Digital efforts in capital markets to date have often been aimed at making existing processes more efficient and reliable. “We can digitise paper documents and streamline the issuance process without re-architecting the market,” Palaniappan notes.

He cites the ‘digital’ CD that Origin structured with Crédit Agricole and China Construction Bank at the end of October. This follows an earlier EMTN in June that the firm collaborated on with Citi (as both dealer and paying agent) and issuer Vasakronan.

Origin expects “a handful” of further issues of this sort soon. Meanwhile, Nivaura’s focus has...
been on documentation, where it supported the major law firms in the launch of ‘global mark-up language’ (GLML). Its Aurora platform enables dealers to create and share term sheets with issuers without the traditional multiple drafts in Word going back and forth between the parties. Produced through a series of logic-driven drop-downs (all FRN options eliminated once a fixed-rate transaction is specified, for example), the term sheet is sent to the issuer through Aurora.

“The technology brings greater efficiency, accuracy and transparency,” believes Philips, who characterises these efforts as “helping market participants do digitally what they have always done.”

A second phase involves proceeding to a legal document, produced either by an in-house lawyer or external counsel. The platform allows data to flow into the document from the term sheet and the issuer’s debt programme documentation, supplemented by some additional questions and drop-downs.

The use of Nivaura’s GLML here “makes documents machine-readable, allowing them to be managed and negotiated digitally as opposed to the cumbersome manual processes that exist today.” Moreover, it avoids the cost and risk of a lawyer having to retype the document.

At the same time, data can flow onwards — ‘downstream’, in the jargon — to custodians and paying agents. This very efficient process contrasts with the current practice of emailing final terms to these parties.

Syndication in sight
Primary market fintech initiatives tend to focus on bilateral debt products such as commercial paper and MTNs. But most have the goal of pushing into the larger, more lucrative syndicated bond market. “The underlying workflows aren’t too different,” notes Philips at Nivaura.

“You still need to align on terms and prepare legal documentation — there are just more participants in the process.”

“Rather than a multitude of duplicative bilateral discussions with the pen holder, we allow for a more collaborative discussion, and provide visibility on the causes of any hold-up,” Philips believes.

This gives scope for quicker launches and shorter settlement periods on a variety of instruments. “The sooner we can allow the bond to start trading, the better for everyone” concludes Philips.

Origin will “ideally” digitise its first public offering early next year, Palaniappan says. He expects both Origin and other providers to have progressed into the syndicated market within the next 12 months. Both MTN issuers and those only

### Secondary blockchain bond drive

**BESIDES PRIMARY landmarks such as the World Bank’s Australian dollar bond-i transaction with Commonwealth Bank of Australia and Banco Santander’s US dollar one year, supported by Nivaura, blockchain is also making notable headway in secondary markets.**

Bond-i forms part of this, with the A$100m two year having added secondary trading capability recorded on blockchain in May, when TD Securities was appointed market maker in the bond. In August IBRD tapped the deal by $50m through CBA, RBC Capital Markets and TD.

Bond-i offers “tangible evidence from our first bond offering using blockchain technology and subsequent bond management, secondary trading and tap issue via the same platform that blockchain technology can deliver a new level of efficiency, transparency and risk management capability versus the existing market infrastructure,” says Sophie Gilder, head of blockchain and AI at CBA in Sydney. “Next we intend to deliver additional functionality to deliver greater efficiencies in settlement, custody and regulatory compliance.”

Having reduced the number of intermediaries required in the process, making the transaction faster, more efficient and simpler, Santander also sees its blockchain bond serving as “a first step towards a potential secondary market for mainstream security tokens in the future.”

In addition, in October Commerzbank and MEAG, the asset manager of Munich Re and Ergo, settled a legally binding trade in an undisclosed security via digital tokens. The pair exchanged cash and securities tokens in a DvP transaction on a blockchain platform created by Main Incubator, Commerz’s research and development unit.

“For us as an investor, distributed ledger technology has a significant potential to increase efficiency of operations. By reducing the need for intermediaries, the transaction process of securities is going to accelerate,” says Frank Wellhoefer, member of the board of management at MEAG.

“The involvement of tokens representing securities and money will facilitate network efficiencies and build a foundation for the creation of standards. This is important for the buy side as standards lead to broader market acceptance and thus create liquidity on DLT platforms in general.”

Moreover, Commerz added a further dimension to the deal. It used the cash tokens it received as collateral to cover margin requirements at Deutsche Boerse’s Eurex.
active in public bonds are showing interest. Automation of documentation and the workflow around paying agents, stock exchanges and clearing systems appear particularly strong drivers of this. “Those are very, very manual processes, but we can open up the API and the paying agent can read all of the information electronically,” Palaniappan says. “That’s solving the problem of the manual transmission of information to the post-trade eco-system. It should significantly reduce both cost and scope for errors.”

He points to Vasakronan’s use of a digital signature on its landmark digital MTN. “Many issuers are still printing out and hand-delivering. But back-end workflows will become a lot more streamlined, hopefully.”

**SRI impact**

With its need for verification of use of proceeds, the green and socially responsible bond sector may be a particular beneficiary of the digitisation of capital markets. “How do you ensure that proceeds are compliant? Technology can help improve this as information is traceable on the ledger,” notes Main Incubator’s Spitz.

This assumes that the bonds are on DLT. Once they are, the role of external providers of green review becomes questionable. “You replace trust [in the provider’s review] with an immutable database,” he comments.

Similarly, ESG ratchets, found in Sustainability-linked deals, would no longer require the review provider to inform the calculation and paying agents whether conditions have been met for a higher payout. Programmable logic would make the coupon step-up automatic.

**Disintermediation ahead?**

One issue looming over discussions of new technologies in capital markets is disintermediation. “Some believe that the end-game of all fintech businesses is to disrupt incumbent providers and that there will be no role for investment banks in the future — issuers and investors are going to connect directly,” notes agora’s Berman.

He doubts that digital capital markets will revert to this 19th century model of direct lending by investors to borrowers. Moreover, he is sceptical about the likelihood of many issuers adopting digital auction mechanisms.

Instead, Berman counters that banks will continue to “perform the vital function of intermediating risk”. “The need for that role is not going away, though it can be done more efficiently,” he says. “These are very regulated markets and counterparty risk, settlement risk, ‘know your customer’ and anti-money laundering checks are all important facets. How is that going to operate without the banks?”

“Yes, you’re not going to see other major market participants wanting to take on those obligations. When it is introduced, Atomic settlement will undoubtedly reduce counterparty default/failure risks but KYC/AML responsibility remains.”

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**Post-trade potential**

**ONE AREA where market participants see significant potential for new technologies is the multiple post-trade processes.** “There is a lack of innovation in post-trade.” says Darren Coote, CEO of Cobalt, a fintech focused on currency markets. “Current processes are fragmented, which has led to market participants’ post-trade costs reaching an uncontrollable level. A single trade today creates multiple records for all parties, which introduces inconsistencies and errors throughout the trade lifecycle. The legacy systems that are currently in place pose significant operational and systemic risk to the market. “People are starting to wake up to the fact that there needs to be a change.”

New technologies can bring “huge benefits” to the post-trade area, believes Michael Spitz, CEO at Main Incubator, since “information is on the chain” — especially as this allows immediate focus on the small minority (about 3%) of trades that fail.

One example is the Utility Settlement Coin (USC) that the Fnality consortium of banks is now seeking to commercialise. USCs in five currencies — Canadian and US dollars, euros, sterling and yen — will be private digital chains backed by fiat currency held at the appropriate central bank and always convertible back to that currency at par.

The goal is to reduce post-trade settlement, counterparty and systemic risk. Another is HQLAx, a collateral management system for the high quality liquid assets that globally systemically important banks are required to hold. Built on R3’s Corda private blockchain, it involves token transfers rather than exchanges of securities between custody accounts. Clearstream is the system’s custodian.

Cobalt has created a centralised shared post-trade infrastructure. It argues that a single post-trade system across all FX relationships and one joint record between counterparties “dramatically” reduces post-trade costs — “along with unnecessary risk,” Coote adds.

More generally, instant delivery versus payment is both technically feasible and the direction of markets’ travel, according to Main Incubator.

“But it puts more pressure on the system. You need to rely on the quality of data, and it needs to interact with legacy systems,” notes Spitz, who emphasises that clients and regulators will regard banks as responsible for this.
Proliferating MDBs find politics a developing challenge

We have more multilateral development banks than ever before. They perform an invaluable job in a challenging and ever-changing world, but as they expand, and as new MDBs emerge, a fear is growing that they are being used as political tools by sovereign shareholders, keen to promote their own interests around the world.

By Elliot Wilson

It’s never been a better or more challenging time to be a multilateral development bank. MDBs are growing in scale and number as they scramble to meet surging demand for new or improved infrastructure. The world now boasts more than 30 of them, from the big boys in China, the US and Europe, through to the regional champions, to a gaggle of local or niche players.

Size varies wildly. At the end of 2018, the European Investment Bank (EIB), the world’s largest lending institution, had €451bn ($497bn) of outstanding loans on its books. Compare that to the Black Sea Trade & Development Bank, with its 12 member states including Turkey and Russia, and €2bn of outstanding loans as of October 2019.

“It’s just not enough,” the bank’s president Dmitry Pankin told GlobalCapital at the IMF’s annual conference in Washington DC in October. “We need to be a stronger institution that encourages regional co-operation by starting more serious projects.”

Focus of course differs too. Most MDBs are handed a remit in projects dotted around Asia, focusing on emerging or frontier states, with the African Development Bank and the Inter-American Development Bank doing the same in Africa and Latin America respectively.

Others are all but unrecognisable from their early days. Take the European Bank for Reconstruction and Development, set up in 1991 to help ex-Soviet states make the transition to free markets. At times the London-based MDB seems more focused on North Africa and the Levant — two regions it expanded into in the wake of the Arab Spring — than on its original outposts in emerging Europe and Central Asia.

Going forward, the big question for EBRD shareholders is whether to continue this southward push, into sub-Saharan Africa. Its president, Sir Suma Chakrabarti, certainly believes it should, and rarely misses a chance to push this narrative. In his speech to the EU’s powerful Economic and Financial Affairs Council in early October, he used the word ‘Europe’ four times but mentioned ‘Africa’ six.

Several new MDBs, despite only recently bursting on to the scene, already seem an integral part of the multilateral map. The Beijing-based Asian Infrastructure Investment Bank has 69 member states and, at the end of 2018, had lent $7.5bn to 35 projects in 21 countries, mobilising $715m of private capital along the way. With members ranging from the UK to Brazil, and South Korea to Saudi Arabia, it is already a global entity in nature, if not actually in name.

Another sparkly new IFI, the New Development Bank, often called the ‘Brics Bank’ due to the initials of its five founding members states — Brazil, Russia, India, China and South Africa — was slower to get going, but has outsized ambitions of its own. It projects net new annual lending to be $10bn in 2020, and $41bn in 2027, from a projected $7bn-$8bn in 2019.

“We will over time become a global institution with the Brics [markets] at our core,” Leslie Maasdorp, the bank’s finance director, told GlobalCapital. “Over time, the bank will evolve, building far more of a global role” for itself. When quizzed earlier about the bank’s expansion plans, he tipped its roster of members to at least double by the mid-2020s, to include both developed and developing nations.

Remarkable success

When left to their own devices, most big-ticket multilaterals have proved remarkably successful. “The MDB model is tremendous in general,” says Christopher Humphrey, an economics professor at Swiss university ETH Zürich. “You print bonds, and the capital you raise at a really good price pays for your administration costs. You are constantly generating retained earnings, which further boosts your capacity to lend.”

Humphrey reckons that since its inception in 1944, the World Bank has tapped shareholders for a total of $17bn (not adjusted for inflation), of which the US has contributed $2.3bn. “With that money, the IBRD [the first of the World Bank’s five lending divisions] has generated $30bn of retained earnings, and lent $700bn, mostly to poor countries. No wonder China wanted to build its own equivalents.”

The re-emergence of China as a 21st Century superpower is tremendous in general,” says Christopher Humphrey, an economics professor at Swiss university ETH Zürich. “You print bonds, and the capital you raise at a really good price pays for your administration costs. You are constantly generating retained earnings, which further boosts your capacity to lend.”

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The re-emergence of China as a 21st Century superpower
has changed the entire face of development banking. Its leaders likely would not have formed the AIIB, had it successfully convinced the World Bank to give it a bigger seat at the table. But the emergence of the AIIB, added to the existing firepower of China Development Bank and Export-Import Bank of China, both aggressive lenders to emerging nations, forced the US and Europe to act.

The US is rolling out a new federal agency called the US International Development Finance Corporation (DFC) out of the bones of the Overseas Private Investment Corporation (OPIC). It aims to modernise the country’s development lending capabilities and, in the long term, to mobilise up to $60bn of private capital, to channel to worthy projects in the developing world. Much of that freshly tapped capital will be directed to fast-growing Asian markets, where the DFC will compete and likely also collaborate with, among others, the AIIB and the Asian Development Bank.

Europe on the move
Europe in turn is still mulling the future of its own extra-territorial lending activities. In March, a so-called ‘high level group of wise persons’, which included bankers and academics, were asked to analyse how the EIB should operate outside the European Union.

Their report, published in October, suggested three courses of action. First, it could transfer all of its non-EU lending activities to the EBRD. Second, it could merge its lending operations with the EBRD’s, creating a new agency owned by both development banks as well as the EU and its member states.

With the first a non-starter and the second unlikely, given that the EBRD’s shareholders include the Russian and US governments, the third option on the table — to task the EIB with creating a new division that would be part-owned by EU-based national development banks — is by far the most viable.

When interviewed in October by GlobalMarkets, EIB president Werner Hoyer described it as the “best option” of the three. The aim as it stands is to create, by 2027, a €60bn off-shoot, tentatively called the European Bank for Sustainable Development, which will put European development capital to work in projects across Africa and Asia.

Much political wrangling will likely need to take place before a decision is made and any new development bank is created. But the fact that the various arms of the European project are working largely in harmony to project internationally the EU’s significant financial firepower, in the hope of boosting its hard and soft-power status, is in itself interesting.

Europe’s migrant crisis, which began in 2015, and saw millions of undocumented immigrants enter the EU from Africa and the Middle East, accelerated thinking in Brussels and the main European capitals. That coincided with a wider problem of how the EU targets lending opportunities in member countries.

“For sure, politically directed lending happens at the legacy development banks,” says the ETH Zurich professor Humphrey. “There is no doubt that throughout history, the United States has used the World Bank to ensure that countries like Afghanistan and Iraq get the loans they need.” By contrast, he says, very few of the loans disbursed so far by the AIIB appear to be made with a strategic national imperative in mind.

“I’m finalising a paper on the first three years of the AIIB and the NDB, and a key question I asked was if China was using either bank to channel cash to Belt and Road Initiative projects,” Humphrey adds. “The answer is a pretty definitive ‘no’. Two of the biggest sovereign recipients of Belt and Road loans are China and India. Certainly, China is not lending to itself on its own behalf, and India is highly vocally opposed to the entire plan.”

In turn, he adds that of all the NDB’s outstanding loans, only three can be construed as being connected to Belt and Road projects. One is a port in South Africa, and the other is a highway in eastern Russia. “The evidence is that neither development bank is being used to further China’s own initiatives. That’s not to say that won’t change, and perhaps [China is] just trying to build up the banks’ brands before being more heavy-handed and political with them” further down the line. Watch this space.
The hottest thing in capital markets

The must-have new business line in capital markets is raising capital for companies that might be nowhere near coming to market. Tech companies stepping outside the private markets have stumbled this year, but banks still hope to take a slice of a fast-growing pie. Owen Sanderson reports

Once upon a time, if a fast-growing company wanted to fuel its growth, it had to go public. Stock exchanges were where the money was, and where chief executives had to go to sell their story. Now, whether it is Masayoshi Son committing $4bn in a 12 minute meeting, or a team of grizzled venture capitalists committing $4m after extensive due diligence, many fast growing tech-related firms would rather tap sources of private capital rather than rush into listing.

“With the change in the yield environment, investors are allocating larger pockets of capital to alternative investments in general, and direct investment has been one of the major alternatives,” says Isabelle Toledano-Kourkois, head of private capital markets EMEA at UBS. “As companies stay private for longer the size and complexity of transactions is increasing therefore strategically we had to respond to that need.”

Where there’s money, investment banks tend to follow, and none faster than Goldman Sachs, which has a dominant spot in tech initial public offerings to defend, and a desire to find new and fertile corners of capital raising. The firm set up an alternative capital solutions unit in 2016, aiming to serve this need. In hindsight, it seems like an obvious step — who better to find potential investors than a global trotting investment bank, facing investors from family offices to giant corporations, sovereign wealth funds and institutional accounts?

Goldman Sachs and others are following some of their better clients into this market — the largest fee payers in investment banking are the big financial sponsors, and the likes of KKR, CVC, Advent and Permira have all established growth capital units in recent years.

“Lots of our more traditional financial sponsors have raised dedicated growth capital funds,” says Mike Marsh, head of EMEA credit financing and global co-head of alternative capital solutions at Goldman in London. “The investment opportunity for the funds is clear but the insight this flow of intelligence brings to a GP can be valuable also.”

Staying private for longer

While the individual capital investments may be small, businesses may prove disruptive to existing portfolio companies — or buy-out targets. But intermediating the flow of private capital through an investment bank has not necessarily been the norm. Specialist boutiques will help to connect venture money to start-ups, and a big part of early stage investing is originating your own investment opportunities. Successful funds run incubators to make sure they get first bite of the cherry, knowing that there’s a limited and illiquid market connecting companies needing capital with potential growth company investors.

“The specialist venture capital firms come in at an earlier stage than we do, and we can play a complementary role,” says Toledano-Kourkois. “We might be involved from series ‘B’ or ‘C’ onwards, but companies are staying private for longer. Banks have understood that companies need to be accompanied on this journey, you can’t just show up and pitch for the IPO.”

Fundraising in the early stages of a growth company’s life has historically involved founders themselves tapping family and friends for cash, or managing their own pitching and capital-raising. While a founder or CEO is always going to be involved in a strategic capital raise, they’re unlikely to have the same breadth of investor relationships as the likes of Goldman Sachs.

“Historically we have seen founders using their own network to raise capital, advisers have played a part but it has been less prevalent than in other forms of capital raising,” says Marsh. “We feel that our capital raising platform has not disrupted an existing ecosystem… [rather, it has been more] …accretive and additive to an existing one, offering founders and growing companies access to a broader source of growth equity.”

Other banks have also set up similar units, with the likes
of JP Morgan and Morgan Stanley — the other major tech houses — performing the same role. Swiss banks Credit Suisse and UBS come at the opportunity from a slightly different direction, that of wealth management powerhouses which manage lots of entrepreneur cash.

“I can’t remember a time when there’s been more interest in a new market”

Lyle Schwartz, Goldman Sachs

Starting with founder relationships, they want to convert those into mandates for capital raising.

It’s a symbiotic dialogue — the ultra-wealthy, investing through family offices, are frequently keen to invest directly in private growth tech opportunities directly, and may want a more hands-on approach than if they needed a VC fund. They look to their banks to provide this flow of deals.

“For a family office, they can either travel the world themselves looking for the next Uber or Spotify, or they can plug into our flow of opportunities,” says Lyle Schwartz, a senior member of Goldman’s alternative capital solutions unit looking after equity private placements. “I can’t remember a time when there’s been more interest in a new market.”

UBS set up its private capital markets unit this year, run by former corporate DCM head Toledano-Kourkois, which, unlike the Goldman unit, also seeks to originate and distribute bespoke debt opportunities as well as growth equity and other non-control equity.

“One of the reasons we are an early adopter of this approach is that we are one of the largest global wealth manager in the world,” says Toledano-Kourkois. “A lot of our clients are entrepreneurs, and we can help them access capital or liquidity before they go to the public market.”

Winning big

The business is light on regulatory capital — it’s largely advisory, and, like an IPO, there’s no hard underwriting — but that doesn’t mean it’s cheap. The time commitments and the sheer manpower required, for relatively small-sized, non-principal deals mean that it’s not an obvious standalone money spinner.

It is, however, a business where banks can win big — successful fundraising early on can mean a client for decades to come, a lucrative IPO, debt offerings down the road, and a strategic relationship that can bypass beauty parades. “We hope to build strategic relationships with the companies we raise capital for, we are in for the long term,” says Marsh. “A given capital raise is not a single time events for us.”

Further down the road, the business of raising growth capital could morph into a chance to trade it — but this hits the problem that many growth companies want tight control over their shareholder registers, and choose investors for strategic reasons, not just because they offer the most attractive investment terms.

“The strategic angle is important in private financing,” says Toledano-Kourkois. “Yes, you want to grow your business, but with the right partner. The right investor for expansion in Asia might be different from the right investor for expansion in Europe.”

That doesn’t necessarily mean founders or early stage VCs have the right idea about who their partners should be. Working with a bank, rather than originating their own capital, might come with higher fees — but it means a far broader range of investors might have the chance to come in.

“Some companies start with a preconceived notion of the kind of investors they want — perhaps it’s one of the biggest asset managers, perhaps it’s a top flight VC, perhaps it’s a strategic investor they know they want to work with,” says Schwartz. “Part of what we do is turn them on to the diversity of capital that’s available, and sometimes through the exercise these preconceived views change.”

A broader range of investors, and a relaxation of control over the shareholder register might help to create limited liquidity in some private stocks — and that, in turn, means better reference prices, and the chance to lend against private equity placements.

Again, it’s not a new idea — though it tends to hit the headlines only when it goes wrong. WeWork chief executive Adam Neumann, for example, was able to raise a $500m margin loan with JP Morgan, Credit Suisse and UBS, despite there being no transparent ‘market’ price for WeWork stock.

That will have hurt the banks in question, but one rough trade doesn’t mess up the market. Plenty of founders still have their wealth bound up in concentrated privately held equity positions, and want investment bank help to access this money.

Still, WeWork has cast a bit of a shadow over capital raising in private businesses — particularly those touted as disruptive, tech-enabled businesses. While companies can stay private for longer than ever before, there’s usually a public market exit in mind at some point, and a disappointing run of tech unicorn IPOs this year — WeWork never made it out of the gate, but Uber, Lyft, Peloton, and Slack did — has left valuations less rosy than before.

“The valuations you can achieve in private markets have adjusted to the recent situation in the public markets — everything is linked, and you cannot separate them,” says Schwartz. “Private markets had got a little way ahead of public and recent deals have been a reality check. But big picture, we’re near all-time stock market highs and private capital markets remain open for high quality growth companies.”

Still waiting for the green leap forward

Franklin Roosevelt’s New Deal helped pull the US out of the Great Depression. Climate change is a bigger crisis and requires a similarly total response. But is the European Commission being ambitious enough? And will politicians, business and society accept the changes required? Jon Hay reports

The Green New Deal — 10 year-old campaigning term for a comprehensive reform of economic and social policy to make society sustainable — has risen to prominence in the past two years, especially in the US, as consciousness of climate change has intensified.

“We need a global Green New Deal that is bold and attacks the climate issue like the emergency that it now represents,” says Steve Waygood, chief responsible investment officer at Aviva Investors. “As well as every regulator we need to call upon every organ of society, every central bank, every institutional investor, every non-governmental organisation and every individual to take strong action.”

The European Union is about to make the first attempt. When she pitched in July to be president of the European Commission, Ursula von der Leyen put a European Green Deal top of her agenda. Implemented ambitiously, it would shape business and financial markets, accelerating the transition to cleaner energy and reforming sectors such as vehicles, shipping, construction and agriculture.

A leaked draft of the policy was remarkably broad and far-reaching, although scant on detail: it consisted of one line bullet points, and there were many gaps. Already, there are signs of the battles to come over how fast the EU can move.

Central to the Green Deal is passing a law by March 2020, requiring the EU to achieve carbon neutrality by 2050. Since 2014, Europe has been committed to cutting greenhouse gas emissions by 40% from 1990 levels by 2030. The Green Deal would raise that target to “at least 50% and towards 55%”, with a plan on how to do this by October.

In July, von der Leyen announced a €1tr Sustainable Europe Investment Plan. “A huge question is... is there fresh money on the table?” says Sébastien Godinot, economist in the European policy office of WWF.

The EIB plans to “support €1tr of investments in climate action and environmental sustainability” in the decade to 2030. But that would only be about a 45% acceleration on the pace of its financing since 2012. Meanwhile, fossil fuels are subsidised in the EU to the tune of $289bn in 2017. worryingly, in Godinot’s view, the draft Green Deal policy does not mention the sustainable investment plan at all.

WWF has set five tests for the Green Deal: it must set targets for both decarbonisation and preserving biodiversity; make food sustainable; have zero tolerance for non-compliance; stop financial support for harmful activities and make finance support sustainability; and ensure the transition does not impoverish disadvantaged groups.

A Just Transition Fund is promised to help regions affected by abandoning coal. But the private sector will have to contribute. Enel, the Italian electricity company, has redeployed workers from closed coal plants and refashioned the sites for new economic uses.

“We have cut, starting from 2015, about €1.5bn of costs — have you heard anything about social problems?” says Alberto de Paoli, Enel’s CFO. “That’s because we managed things not to impact people.”

The Green Deal will produce a new action plan on green financing in June 2020, building on the 2018 Sustainable Finance Action Plan.

Kate Levick, sustainable finance lead at the think tank E3G says the Commission’s thinking is wide open and there is “very much to play for”. She hopes the plan will include stimulus measures. “If you are doing economic stimulus, you should not just be doing short term, non-green projects, but think about how to use it for the transition,” she says.

Christine Lagarde, new president of the ECB, is making climate change “mission-critical”. This could include skewing ECB asset purchases away from bonds of polluting companies and towards cleaner firms or green bonds. But this would do little to speed up the transition: it is not being held back by a lack of bond demand.

Much more difficult is planning the transformational projects needed and bringing them to financable states. Member states must produce National Energy and Climate Plans about projects needed and bringing them to financable states. Member states must produce National Energy and Climate Plans about this.

“The first drafts were mostly awful,” says Dörte Fouquet, director of the European Renewable Energies Federation. “They were all hiding under the table in terms of giving figures.”

Final drafts are due by the end of this year. They will give the first concrete sign of how likely the Green Deal is to become a reality.
The public development bank financing green and social investments across the French territory

As the leading local public sector lender, SFIL Group finances a significant share of investments in clean local public transportation, sustainable water management, waste management, green public buildings, and public healthcare.

Since 2019, SFIL Group is a regular issuer of green and social bonds to finance public green and social investments.

More information on SFIL Group Green and Social Bond issuance under: sfil.fr/en/sfil-group-investors/
2019 bond deals of the year: public sector borrowers

2019 proved more fruitful for supranational, sovereign and agency borrowers than was expected in 2018 – in part thanks to a rejuvenation of the ECB’s asset purchase programme and a wholesale return to dovish monetary policies. GlobalCapital’s SSA team used its editorial judgment, with inspiration from GC’s world famous bond comments, to pick the top trades of the year. We strove to find deals that were not just the biggest, but that set pricing markers, were innovative and brave, or made an impression in other ways. GC presents the winners here. Congratulations to the issuers and banks involved.

**SOVEREIGN DOLLAR BOND OF THE YEAR**

**Italian Republic**

$2.5bn 2.375% October 2024, $2bn 2.875% October 2029, $2.5bn 4% October 2049

Barclays, HSBC, JP Morgan

Dollar bond issues from eurozone sovereigns are rare — especially from Italy. Italy last came to the dollar market in 2010, but it had been planning to return to the currency for some time. It had hoped to make its comeback in 2018, but ended up postponing due to volatility in the Italian bond market, before finalising plans for a date in October 2019.

But the deal was worth the wait. Italy received more than $18bn of orders across the deal’s three tranches. “Even in the best times, getting 30 year dollars is an impressive achievement,” said a head of SSA syndicate away from the deal. “It’s a great sign for Italy’s future as a regular dollar issuer.”

**SOVEREIGN EURO BOND OF THE YEAR**

**Hellenic Republic**

€2.5bn 3.875% March 2029

BNP Paribas, Citi, Credit Suisse, Goldman Sachs, HSBC, JP Morgan

Greece strode past another milestone in March, on its road back to becoming a frequent issuer in the capital markets with its first 10 year bond since 2010, soon after a two-notch rating upgrade from Moody’s. The sovereign built a final book of over €11.8bn, which, at the time, was its largest book on any of its syndications since it had made its comeback to the capital markets in April 2014. It was also able to keep the proportion allocated to hedge funds to only 11%. Greece was able to tap the line in October, adding an additional €1.5bn.

**SUPRANATIONAL DOLLAR BOND OF THE YEAR**

**Asian Infrastructure Investment Bank**

$2.5bn 2.25% May 2024

Bank of China, Barclays, Crédit Agricole, Goldman Sachs, TD Securities

This deal was a long time coming. AIIB started marketing this offer almost two years before it came to market in May and met around 250 investors. AIIB’s debut gave the issuer a place among the very top supranational names in the capital markets. The bond was sold at mid-swaps plus 6bp, mostly to high quality investors around the world — primarily central banks and bank treasuries. Just over half of the deal was placed outside Asia.

“For a new issuer they probably overachieved, in that they arguably haven’t paid any new issue concession,” said a head of syndicate away from the deal.
**SUPRANATIONAL EURO BOND OF THE YEAR**

**European Investment Bank**

€1bn €str plus 20bp October 2022
BNP Paribas, Crédit Agricole, Deutsche Bank, HSBC, RBC Capital Markets, TD Securities

The European Investment Bank got the €str ball rolling in October with the first benchmark bond linked to the rate, which came after 18 months of preparatory work by the supranational. Euro floaters are not an easy sell, given the ECB’s well-established dovish leanings. But despite concerns of a lack of investor demand before the trade, EIB received a final book of over €2bn, which allowed it to comfortably print a size of €1bn. Bank treasuries were always likely to drive demand, but there was also strong interest from other investors, including central banks and other real money accounts. The deal used the same structure that the EIB had pioneered for Sonia and Sofr FRNs, with a coupon calculation that is compounded over the quarterly payment period with a five-day look back period.

**AGENCY DOLLAR BOND OF THE YEAR**

**Bank Nederlandse Gemeenten**

$3bn 1.5% September 2022
HSBC, Morgan Stanley, Scotiabank, TD Securities

BNG hit the dollar bond market at the end of August, a period of difficult market conditions, braving volatility in swap spreads and underlying rates. Nevertheless, BNG braved the turbulence and managed to find enough demand to print its biggest bond in any currency. Bankers said that setting the spread at the deal’s announcement helped, giving investors clarity on the price of the bond. The timing was also important, as BNG waited for the EIB and KfW to announce their trades first. It also came before a crucial set of central bank meetings in September, in which the ECB announced a comprehensive stimulus package and the US Federal Reserve cut rates for the second time in 2019.

**AGENCY EURO BOND OF THE YEAR**

**KfW**

€5bn 0% June 2022
BNP Paribas, JP Morgan, TD Securities

This was KfW’s first three year euro benchmark bond since 2015, as it made a strategic choice in March to return to the maturity as part of its efforts to be a frequent issuer across the whole curve. Despite a negative yield, investors backed the move — the final book closed at over €7.7bn, and the bond immediately performed in the secondary market. “I was not convinced a €5bn deal was on the table and I thought it would have needed a significant new issue premium,” said an SSA banker away from the deal. “Clearly, I was wrong.”

**SUB-SOVEREIGN BOND OF THE YEAR**

**Autonomous Community of the Balearic Islands**

€400m 1.549% November 2028
Bankia, BBVA, Caixabank, HSBC

The Balearic Islands returned to the bond markets in February, after a seven year hiatus. The deal kick-started the return of Spanish regions to the bond markets, after the central government ruled that regions meeting their deficit and budget targets could access the capital markets while still being part of the government’s Fondo de Liquidez Autonómica (FLA) programme (or Regional Liquidity Fund). The tensions over Catalan independence and Spain’s handling of the issue meant that market conditions were not easy for the Balearic Islands’ comeback, but in spite of that, the issuer was able to sell its biggest-ever single tranche bond.

**STERLING SSA BOND OF THE YEAR**

**World Bank**

£1.25bn Sonia plus 27bp May 2024
Bank of America, HSBC, TD Securities

The World Bank set out in May to raise £500m, and to push out its Sonia curve to five years, but the overwhelming demand it received meant that it was able to raise £1.25bn. That made this deal not only the largest Sonia bond ever from an SSA borrower, but the largest sterling floater from an SSA borrower since Network Rail’s in 2004. It was also the second largest sterling bond of any format from a non-UK SSA issuer in 2019. The trade was a superb follow-up after the World Bank had become the first supranational to issue a Sonia linked floating rate note in 2018.

**SSA SRI BOND OF THE YEAR**

**Kingdom of the Netherlands**

€5.985bn 0.5% January 2040 green bond
Green bond structuring adviser: ABN Amro
Independent green consultant: Crédit Agricole
Advisers: ABN Amro, HSBC, Nordea

The Netherlands’ green bond in May marked several firsts for the market. It was the first from a triple-A sovereign. The Netherlands was the first eurozone sovereign to issue its first green bond via auction instead of syndication. And, perhaps most importantly, it broke new ground in the classification of green accounts by allowing investors to register as green investors before the transaction in order to receive priority in the allocation process. The book closed with a total bid volume of €21.2bn, the second largest order book ever for the Netherlands.
Climate and digitisation to dominate SSA’s 2020

An unusual note of optimism defines the attitude of Europe’s public sector issuers as they approach 2020. While many other markets are beset by fears of a slowdown in global growth, trade wars, and Brexit, SSA borrowers are confident in their borrowing strategies and loyal investor bases.

Despite a change of face in the ECB’s top job, rates are still set to remain low for the foreseeable future. Accordingly, investors are having to grit their teeth to stomach the scanty yields on offer for euro SSA assets.

Although SSAs are offering little in the way of yield, their place as pioneers of the evolving SRI market always ensures lively debate. In this roundtable, held in early November, market participants on both the buyside and the sell side favoured a more holistic assessment of issuers’ ESG profiles, rather than relying on labelled assets, but whether or not the ECB should take a role in promoting the SRI market through “green QE” divided the group.

Participants in the roundtable were:

David Zahn, head of European fixed income, Franklin Templeton
Lucette Yvernault, head of systematic investment, Fidelity International
Sami Gotrane, head of treasury and financial markets, SFIL
Axel Bendiek, head of treasury and investor relations, Federal State of North Rhine-Westphalia
Otto Weyhausen-Brinkmann, head of funding, KfW
Philip Hertlein, head of SSA syndicate and origination, LBBW
Siegfried Ruhl, head of funding, European Stability Mechanism
Lewis McLellan, moderator, GlobalCapital

GlobalCapital: What are your funding plans for 2020, and does it differ from 2019?

Siegfried Ruhl, ESM: We announced at the end of last year the preliminary numbers for 2020, which are in total €27.5bn. We’re issuing for two borrowers, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). In 2020, we have €19.5bn for the EFSF and €8bn for the ESM. Our final numbers will be communicated in our investor relations newsletter in December.

In 2019, we issued €29.8bn — €20bn for the EFSF and €9.8bn for the ESM. We’ve already completed our funding programme for the year.

Otto Weyhausen-Brinkmann, KfW: We have a funding programme in 2019 of €80bn. We have raised €79bn so far so we are almost done and we will announce the borrowing programme for 2020 on December 12th.

Axel Bendiek, NRW: For NRW, our funding programme for 2020 will be €15bn and that is exactly the amount of our maturing debt because the state runs a balanced budget and so we only refinance maturing debt.

In the current year, the programme was significantly larger, €23bn, and we finished it this week with a large transaction. The only reason why it was so large is because we had a shift in our liquidity management. We no longer use short-term funding or money-market instruments. That was a one-time boost to the programme worth around €6.5bn in 2019.

Sami Gotrane, SFIL: For SFIL, as with ESM, we manage two different issuers, the parent company, SFIL, and Caffil. Globally next year it should be about €6bn, which is the level this year: no change but down from €7bn last year because we decided this year to reduce our liquidity buffer significantly.

We will continue in the coming years to do that but we want to keep the size of the refunding profile...
around €6bn.

GlobalCapital: Euros has been a much more significant borrowing currency than dollars this year. What are the main considerations that drive your decision to issue in euros or dollars?

Weyhausen-Brinkmann, KfW: That’s an interesting question. The perception is that euros has been dominant. However, comparing our borrowing programme from 2019 to 2018 we actually have decreased our euro borrowing this year from €46bn to €41bn and this has not been substituted with dollar borrowing. Dollar funding has been pretty much stable but we have seen a strong increase in sterling funding.

There are some specific reasons for that. We offered a very attractive spread to UKGilts and in addition saw very strong demand because of the Brexit uncertainty. We also diversified more into other currencies like Australian dollars and Norwegian kroner, so our issuance in these market segments increased quite significantly as well compared to 2018.

There are two new challenges for our decisions on issuing in euros or dollars. In dollars it’s clearly the swap spread. At one point in time we issued a dollar benchmark with only 7bp spread over Treasuries and this really becomes challenging.

In euros, we’ve been in a negative interest rate environment even for longer maturities for several months now. Investors or market participants are becoming more and more familiar with that but in August we had times when the entire euro curve for KfW was trading with negative interest rates. This makes it very challenging to find significant demand for new issuance.

GlobalCapital: How do you, as investors, manage the negative yield environment?

Lucette Yvernault, Fidelity: It is a reality of the world we’re living in that the ECB unfortunately has decided to increase their intervention and force more quantitative easing into the system. From their point of view, it’s something they feel is needed for liquidity in the system. From an investor point of view it’s not. We are in a conundrum in terms of the solutions we can offer to our clients and obviously how we can support European borrowers in this kind of market environment.

David Zahn, Franklin Templeton: Obviously negative yields make it quite difficult, but it has, similar to what Otto described, meant that we’ve been looking for other currencies to invest in. We’re mostly looking at Europe, so we had exposure to Polish bonds and we have exposure to Norwegian, Czech, Hungarian assets, either hedged or unhedged depending on the currency, as well as the UK.

Looking at the core, the really high quality assets in Europe are just too negative so beyond things like Italy and Spain that still have positive yields but in the SSA space we would tend to go elsewhere to look for where we can pick up better yields.

GlobalCapital: This time last year, a lot of people thought that QE would be coming to an end soon. This year, it’s been given a new lease of life. What does that mean for your strategies as borrowers?

Gottrane, SFIL: The main impact is more on our investor base. There has been a shift. We have more and more bank treasuries and less and less institutional investors. The bank treasuries are buying our paper because it’s level one HQLA and because all the French agencies are paying a bit more at the moment.

It’s still a very small pick-up compared to three years ago — around a third of what it was compared to Caisse des Dépôts et Consignations, or Cades. In this environment, everything is tighter and the pick-up is no longer so significant. But investors are still buying because they need to buy. The bank treasuries balance their balance sheet on a floating rate basis, so the negative interest rates are not a barrier. Their liabilities are floating, so it makes sense to have floating assets too.

Bendiek, NRW: We do not adjust our strategy because of QE being live or not being live. We see the effects, of course. In particular, our spreads up to around 30 years are tighter than they would otherwise be. The credit curve here is not as steep compared to the very long end but the spread is only one aspect. For a public sector borrower, yield is much more important and of course we like the low yield environment.

We go for very long duration, up to 100 years. Thirty years is a nice point in the curve and it provides significant duration but we wouldn’t restrict ourselves to such tenors just because they are QE-eligible.

Siegfried Ruhl
ESM

Ruhl, ESM: Our funding strategy is independent from a specific yield environment or central bank policy. Our strategy is to be present on all parts of the curve on a regular basis. This gives us access to a wide investor base. This year we issued on all parts of the curve. We saw lots of strong demand also at the short end.

We were able to issue a three year benchmark for the first time in two years in spite of deeply negative rates. Investors have to buy. The demand is regulatory-driven or driven by the way the investors manage their portfolio — based on relative value and not absolute yield level.

If you have a wide investor base, you always find somebody who is interested in your offers as long as they are fairly priced.

Philip Hertlein, LBBW: In terms of the broader backdrop that we touched upon, we’re set to live with the measures that were announced at the ECB September meeting for the foreseeable future. A year ago, many believed that the ECB’s QE programme was running out and we were discussing a new rate environment. That’s no longer the case. Now we’re looking, certainly in Germany, at the Japanification of the economy. It’s tough to see how we get to a sustained positive interest rate backdrop in the near future.

GlobalCapital: With Christine Lagarde taking over the
ECB presidency, do you have any expectations of monetary policy being normalised?

Zahn, Franklin Templeton: I don’t really think she can normalise policy; given where inflation is and given where growth is in Europe, you don’t want to start hiking rates. I think the ECB will be doing QE for several years. Rates will be on hold for probably the next five years and I think that you will see her pushing governments and/or the EU to pursue fiscal measures. That’s where her main focus will be.

She’s already talked about buying green bonds. Given the size of the market, that would be bad for the moment. But if there were a huge increase in green bonds, maybe from some of the people around the table then the ECB might be able to buy green bonds.

That’s where we might see development, but there’s no chance of normalising policy.

Bendiek, NRW: Politicising the ECB, through buying green bonds or focusing on climate change, would be difficult, in my opinion, because it is not straightforward monetary policy. Unless you can show that climate risks are financial stability risks, it’s a difficult step to take because it’s not within the ECB’s mandate.

Yvernault: Fidelity: I beg to differ. I think we are all responsible for the future of this planet, not just a small portion of the population. We in the financial industry have our roles to play. Going forward, expecting investors to fund your programmes without disclosing the use of proceeds beyond ‘general purposes’ is not palatable.

Regulators all around the planet are increasingly forcing insurance companies, pension plans, retirement plans to focus on investing to have a more positive impact on the planet. We cannot carry on just closing our eyes and saying general purpose is as good as having clarity over what the money is used for.

We all know that agencies were created to essentially issue on behalf of governments. If these same governments, including the local regulator, are pushing pension and retirement plans to invest in more sustainable futures we need to source bonds that are more responsible and sustainable.

So if you’re not prepared to do your piece as issuers in this market, I’m afraid we’re going to look for assets elsewhere. I believe that the ECB should be a role model in that play. I don’t see any difference in terms of pattern of trading between green bonds and regular bonds, only that we know what the proceeds are being used for, as opposed to this veil of ‘general purposes’, where we just have to believe that you’re doing the best as an agency to promote the local economy.

The social status of governments and governmental agencies has to be examined, especially when the gap between the rich and the poor all across Europe has increased stupendously over the last 10 years.

Bendiek, NRW: I agree with what you say, but I don’t think it should be QE delivering on those goals, by giving preferential treatment for green bonds or sustainable bonds. QE has a different perspective and a different target and that’s why I think green bonds should not be the focus of QE.

Gottrane, SFIL: I think there is a consensus from all the issuers, even if I know there is a difference of approach between France and Germany, that we need to support the green market. It’s a law in France, which is why, this year, we did both our social inaugural and green inaugural transactions. There is a lot of pressure on the government and a consensus in the community that we need to do something.

My fear is that if the ECB is buying green bonds, the market is quite small and will be distorted. We are in a ramp-up period of the green bond market, so the pressure could cause some mispricing.

I’m not going to discuss whether there should be a premium on green bonds — that’s not my job as an issuer; it’s the job of investors. But if there is to be a difference in pricing, it should come from investors, not the ECB.

Yvernault, Fidelity: It’s no different from the ECB buying covered bonds. The difference between senior and covered bond, as we know, has been extremely compressed. That has not jeopardised liquidity or investor appetite.

So I see no difference between that and the green bond story. It is on everybody’s agenda. If the ECB is only going to not buy green bonds I don’t see how they’re showing the example in terms of where money should be invested.

Zahn, Franklin Templeton: I think that’s where we might disagree a little bit. I think that with the green bond market at its current size, it would be very difficult for the ECB to enter and start buying. But what I foresee is that you will see a green infrastructure project that will come out in Europe over the next couple of years from the European Commission, backed by the ECB, that could be in the range of trillions.

If all of a sudden you’re going to bring the green bond market from a couple of hundred billion to half a trillion or a trillion in the course of five to 10 years then you probably do need another buyer there; that will help and it helps diversity.

I think in the current green bond market, that would not be very helpful. But if you see this exponential growth which I expect, you have to start addressing it, otherwise what you’re doing is you’re actually skewing the market the other way by saying ‘we won’t buy green, we’ll only buy the conventional stuff’.

Ruhl, ESM: I would like to pick up on your point that it’s a responsibility of all of us to care about the future of the planet. You said the public sector, on the one hand, expects investors to behave in that way, and so it should offer the appropriate investment opportunities.

I would like to look at it from a wider perspective. So far, we were talking about the labelled bonds: social bonds and green bonds. This was a good starting point to
LBBW – serving our clients with excellence.

- State of Saxony-Anhalt Joint Lead Manager
  EUR 1,000,000,000
  0.75% January 2029
  January 2019

- Joint Lender #56 Joint Lead Manager
  EUR 1,000,000,000
  0.625% February 2029
  February 2019

- State of North Rhine-Westphalia Joint Lead Manager
  EUR 1,760,000,000
  + Initial 290,000,000
  2.15% March 2119
  March 2019

- The Flemish Community Joint Lead Manager
  EUR 750,000,000
  1.5% April 2044
  April 2019

- Region Wallonie Belgium Joint Lead Manager
  EUR 500,000,000
  0.25% May 2026
  May 2019

- KFW Kreditanstalt fuer Wiederauffbau Joint Lead Manager
  EUR 5,000,000,000
  0.5% July 2024
  July 2019

- State of Lower Saxony Joint Lead Manager
  EUR 1,000,000,000
  0.5% July 2026
  July 2019

- State of North Rhine-Westphalia Joint Lead Manager
  EUR 1,500,000,000
  0.8% July 2049
  July 2019

- Joint Lender #57 Joint Lead Manager
  EUR 1,000,000,000
  0% September 2029
  September 2019

- EFSD Joint Lead Manager
  EUR 3,000,000,000
  0% July 2023
  October 2019

- IsDB Trust Services Ltd Joint Lead Manager
  EUR 1,000,000,000
  0.037% December 2024
  November 2019

Breaking new ground
public sector issuers' roundtable

03/12/2019   08:47

raise this topic. I see during discussions with investors, a small but positive change here. Investors are moving away from looking purely at the label of a bond, and starting to look at the issuer in a more general, more holistic way. This changes the general behaviour of us as issuers, which is positive.

Zahn, Franklin Templeton: It's very specific to you given the ESG risk embedded in your portfolio. Disclosure of that from an investor standpoint is really helpful. But how do you look at the ESG risk within your portfolio?

Otto Weyhausen-Brinkmann
KfW

Ruhl, ESM: We cannot issue labelled bonds because of our specific mandate but we have a very socially beneficial purpose. We provide financial assistance to euro-area member states, which essentially supports the people in the five countries strongly.

This has a social purpose in general but we don’t have specific social projects that we can link to a bond. But as it is our mandate to safeguard financial stability for the euro area you can refer to our bonds as stability bonds. This year we added a special ESG page to our website and we increased our transparency in general. There is the database where you can get all kinds of information about the programmes we gave to member states and we are following up also on our investment side.

We are working towards signing the UN PRI. The change in investors, looking at issuers more carefully, changes the behaviour of issuers and this is a positive development for the future.

Weyhausen-Brinkmann, KfW: I agree with all of you. We have seen in 2019 a strong push in sustainability. First of all, I would like to highlight the EU taxonomy. It's a big achievement and gives clarity about what is perceived as green and what’s not. Going forward the EU taxonomy will become an integrated part of decision-making and I think it’s very helpful for issuers, for investors, for the entire market so I think that’s positive.

We are quite active in the issuance of green bonds. We amended our framework and added another major loan programme — energy efficient buildings — aside from renewable energy. Usually green bonds were much smaller than traditional bonds, so this year we were able to issue a €3bn green bond, and even increase it to €4bn. This allowed us to close the liquidity gap. We now have a new green bond curve as well.

I think the other theme is the sustainable development goals, not just green bonds. KfW has mapped its entire loan programme on to the SDGs and all of it has been published on our website. I have not attended a single meeting this year where ESG was not a topic. Investors are looking at it in a more holistic way. It’s not only about issuing green bonds, traditional bonds or other themed bonds, but how the issuer works. Yes, it puts pressure on issuers, so it’s not only what one is lending but also the policies of the issuer. That’s filtering through into KfW as well of course.

I think there’s still a long way to go because ESG ratings are quite heterogeneous and not that easy to compare from one issuer to another, from one rating to another but I think the importance will certainly increase.

Bendiek, NRW: I think this is an important point; issuers are changing their behaviour and making ESG a strategic goal. That makes the ESG rating more and more important so a bit more transparency about ESG ratings would also be helpful for the issuers, not only the investors.

Weyhausen-Brinkmann, KfW: Including the methodology behind the ratings.

Bendiek, NRW: Exactly.

Weyhausen-Brinkmann, KfW: Because the results are not as easy to compare as in the case of a credit rating. Depending on which agency you look at you have different results.

GlobalCapital: How do you decide how green investors are and how to allocate your green bonds? Otto, KfW is one of the first issuers to have a systematic approach to this.

Weyhausen-Brinkmann, KfW: It’s true. When we’re issuing green bonds we also want to have green bond investors investing in the product so we tend to give a higher allocation to green bond investors. I would love to have a single metric where I can just tick a box. Unfortunately it’s not there. There are a lot of moving parts. Many investors have different portfolios; some are green, some might be light green and some might be for other purposes, but they’ve put in one single order; so how green is that?

So our approach is for the lead managers to speak with sales, who speak with the investors. We take a joint approach based on their information, our own information, what we have seen in the past, which information we have gathered from investor meetings and then make that decision.

Bendiek, NRW: We take the same approach.

Zahn, Franklin Templeton: Yes, we have a dedicated green bond fund. It’s an ETF but it’s still the same thing and we do see much better allocations from green issuers, corporate and SSAs, when we tell them this is for our green fund, as opposed to just for our normal European funds. I think that makes sense because it does match things up.

But I also would say that we use green instruments across all of our European fixed income portfolios. If we can buy something that has almost the same yield but it’s green, why wouldn’t I do that? We do also look at it from a holistic issuer perspective, so we don’t really care if there’s a label. We will look at it and say, actually does the whole company work on being green?

It goes back to your point; what does the issuer actually do, as opposed to just the label. We have the ability
to buy issuers in our green bond fund that are not actually labelled green, because they do meet the carbon transition and are active in the space. I don’t want to go into specific names but there are companies that are very dedicated to reducing carbon emission and they should also be rewarded. So we’re just looking at the holistic approach, not just a label but we do find better allocation when we tell them it’s for our green fund as opposed to our other ones.

Global Capital: A few years ago, green bonds were the only products in this sector. Now, there are many new themes: social, sustainable, SDG, blue etc. Does this dilute the product, or are you happy to see a broad range of products?

Zahn, Franklin Templeton: You have to go back to what is actually being done, what the proceeds are being used for. Once you can see what the proceeds are being used for that helps drive whether or not we think it makes sense.

The other area that’s starting to develop is blue bonds. I don’t think anybody here issues a blue bond, as far as I’m aware. Those are the ones that help with the ocean. I think these are areas where you’re going to see more and more of this development.

I hope we don’t get too many colours because I think that starts to cloud the environment but I think if you could show that these particular proceeds will be used for an area that people care about and want to make an impact on that actually is quite helpful.

There are all types of bonds, but it’s good to focus on the big themes like carbon. That’s easy to measure and that’s one of the reasons people are focused on it.

Bendiek, NRW: I’d like to ask a question for the impact investor. We’ve seen a number of KPI-linked transactions: issuers who face a step-up coupon if they don’t deliver on their sustainable goals or their targets regarding improvements to their carbon footprint. How do you look at these products? Is it a good development, or is it diluting the green segment?

Yvernault, Fidelity: I don’t think we need to have necessarily a green label on many of these transactions but we definitely need to increase seriously the disclosure for the use of proceeds. We are lending less to borrowers who are less transparent about their use of proceeds.

All our portfolios are now allotted a quarterly score, no matter if there is ESG on the label or if they’re just a solution or even if they’re not a publicly listed fund but simply a mandate for a given client.

It is not linked to the desire of the client to force us necessarily into responsible investment. Some are obviously ultimately higher-score permanently but even the lower-scored ones are being pushed up and I think our CEO has been on the record multiple times to say we’re all responsible and we all have a part to play as investors.

So this is the reality; it is not something that we’re going to back-track on. All the agreements or prospectuses for the new funds being listed are being meticulously scrutinised by all the regulators around the world for their ESG situation, and I believe there’s probably more scandals upcoming.

There’s been some recently and I’m sure there will be more going forward but I definitively say people who can ignore ESG for the foreseeable future are being very, very short-termist. We have the opportunity to be recognised as investment companies by being part of the infrastructure promoting movement in the right direction.

It’s not only asset managers. It’s also investment banking and the entire investment community which is coming together. It’s also the insurance and pension plan regulators all over the world as well. I don’t see the movement back-tracking.

I think it’s going to push all the issuance more or less, especially for public deals, to be making more thorough disclosures and improving the issuers’ ESG policies. Obviously we’ve heard around the table some people who are being impacted from board decisions on this topic. I think it’s a trend which is here to stay. I don’t see how we can close our eyes and think it’s for others or for the generations to come.

Everything is being scored ultimately and we have to respond to questions about why we have lowered the score quarter by quarter for our funds. Ultimately we are only investing in companies which, if they have a low score, are at least on the right trajectory.

Part of the solution is having the right outlook, not focusing on particular ESG notation but how this issuer handles ESG policy.

Bendiek, NRW: But would you prefer to see the use of proceeds format remain the dominant choice, or should the structure be linked to ESG performance?

Yvernault, Fidelity: We need to move from these very murky waters where we have no appreciation of whether an asset is green enough or renewable enough. Obviously it’s very hard to have a set guidance but the fact that there’s no real taxonomy or real guidance in terms of what constitutes green or renewable makes it a little bit difficult for myself and other investors.

Obviously we have been one of the pioneers for saying covered bonds need to be covered bonds. There needs to be a strict rule on why it’s a covered bond and not something else. I think the same applies if eventually you want to benefit from this green label. For it to be something issuers benefit from, there has to be quite strict rules.

We know it’s a market which is in the process of evolving as we speak. That means, like any other evolving markets, clearly we’re missing some rules of the game as we speak. But I think the rule of the game is to have some proper green programmes in place that we can lend money to in order to bring about a better environment altogether — a better set of borrowers to lend our client money to basically.

Zahn, Franklin Templeton: We have seen some selective bonds that have a step-up or step-down in coupon depending on what the issuer’s ESG score does. My big-
gest concern with that is that some of the scores that are being put about are calculated by the issuing company. I’m sure that there’s nothing untoward happening, but I think if you’re going to do that format, then a secondary party should be involved in calculating it. There’s nothing wrong with the format though.

I also think the step-ups and step-downs that we’ve seen so far in most bonds have been relatively modest. I feel that two basis points or something like that is not really a significant penalty for failing to achieve the ESG score that you were after. I don’t think it’s quite enough to make sure the management and the board are focused on the topic.

GlobalCapital: Last year, we were very concerned about the backdrop this year, but it was better than expected. How do you feel 2020 will be?

Ruhl, ESM: I’m always optimistic. I was optimistic last year and we opened this year the market on the first Monday with a €3bn seven year bond and it went quite well. I’m also optimistic for 2020. It might not be a copy of 2019 — there is a different environment — yet already we see some comparisons. At the end of 2018, the market was over-positioned for the end of QE, as we saw in the first weeks of 2019 when market participants had to close their shorts. At the moment, it feels that the market has over-positioned to the restart of the QE. The market seems to be a bit long in total but this is something that will be digested over the coming weeks.

There is investment need from the investor side. If I look specifically at the ESM, at the moment we don’t have any active programme. We don’t need fresh liquidity. All our funding needs are there to roll over maturing debt. There are the overall needs of investors. We estimate 46% of our eligible debt is in the hands of the European system of central banks. As well as other investors they have the roll-over needs so there should be stable demand for our transactions also in 2020.

GlobalCapital: Do you have plans to issue bonds benchmarked against ESTR?

Bendiek, NRW: We’re certainly looking at it. We’re not quite in a position to do it right now. Some back-office issues need to be resolved and we would like to see the market develop a little bit further. In general, we don’t like to be the pioneers; we would leave that to the bigger issuers such as KfW and EIB.

But it is definitely an interesting market; we always have a significant need for short-term financing. It’s about shaping our maturity profile. Much as we like duration, we cannot and do not want to do all our issuance at the ultra-long end of the curve. Otherwise our funding programme would shrink to a size which is not appropriate, in our view.
So we need the short tenors and €STR would be a form that lends itself to shorter tenors. If the market is constructive and back-office issues are settled we will certainly look at it more closely.

**GlobalCapital:** As one of only two benchmark €STR issuers, do you have any advice for issuers following in your footsteps, Otto?

**Weyhausen-Brinkmann, KfW:** Yes, we had a couple of things to be sorted out before we were able to issue as well. For us, it was a contribution to the development of the €STR market. Sonia is much further developed so far, but €STR will also develop and I think it's important to bring products out that investors can invest in and that can be traded. I'm pretty sure in 2020 we will see other issuance.

**GlobalCapital:** We aren't seeing much floater issuance. Is there a problem with demand for €STR, given we expect rates to remain low?

**Gotrane, SFIL:** We have only done one floating transaction; it was three years ago and for the time being we have no interest in doing more. On the €STR side it's very interesting. What we will do on our side is monitor the development of the derivative market using €STR, because we want to do that at the same time.

We think that if we can move our derivatives to €STR we could potentially also contemplate doing an issuance in that format to make sure that we will have the development at the same time of the cash market and the derivative market.

**GlobalCapital:** New technologies for primary market bond issuance are often tested out in the SSA market. There have been promises of innovations for years, but we seem to actually be getting close with some of these ideas. What initiatives are you most excited about?

**Ruhl, ESM:** We're constantly looking at new technology and, as an issuer, new technology in the primary markets is particularly interesting. It's not about just having something new and different. It should serve the needs of the issuers and all market participants.

What is important for a public sector issuer? Reliability, trustworthiness, safety and efficiency. Here we think the European distribution of debt instruments service, this initiative — in short EDDI — of the European Central Bank is an opportunity of the market and this is why we think it's important.

It is a front-to-back, straight-through processing system that will make the whole transaction more efficient, reduce operational risks and allow for settlement in central bank money. That is particularly important for us, specifically because of our role as a crisis resolution mechanism.

It will be provided by the European Central Bank. This is a trusted institution so it will be reliable and available to everyone. Data will be managed in a very careful way. From this perspective it satisfies the key public issuer needs: reliability, trustworthiness, safety and efficiency. Finally, it reduces the execution risk.

One of the most important advantages of EDDI for investors and banks is that it keeps the current structure. The roles and responsibilities don’t need to be changed because the current structure works quite well. The ‘how’ can be improved, not the what, where and when.

EDDI brings the current process on to a technical state-of-the-art level. It increases and improves the communication with investors and increases the transparency and the public governance, which is also very important. We’re talking here about infrastructure and it’s important that this is managed in a neutral way and not driven by commercial objectives.

So ultimately EDDI offers the opportunity for a higher degree of standardisation and the strengthening of the euro area capital market and therefore finally it supports the objective of a capital market union.

The ECB has now to decide if they want to go ahead with this initiative. We expect that there might be an update in the first quarter of 2020.

**Yvernault, Fidelity:** I think this initiative is only positive. We haven’t had transparency about liquidity, and what is available to buy. It’s very hard for us to test any systematic rules on new issue and bond purchase unless they have been purchased, because otherwise they’re not in the security database.

Any transparency and electronic communication of all this information, which we can quickly pass through what is an increasingly complex network of rules and conditions for every customised mandate that we are given to manage is positive from the investor’s point of view.

It can only mean that we can participate in more deals rather than fewer deals going forward.

It also means that, as the head of systematic investment at Fidelity, I need to create a rebalancing set of transactions that are liquid and can be implemented in the market. So any additional information in terms of what is available, where I can source it, who is the market-maker or who has got positioning is positive for me.

**Hertlein, LBBW:** I agree with that notion as well. From the perspective of everyone around the table — investors, issuers and banks — technical advancement in how we process both the front-office issuance and investments in bonds as well as back-office, post-trade processes (blockchain is the technology that’s been discussed there) can only be beneficial to everyone involved.

Yes, even before the EDDI initiative grew in importance on the commercial side, organisations have been working to come up with ideas and platforms or market standards to improve those processes.

So it remains work in progress and let’s see in 2020 where we’re going with the ECB initiative and the private sector initiatives.
Gotrane, SFIL: We believe that blockchain could be something that could help on the private placement side for us as an issuer. It will require us to fix various problems and overcome certain challenges internally to manage, but it could be useful for private placements.

GlobalCapital: On the topic of private placements, how has 2019 been? Have you noticed changes in the patterns of demand for MTNs and private placements?

Gotrane, SFIL: It was a difficult year for us. The feedback we had from our dealers was that a lot of usual buyers of private placements prefer public issuance, perhaps for accounting or for regulatory reasons. We’ve seen a major shift. This year, we printed just €400m, well below the average of €800m that we usually print. I don’t know if it could change next year, but it’s certainly something we’ve noticed and is really challenging and tough on our side.

Bendiek, NRW: We see the same development, especially from the insurance community, moving more into public bonds rather than private placements. We used to have a decent Schuldenschein business and we still have some business there but it’s not very large.

What we do see in terms of structured products is demand for very long tenors, sometimes longer than we can accommodate. Although we like the long tenors, we need to hedge the risks and we can only use derivatives with a tenor of up to 50 years. There was demand for even longer structured products, which we could not issue.

Hertlein, LBBW: We at LBBW have been fortunate again in the past year, 2019, to help facilitate numerous transactions for the issuers at the table here present — and we’ll work on continuing to do that in the future.

Specifically in the euro market, obviously the continuing very low or at times negative rates make things difficult. As we discussed earlier, when the entire swap curve is in negative territory, that certainly does not help demand among investors. Also including the other important insurance and pension community from Germany, when 60 years outright is negative you won’t see a bespoke transaction going through the market at that point.

Bendiek, NRW: At one point we sold a ticket for a 100 year bullet transaction with a fixed coupon of 0.85%. That’s how low yields got at one point.

GlobalCapital: What do you see as the big risks next year, either for the primary market, or macro-economically?

Hertlein, LBBW: Disappointment in the outcome of the trade war or the US/China negotiations that are ongoing. I think a lot of positive outcome is priced in so that would be a risk factor.

Bendiek, NRW: Brexit still is a risk. From my understanding, even if the elections lead to a stable majority there will be another timeline and another running down the clock until the end of 2020 in order to reach a new trade agreement, which is a short time frame.

So maybe some market participants are too complacent right now about the risks related to Brexit. I’m not saying that the SSA issuers are heavily affected, not the ones from Germany, anyway, but it could certainly distort the market to a certain degree.

Zahn, Franklin Templeton: I think the other big risk is US politics. I think that’s going to be something that’s going to dominate the headlines for a lot of 2020. Depending on who gets Democrat nomination, I think that’s something that could move bond markets quite significantly.

I think the other one that is a risk is obviously Brexit but given the new government, whichever one it is, they all have very big spending plans and nobody’s planning to rein in spending.

So I just question whether or not we’re going to see a big fiscal splurge around the world. That could push up long end yields much more than we expect. But I think that’s one of the other risks that people aren’t really focused on. They just thinking, ‘we’re going to be down here for a long time’.

Ruhl, ESM: Of course there are the aforementioned risks but I’d like to focus on the opportunities. There’s always a flip-side of the coin and the flip-side of the risk is the opportunity. The opportunity is now for Europe to be the safe haven. We have seen, as I mentioned, shifts of investments to Europe and the euro area.

The opportunity for us is that this continues. Within Europe or within the euro area, the situation is very positive. The euro and the euro area are at a 10 year high regarding support from citizens in Europe. We have a new Commission with new objectives so the crisis is behind us. The new Commission can focus on the future.

Climate and digitalisation are core topics here—there are a lot of opportunities ahead of us and we should take them. GC
Can Sofr and €STR catch up to Sonia?

In 2019, public sector borrowers led the way in the implementation of the new risk-free rates, with Sonia becoming a mainstream product. The question is whether Sofr and €STR can become as widely adopted as financial markets prepare for the end of Libor. Burhan Khadbai reports

Watching three core markets implement new risk-free rates almost simultaneously is a good opportunity to learn about the character of the respective investor bases and the approach of their regulators.

So far, they have managed with a minimum of disruption, but the process is by no means over. €STR, the eurozone’s preferred replacement for interbank offered rates, has scarcely begun its journey and, while the UK’s Sonia has rapidly achieved widespread adoption, the same cannot be said for Sofr FRNs in the US.

Sofr and Sonia both arrived as SSA benchmark rates in mid-2018, but since then, sterling investors have plunged straight into Sonia, while in the dollar market, Sofr is still struggling to gain momentum.

While some £33bn of sterling issuance used Sonia in 2019 (up from £6.9bn in 2018), Sofr is lagging behind with only $20bn of which only just over $2bn came from sovereign, supranational and agency borrowers.

Sonia has swiftly become a staple, with bookrunners and investors confidently embracing the central bank’s new system. “It’s worth noting that the number of bookrunners on Sonia deals this year has been 25, which is the majority of underwriters in the sterling market and more than double the number of bookrunners last year,” says Sean Taor, head of European debt capital markets and syndicate at RBC Capital Markets in London.

Since the European Investment Bank pioneered the move to Sonia-linked issuance in June 2018, almost every big supranational has issued a Sonia floating rate note, including World Bank, the International Finance Corporation and the Asian Development Bank. In 2019, several public sector agencies and even a sub-sovereign also entered the Sonia market. A key driver to the rapid growth of Sonia FRNs has been the swift decision to adopt and stick to a consistent structure, according to market participants. Every transaction has come with the same coupon calculation comprising a daily compounded coupon and a five day lookback. “The work that went into getting the structure right for the first couple of issuances helped the market find a standard quickly, giving both issuers and investors confidence in the format and now thanks to that tried and tested format Sonia FRNs have become the norm,” says Charlotte Bacon, head of the liquid asset portfolio at Lloyds Bank in London. “The Sonia FRN market is flourishing, and I only expect that to continue.”

The US’s Sofr can boast no such uniformity, with many issuers taking their own approaches to the new rate. “While there has been one calculation method for all Sonia bonds, there have been seven or eight different calculation methods in the Sofr bond market and that has perhaps not helped adoption,” says Taor.

The failure to land on a market standard for Sofr FRNs has been a factor as to why its issuance has lagged behind Sonia FRNs, says Bacon. “Until there is a standardised approach I think the format will struggle. As investors, we would like to see the Sofr market follow Sonia in terms of structure.”

But a consensus is building. The latest Sofr trades indicate that public sector borrowers are favouring the same coupon calculation used in the Sonia market and matching the Sofr derivatives market.

Another big step in the development of the Sofr FRN market awaits, with the New York Fed aiming to start publishing backward-looking average Sofr rates by the first half of 2020. “When the Federal Reserve Bank of New York starts publishing a backward-looking Sofr average rate, that will be helpful in clearing up the discrepancies of calculating the compounded coupons,” says Mark Byrne, a bond syndicate official at TD Securities in London.

Currently, the US Federal Reserve only publishes the daily overnight average rates of Sofr. It does not publish the compounded rates — used by borrowers issuing FRNs linked to the new benchmarks. That leaves issuers to calculate the compounded rates themselves and this has proven to be a serious headache.

The Bank of England and European Central Bank also only publish the daily overnight average rates for Sonia and CSTR, respectively. The ECB began publication in October.
Public sector borrowers say that when they paid out the first coupons of their Sonia-linked bonds, the paying agent, swap counterparty, Bloomberg and the issuer’s own internal systems all produced different figures as they were all rounding to a different number of decimal places.

Although Sonia has achieved mainstream adoption without a central bank-published average rate, introducing one would likely smooth the implementation process for all three rates.

“One time perhaps the Bank of England and European Central Bank may look at doing something similar and it makes sense for them to,” says Byrne.

In September, the Federal Housing Finance Agency provided another positive development for the Sofr transition with a letter to the Federal Home Loan Bank systems instructing them to stop investing in assets tied to Libor by the end of 2021.

“As of March 31 2020, FHLBs cannot enter Libor-based transactions involving advances, debt, derivatives, or other products with maturities beyond December 31, 2021. That’s a very proactive approach and the strongest regulatory action we’ve seen so far,” says Byrne at TD Securities.

While around 36% of FHLB FRNs are already linked to Sofr, the FHPA’s instruction is expected to accelerate the issuance of more Sofr FRNs by the FHLB.

**€STR vs Eonia**

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<thead>
<tr>
<th>Eonia</th>
<th>Administrator</th>
<th>Data Source</th>
<th>Underlying Transactions</th>
<th>Input Data</th>
<th>Calculation Methodology</th>
<th>Discounted Calculation Trigger</th>
</tr>
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<tbody>
<tr>
<td>Private sector, CBDE, a Belgian association of national banking institutions in the EU</td>
<td>28 panel banks</td>
<td>Unsecured overnight lending transactions on the sterling market</td>
<td>Individual bank contributions; total volume of daily transactions and average weighted average interest rate</td>
<td></td>
<td></td>
<td>Trigger: four or less than four non-zero volume contributing banks</td>
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In 2019, there were the first few FRNs linked to Eonia, the recommended replacement for Sonia, which will be discontinued on January 3, 2022. The ECB took its time in developing €STR, using a typically gradual, step-by-step approach. But investors seem willing to engage with the result.

“€STR is at the very beginning,” says Adam Kurpiel, head of rates strategy at Société Générale in Paris. “But I believe that the transition will be smooth and easy. The next big step will be the switch to €STR flat discounting at the middle of 2020. That will be a major step in the transition away from Eonia to €STR.”

In September, L-Bank raised €250m with the first €STR-linked transaction.

The deal came a few weeks before the European Central Bank started publishing €STR rates on October 1. However, the two year FRN was priced with a settlement date of October 8, which made the trade possible.

“Both the L-Bank and EIB transactions proved that there is demand for euro FRNs at the right spread,” says Taor. “What was encouraging with the EIB trade was that it achieved an order book of over €2bn for a €1bn deal. It also came with the same coupon calculation as the Sonia and EIB’s Sofr-linked FRNs. EIB has been very thoughtful in taking the lead in using similar calculation language across all the risk-free rate currencies they have issued in.

“We have also executed a risk-free rate test trade in Canadian dollars for EIB to make sure settlement and payment systems work. Again EIB used the same coupon calculation in Canadian dollars as they have done in other RFR currency issuance.”

In November, KfW followed with a €1bn three year €STR-linked FRN. The deal came with a spread of 10bp over €STR, making it the tightest €STR FRN to be issued so far. Crédit Agricole, Deutsche Bank and UniCredit were the leads.

While Eonia and €STR both rely on transactions from the euro overnight unsecured money market segment, they differ in many other ways.

Eonia is administered by the private sector through the European Money Markets Institute and relies on voluntary data. €STR is governed by the private sector through the European Central Bank and is based on individual unsecured overnight borrowing deposit transactions.

**Legacy conundrum**

As borrowers move to the new risk-free rates, there is uncertainty as to what will happen to outstanding Libor FRNs.

“In the SSA market, the vast majority of Libor FRNs will mature before the end of 2021 or have robust fallbacks,” says Byrne. “But there are smaller private placements that go past 2021.”

One way to address this would be simply to change the reference rate on the outstanding FRNs from Libor to the new risk-free rates, as long as investors give permission to do so.

Associated British Ports became the very first issuer to request a switch from Libor to Sonia in 2019. Other issuers have followed, including Lloyds Bank, which completed the first interest rate conversion from Libor to Sonia in the UK covered bond market.

“The recent consent solicitations to convert Libor FRNs into Sonia FRNs have been a good development and I would hope that would continue for all outstanding sterling Libor FRNs maturing past the 2021 deadline,” says Bacon.

In addition to a consent solicitation, there are other options.

“One solution is to push back the deadline, while another be would to allow Libor to survive under a different format away from the dependence of bank contributions,” says Kurpiel. “For this to be done, it would need the active involvement of legislators.

“Everyone agrees that the new risk-free rate benchmarks are the way forward but there is uncertainty about the legacy transactions. At this stage there are more questions than answers.” GC
Advertising works, as you can see
SSAs to spur digital evolution of bond market

After years with little in the way of technological improvements, momentum is finally building behind several projects that could reshape primary capital markets. These systems will undergo their first tests in the SSA market. Intriguingly, the winner could come from either the public or private sectors. Burhan Khadbai reports

Innovation in the debt capital markets begins with public sector borrowers. The digitalisation of the bond market is no exception. Sovereigns, supranationals and agencies are kick-starting initiatives to transform the processes of issuing bonds. One of the most ambitious projects is the European Distribution of Debt Instruments (Eddi), which aims to create a one-stop shop synchronised platform for selling euro bonds and handling everything from bookbuilding to settlement.

The European Central Bank is developing Eddi, in conjunction with five of the best-known borrowers in the euro public sector bond market — the European Stability Mechanism, the European Investment Bank, KfW, Bank Nederlandse Gemeenten and the Council of Europe Development Bank.

Kalin Anev Janse, chief financial officer at the ESM in Luxembourg, is a key supporter of the Eddi project, believing there is a big opportunity for a homogenous solution to catapult Europe’s debt capital markets into the digital age.

“The biggest problem is that there is no pan-European, neutral and harmonised channel for the issuance and distribution of euro debt,” he says. “Instead, there is a considerable amount of fragmentation. Eddi would help overcome this problem.”

Eddi aims to cover both ends of a debt transaction. The pre-issuance component would offer functions to support an upcoming debt issue through the creation of an order book, the collection of orders and the allocation.

Once allocations are decided, participating central securities depositories (CSDs) would distribute the bonds simultaneously using the ECB’s TARGET-2 Securities settlement infrastructure. Eddi’s post-trade component is its unique selling point. Unlike the dollar bond market, in which the majority of bonds are settled through one system — the US Federal Reserve’s Fedwire — there is no single mechanism in the eurozone bond market.

“Are we based in Hague and don’t have branches all over the globe to collect feedback from investors such as those in Asia to see what they’re after, whether that’s 10 year euros or two year dollars”

Bart Van Dooren, BNG

Another unique feature of Eddi is that it is creating the first public sector-backed debt issuance platform.

“We are not commercially-driven,” says Janse. “Eddi is a public non-profit initiative. It comes closest to a fair and neutral set up, led by the ECB and eurosystem, with European data on government and SSA debt in European hands. When and if this is developed, it will be truly disruptive as a technology, which will be beneficial for all the stakeholders in European bond transactions, for the euro and the CMU [Capital Markets Union].”

However, a number of concerns have been raised with Eddi. In response to the ECB’s market consultation on Eddi, the International Capital Markets Association identified 12 issues, including a perceived conflict of interest with the ECB running Eddi, with the central bank being the largest holder of euro bonds.

“The big question is whether the perceived benefits of Eddi, post-trade and pre-trade, are worth the likely cost and disruption for market participants,” says Leland Goss, ICMA’s general counsel in London. Investment banks also voiced their criticisms of Eddi, saying that the private sector already has solutions to the problems in the primary bond market and that Eddi should instead focus on the post-trade aspects.

The ECB’s governing council is expected to make a decision on whether to approve Eddi in 2020.

Private sector platforms

One private sector initiative that is being developed is agora, which is creating an end-to-end digital platform to cover the entire life of a bond from the pre-mandate stage, through execution, pricing and primary settlement until final redemption.

Agora, co-founded by bond market veteran Charlie Berman, aims to connect issuers, arrangers and multiple service providers such as custodians, central securities depositories and paying agents to a single channel. This will enable them to share and distribute information during the process of issuing a bond using digital ledger technology.

“I joined Salomon just after they joint led the first global bond in late 1989, which was for the World Bank,” says Berman, chief executive of agora. “The structure was heavily driven by the issuer and I would argue that was the last time we had a significant change in the nuts and bolts of how bonds get done.”
It took until the mid-1990s before this huge innovation was generally accepted and adopted. “About 18 months ago, I started to seriously think about how distributed ledger technology could be applied and make a meaningful impact on capital markets. Few front office people have had the time to immerse themselves and understand what the new tech can do. The response I have got from the Street was amazing and very positive.”

Berman says, when mapping out the process of issuing a bond, he found the market is composed of a series of linked deep subject matter experts performing critical and interdependent functions. “Many of the functions are enshrined in statutes and are heavily regulated,” he says. “It’s pretty pointless to try and introduce tech that bypasses the incumbents but can’t then be utilised. Our approach is to work with the existing stakeholders to develop solutions that they need and will embrace and adopt.”

In November, agora closed its initial seed funding round with contributions from a small group of individuals, including Michael Spencer, the founder and former CEO of interdealer broker Icap, which later became Nex Group.

The timeline for launch is “weeks and months, rather than months and years,” says Berman. “We are starting with SSAs as that’s where innovation begins, closely followed by banks as issuers and ultimately even less frequent issuers will benefit from the improvements.”

The private markets too are ripe for digital innovation. DZ Bank launched Ingen, a medium term note (MTN) platform in 2019. “At the heart of InGen we have a database that we make available to investors to search through around 400,000 structured private placement opportunities from over 200 issuers in euros and dollars,” says Friedrich Luithlen, head of debt capital markets at DZ Bank in Frankfurt. “So for example, an investor hooked to the system can input that they’re looking for a triple-A product in euros, an SSA or covered bond for ‘x’ amount with a specified schedule including call rights.” He adds: “Then it takes half a second to bring up the top 20 picks within that criteria based on the highest yields. We have currently 30 institutional investors on board who are using the system actively. There has been nice traffic since we launched in the summer.”

Trades cannot be completed on the platform, so investors are still required to call DZ’s sales team. DZ is also a partner in the European private placement facility (EPFF), which in 2019 was used to place the first “smart n-bond” for Bank Nederlandse Gemeenten in a move that was seen as a step towards a functioning pan-European private placement market.

The €10m three year bond pays a coupon digitally, without the exchange of paper. All documentation on the new system is fully machine-readable and standardised. “When and if this is developed, it will be truly disruptive as a technology, which will be beneficial for all the stakeholders in European bond transactions, for the euro and the CMU.”

Kalin Anev Janse, ESM

“What it was the first electronically settled NSV [Namensschuldverschreibung],” says Bart van Dooren, head of funding and investor relations at BNG in The Hague “It makes life easier on the documentation side.”

Using EPFF’s platform, issues are given an ISIN code like any other security. This means some investors, who previously could not buy NSVs (or Schuldscheine) owing to regulations around purchasing loans, are now able to participate.

The market will largely be used for well-rated western European borrowers, according to people familiar with the strategy.

New role for banks

As the bond market goes through a digital evolution, investment banks will find their roles redefined. “The primary market has, relative to other parts of finance, remained a fairly manual process with some speculation that it is ripe for a digital transformation,” says Goss. “So the elephant in the room is whether there will be at some point a disintermediation of banks from the new issue process. However, the view from at least some frequent official borrowers is that for the foreseeable future there is a desire to have bank syndicates as they provide a valued range of services.”

“Issuers need the expertise from banks,” says Luithlen. “That is delivered through the syndication process. What we as syndicates are providing is greater execution certainty amid the political uncertainty from Brexit, trade wars, etc. We further bring critical flow knowledge from secondary markets and our discussions with investors to the table. Finally, we put our own skin in the game and help trades across the line if the market is underwhelming on a given day.”

BNG’s van Dooren agrees on the importance of investment banks in the syndication process. “We are based in Hague and don’t have branches all over the globe to collect feedback from investors such as those in Asia to see what they’re after, whether that’s 10 year euros or two year dollars,” he says. “This is information we get from investment banks and therefore the role of syndicates is important.”

New supras poised to make a big splash

A trio of recently launched supranational borrowers will be a frequent presence in 2020, as they look to cement their positions among the top names in the public sector bond market. Burhan Khadbai reports.

The public sector bond market will be watching the Asian Infrastructure Investment Bank (AIIB), the International Development Association and the New Development Bank closely in over the next year as they establish themselves as regular fixtures in the SSA market. "In previous years, there may have been a question of whether there is room for all these new names and whether there would be some competition with existing supras," says Lee Cumbes, head of public sector EMEA at Barclays in London. "However, the way the modern market is, there is plenty of cash available and a structural need for high quality assets that will sustain long term, successful programmes."

IDA, the part of the World Bank that helps the world’s poorest countries, aims to carve out a $10bn-$15bn funding programme, in line with the International Finance Corp, its sister organisation, while AIIB is looking to secure authority to borrow $5bn-$6bn of long-term funding.

"Dollars are the cornerstone of our funding programme," says Maritime Mills Hagen, head of funding at AIIB in Beijing. "We'll be looking to return to the dollar market as soon as we can. We want to be seen as a frequent issuer of dollars and if possible to be in the market in dollars more than once next year depending on market conditions."

AIIB debut

In May, the Beijing-based supra, which has 69 member states, became the newest addition to the supranational borrower community as it sold its debut bond with a $2.5bn five year global dollar benchmark, led by Bank of China, Barclays, Crédit Agricole, Goldman Sachs and TD Securities.

"It was long in the making," says Mills Hagen. "We started working on our debut bond in the autumn of 2017 and had naively thought that we could issue in 2018."

The delay was down to the supranational getting its global documentation in place, something it was very keen on in order to be seen as a global borrower. The end result was impressive as AIIB achieved a high quality and well subscribed order book and pricing at a spread of mid-swaps plus 6bp.

"It landed at exactly the right price for that credit, coming in line with the top supranationals," says Cumbes at Barclays. "They've established themselves as a platinum quality supranational right away and they'll attract even more investors for their next bond. Others have had to pay their way into the market and then develop pricing over time, but a lot of work went in before AIIB announced the deal."

Mills Hagen says: "It has always been our goal to become a diversified issuer. By the second quarter of 2020, we hope to have an SEC registered shelf, a global MTN programme, a Kangaroo bond programme and a Panda bond programme in place."

AIIB was the first supranational to make its debut in the capital markets with a benchmark deal since the International Development Association’s $1.5bn five year bond in 2018. In October, IDA returned to the capital markets for its debut euro bond, raising €1.25bn with a seven year euro benchmark at a spread of mid-swaps minus 6bp, led by Crédit Agricole, DZ Bank, JP Morgan and Natixis.

In addition to building a curve in dollars and euros, IDA is also keeping a close eye on other markets such as sterling, Australian, Canadian and New Zealand dollars and private placements.

There is plenty of cash available and a structural need for high quality assets that will sustain long term, successful programmes

Lee Cumbes, Barclays

"The different nature of IDA means they have their own distinct funding strategy," says Cumbes. "They're moving more quickly into a variety of major currency markets in benchmark form, to match their SDR [Special Drawing Rights] balance sheet."

Bric by brick

The next supranational to arrive for a debut benchmark bond will be the New Development Bank, often called the “Brics Bank” due to the initials of its five founding members states — Brazil, Russia, India, China and South Africa. Unlike AIIB and IDA, NDB aims to match its lending with local currency bonds, rather than swap it. As a result, its needs in core markets are less immediate.

While the NDB has been busy growing its lending portfolio, it has only issued a pair of Panda bonds and a few trades from its Euro commercial paper programme. But over the next year that is set to change.

NDB is looking to launch a dollar bond programme and tap into the offshore bond markets of its member countries such as as India, Russia and South Africa.

"NDB is rated AA+ by S&P and Fitch, one notch below AIIB, IDA and other top tier supranationals. Nevertheless, it is expected to be warmly welcomed by investors. "They are a very high quality institution that would find a strong market reception," says Cumbes. “A benchmark transaction would transform their market profile.”

GC
Dollars lose dominance for SSA borrowers

The mighty dollar has lost its position as the default borrowing currency of the SSA market, and with a presidential election in 2020, that is unlikely to be reversed next year. However, that doesn’t mean that SSA borrowers can ignore it. Lewis McLellan reports

Public sector bond market participants have their sights permanently trained on the US Federal Reserve, watching for any hints as to the direction of the US Federal funds rate. After eight years without a move, the Fed has recently lurched between hawkish and dovish with a rapidity that has wrong-footed many investors.

Now that the US trade war with China is dragging on global growth, the tone of the investor community has shifted from expecting rate hikes to calling for, and pricing in, further cuts to shore up the economy.

At the end of 2018, the market expected US interest rates to climb throughout 2019 and that Treasury yields would be substantially higher. Forecasts put 10 year US Treasury yields at over 3%, but throughout 2019, they have ground lower and lower — at one point dipping below 1.5%.

This dovish shift has worked in the favour of the SSA borrower community in 2019. “Investors have had to supplement US Treasury yields with SSA spreads, especially at the short end of the curve,” says Sean Taor, head of DCM and syndicate at RBC Capital Markets in London.

Indeed, since they can pass on their cost of funds, another cut here or there does not matter as much as stability and conviction on the direction of travel. Sadly, stability and conviction are expected to be in short supply in 2020.

While the president does not control the Federal Reserve’s rate policy, he has not been shy about ramping up the pressure on Federal Reserve chair Jerome Powell to cut rates.

However, if Trump is successful in negotiating some kind of ceasefire with China in the trade war, and global growth picks up, the improvement in the US’s economic outlook might provoke the Federal Reserve to hike rates.

US unemployment is low, and economic growth, though slowing, is ahead of expectations. “If the uncertainty around trade were suddenly resolved, then we may have some meaningful revisions ahead,” says Lee Cumbe, head of public sector DCM at Barclays.

Taor agrees, remarking that the “market may have got ahead of itself, as the US economy is still relatively strong. I think the market is pricing in too much in the way of ongoing rate cuts.”

Not everyone is so confident. James Athey, senior portfolio manager at Aberdeen Standard Investments, believes that the slowdown in growth is a secular trend tied to the slowing Chinese economy.

“It has become received wisdom that the weakness in manufacturing stems from trade, but really it goes back far longer than the trade dispute,” he says. “It’s China’s domestic policy choice to accept slower growth, rather than to stimulate its economy with debt.”

Countries like Germany and the US are feeling the slackening in Chinese demand, not simply because of the tariffs, but because China is prepared to accept a slower rate of economic growth. As a result, Athey believes that a truce in the trade war “would not be economically significant.”

If he’s right, manufacturing and growth will continue to slow. While stocks will rally in relief if the trade war is resolved, the confidence boost is likely to be short-lived, if the economic data does not improve, and the Federal Reserve may be forced into more cuts.

With differing views on the US economic outlook, volatility is almost a given as investors move their cash around as their confidence ebbs and flows.

And whether or not the trade war is a significant event for global growth, enough investors will be attempting to speculate on its outcome that it will certainly affect the market as the year develops.

“If more tariffs are imposed, we’ll see that driving volatility and windows will open and close more rapidly,” says Kerr Finlayson, SSA syndicate banker at NatWest Markets in London.

Unattractive levels keep borrowers away

The cross-currency basis swap has kept many euro issuers away from the dollar market, while dollar borrowers enjoyed excellent terms on their euro borrowing.
Latin America
Dollars
EMERGING MARKETS
PUBLIC SECTOR BORROWERS
Review 2019 Outlook 2020

As a result, SSA dollar borrowing raised only $342bn in 2019, compared to €395.5bn ($437bn) raised in the euro market.

“For euro-based borrowers, the dollar market has been a bit of a tough sell,” says Finlayson. “The basis has continued to grind lower and, unless you’re a big issuer that needs to maintain a presence there, the cost advantage just isn’t there at the moment.”

Olivier Vion, head of SSA syndicate and DCM at Société Générale, agrees, adding that “US Treasuries have been trading close to or above dollar swap rates, which has meant SSAs have had to widen their issuance levels.” That, combined with the unfavourable cross-currency basis swap has meant that many issuers are not issuing any more than they have to in the dollar market.

Of course, many borrowers do have to maintain a presence in the dollar market, and those considerations are not going away any time soon. Euro, sterling and niche currency borrowing alone cannot fill the huge programmes of borrowers like the European Investment Bank and KfW.

And for issuers with smaller programmes, it pays to maintain a presence in the dollar market, even at unattractive levels. While the euro market has been offering cheaper funding, it can close down swiftly and without much warning.

In 2019, issuance in the euro market slowed down ahead of September’s ECB meeting.

“That meant there was a big rush of dollar issuance, even when the pricing wasn’t necessarily highly attractive after the swap for euro borrowers,” says Cumbes. “Once the ECB was over and we had more certainty on policy direction, activity in euros picked back up. Still, it demonstrated that issuers need strategic access to both currencies as even the major markets experience periods where they are subdued.”

And with a new ECB president, the lead-up to 2020’s ECB meetings is likely to be even more fraught than usual as investors do their best to speculate on where Christine Lagarde will attempt to steer ECB policy. Borrowers would do well not to rely on the euro market in the weeks leading up to important decisions.

Reaching for the long end
Opportunities at the long end of the dollar curve are typically ephemeral. While issuers are always keen to issue there, demand is driven by “a handful of investors,” according to Finlayson. “It’s a tough maturity at the best of times — windows come and go very quickly,” he adds.

But despite the scepticism around the strength of long end demand, given that rates are historically low, there should be plenty of investors willing to look at the long end of the dollar curve in order to get some pick-up in yield.

The fortunes of SSA issuers at the long end of the curve will rest on the absolute level of yield available, but on where investors expect yields to move.

That was made clear in 2019. There was almost no issuance at the long end of the dollar curve early in the year when 10 year Treasury yields were yielding around 2.5% or so. But later in the year, in September and October, the market enjoyed a flurry of issuance with 10 year Treasury yields at 1.8%.

The long end opened up because investors were confident that yields, which had dipped to 1.6% only a month before, were going to trend lower. The confidence that this was a temporary high point for Treasury yields gave investors the confidence to buy at 10 years.

That is the same dynamic that will inform the appetite for 10 year dollar paper in 2020. “If yields stay where they are, or go back lower, access to the long end of the dollar curve could be achievable,” says Taor. “But if investors expect rates to climb then in the short term it’ll be more challenging”.

That means that borrowers looking to print 10 year dollar paper in 2020 will have to scrutinise investors’ perceptions of the direction of the Federal Reserve’s rates, and their confidence in the US economy even more closely than usual.

If Trump embarks on another round of fiscal stimulus in an effort to stage manage the US economy into a positive, election-winning shape, investors will flood into equity markets to capitalise and rates will rise. “That, short term, will be a challenge for long-dated issuance,” says Taor.

“However if yields then stabilise at more attractive levels, the market will quickly re-open.”

But if no trade war resolution occurs, and manufacturing data weakens, investors will likely pull cash out of the stock market and pile it back into US Treasuries, pushing down rates, potentially opening opportunities for SSAs to offer spread at 10 years and pick up attractive levels on rare 10 year dollar debt. GC
SSAs forced to get comfortable with negative rates

With the resumption of the ECB’s quantitative easing programme, any hopes of a normalisation of European monetary policy receded further into the distance. With “lower for longer” firmly established as the consensus call, SSA borrowers and investors will have to settle in and learn to love the world they inhabit. Lewis McLellan reports.

Despite the anaemic economic growth in the eurozone, in public sector debt markets the prospect for 2020’s borrowing is remarkably rosy. Sovereign, supranational and agency borrowers enjoyed an impressive run in the euro market in 2019, making up for the more disappointing showing by the dollar market, and bankers believe conditions will remain positive in 2020.

That seemed unlikely at the end of 2018. The Federal Reserve was hiking rates, and it seemed as though the ECB would wind up QE and eventually follow suit. The era of low yields seemed to many to be coming to an end. As a result, the euro market sold off in both yield and spread terms.

Looking at 2020, although those concerns are gone, new ones have emerged. Economic growth in the eurozone has continued to disappoint, hovering close to recession in spite of the ECB’s spectacularly accommodative monetary policy. With low growth, dovish policy looks set to continue.

The departure of ECB president Mario Draghi, and the arrival of Christine Lagarde as his successor, is unlikely to signal a sudden switch to the hawkish side.

For investors in the SSA market, that means more lending at negative yields. With $1trn of negative yielding securities clogging up portfolios, investors have to look elsewhere to shore up their returns.

“QE has driven yields to historically low levels and that has led investors to chase yield by moving up the yield curve and down the credit curve,” says Sean Taor, head of RBC Capital Markets’ DCM and syndicate in London.

Olivier Vion, Société Générale’s head of SSA DCM and syndicate in London, agrees. “Negative yields do reduce the investor base,” he says. “As well as looking for longer duration from SSAs, some investors look at EM or credit.”

That’s not to say there is any kind of technical shortage of demand for SSA paper. And, even among those who leave, “an army” remains poised to switch back into public sector paper to absorb any back-up in yields, according to James Athey, senior investment manager at Aberdeen Standard Investments in London.

“Negative yields do reduce the investor base. As well as looking for longer duration from SSAs, some investors look at EM or credit.”

Olivier Vion, Société Générale

For SSA borrowers in euros, demand has moved out further along the curve. However, bankers are less excited about the long end than they might have been in the past. Lee Cumbes, head of public sector DCM at Barclays in London, points out that the appetite for long end funding is limited. “Not every issuer has an infinite appetite for duration, and while long dated funding is attractive, the short end can be even more so, with issuers even being paid to borrow,” he says.

And with flat curves, the incentive for investors to lend indefinitely longer can disappear. Investors get very little pick-up in yield between three years and 10 years, and are in some cases returning to short end paper, rather than locking up sub-standard yields for the long term.

Beyond the eurozone

“Nothing really looks attractive” to Athey in Europe, although he remains reluctantly invested in core duration eurozone products.

For SSA bankers, catering to a yield-starved investor community when the majority of your products are trading with negative yields requires creativity and innovation. “Investors are being forced to pick up spread,” says Cumbes. “Often that means duration, but also diversifying into areas where they can get some kind of positive yield.

Israel doing 10 years and a debut 30 years, then coming back for 50 years is a great example of investors being better encouraged to diversify.”

While borrowers within the eurozone benefit from the resumption of QE through the reduction of their borrowing costs, those outside the ECB’s purchase programme can sometimes benefit even more dramatically.

Israel’s economy is as robust as many of its European counterparts but it has undeniable issues around regional security, which keep its ratings limited and mean that it is not typically a first port of call for euro buyers. But low yields have persuaded investors to overlook such issues and explore credits like Israel. Finding more will remain a challenge. “While there are pockets of supply like that, Europe is an enormous market with a lot of savings to be invested, and we are searching for more supply to meet the demand,” says Cumbes.

Although issuing in euros is only economical for issuers outside of
New ECB president Christine Lagarde is unlikely to make sudden changes to monetary policy

the eurozone when the cross-currency basis swap is favourable, that was the case for much of 2019, and bankers expect conditions to continue into 2020.

Barclays’ Cumbes will be putting a great deal of effort in 2020 into bringing non-eurozone borrowers to the euro market. “For next year, we’ll be looking at an increasing number of different issuers from outside the eurozone, bringing them very attractive euro market terms. There’s certainly appetite for high quality paper that isn’t directly targeted by QE.”

Finding value
For those investors required by their mandate to stay in core SSA assets, they often have harder work to do in order to assess value when yields are south of zero.

“There’s a more dynamic assessment of relative value among investors,” says Kerr Finlayson, head of FBG syndicate at NatWest Markets in London. “Some of the big French investors have specific yield targets. In other cases, the spread to govs is the relevant metric, we saw examples after the summer where short end trades worked well given the outperformance of the French curve at the short end.”

When compared to the world of government bonds, supranationals and agencies can typically offer a decent spread that should ensure they have a loyal base of buyers.

“State-owned enterprises often have equivalent or even better credit quality than their governments, but still pay a spread over them,” says Athey.

While supranational and agency paper can generally not compete with the liquidity offered by sovereign curves, there is a loyal pool of investors prepared to forgo the liquidity in favour of the extra yield.

How long can rates stay low?
“We’re looking at a situation where economic data is fairly flat and the ECB is giving us another package of rate cuts, TLTRO, QE, and deposit tiering,” says Cumbes. “Their central mandate remains inflation, and the inflation path doesn’t look set to change any time soon, so we might expect more of the same next year: flat curves and negative rates.”

While voices are building in the ECB governing council that the present approach is not working to restore inflation and economic growth, most in the market are convinced that Lagarde will not have the option to impose an aggressive rate hike trajectory for several years.

Taor at RBC says: “Outgoing ECB president Mario Draghi spoke around symmetry of inflation — implying that the ECB would allow inflation to be over 2% for a period of time before acting. Given that inflation has averaged just 1.2% over the eight years of Draghi’s presidency it is therefore likely that European interest rates will stay low for a long period of time.”

“The trade war is taking its toll,” says Vion. “That has forced the ECB into reverse gear.”

But while a growing chorus of voices acknowledges that an expansive fiscal policy as well as monetary policies will be needed to drive growth, few expect a wave of borrowing to fund infrastructure investments.

“I don’t see fiscal policy in Europe turning suddenly more aggressive,” says Athey. “Draghi has openly requested an expansion of fiscal policy, but the political climate, particularly in Germany, is an impediment to increased government spending.”

Germany, once the engine of European growth, is suffering in the global slowdown because of its open, export-driven economy. It narrowly avoided a recession in the third quarter, posting 0.1% growth.

Without economic growth or inflation, the debt burdens accrued by Europe’s borrowers — particularly Italy, where the debt to GDP ratio is projected to trend around 137.4% in 2020 — could become an alarming problem. Italy is looking at zero growth for the next couple of years, and the weak growth, low inflation and wide budget deficits “look set to put the debt ratio on an unsustainable path,” according to Capital Economics.

“Defaults from countries that control their printing press are rare, but in the eurozone, sovereigns are effectively hard currency borrowers,” says Athey. Aberdeen is short Italian government debt.

The emergence of debt sustainability worries is likely to cause a widening of credit spreads although the top end of the SSA market will benefit from a flight to quality. While borrowing costs may climb, for most SSA issuers, these can effectively be passed to their clients without much harm to the balance sheet.

While the broader environment will keep yields suppressed, Taor believes that Bunds will move slightly higher over the next year, in spite of the resumption of QE.

Provided it is not accompanied by a surge in volatility, the higher yields will simply help SSAs to recapture investors who have fled elsewhere for better returns. GC
Sterling SRI bond market roars into life

Sterling is set to take a bigger slice of the socially responsible bond market as a result of a number of initiatives, including reforms that are putting the pressure on UK pension funds to focus on environmental, social or governance (ESG) factors in their investments. Burhan Khadbai reports

UK pension funds are scrambling to put cash into the socially responsible bond market and public sector borrowers are taking full advantage of the rush.

“There’s definitely growing attention on the sterling green bond market,” says Aldo Romani, head of sustainability funding at the EIB in Luxembourg. “We are very happy that UK market participants are moving in this direction.”

Since October, the UK’s Department for Work and Pensions has required UK pension schemes with 100 or more members to produce a Statement of Investment Principles (SIP) to set out how they take account of ESG considerations. UK pensions minister Guy Opperman wrote in a letter to the UK’s biggest funds in October: “Pension funds are a powerful weapon in the fight against climate change. Despite some good work by a number of schemes, some are not acting. We need urgency on this vital issue from trustees and investment managers.

“I’m demanding that the remaining pension schemes and the fund managers they appoint stop shuffling their feet and meet their responsibilities to savers now and in the future, and the future of the planet.”

Before the reforms came into effect, KfW and the European Investment Bank sold record deals in the sterling socially responsible bond market, which benefited from strong demand by UK pension funds.

In July, KfW issued a £650m seven year green bond, the biggest ever SRI bond by a sovereign, supranational and agency until the EIB followed the week after with a £800m five year Climate Awareness Bond (CAB).

EIB’s bond became the largest single tranche sterling SRI bond across any sector. Danish energy company Ørsted issued a £900m green bond in May, but that was across three tranches.

“The transaction was driven by market demand,” says EIB’s Romani. “We initially had plans to launch the transaction at the end of the year but it came earlier than we planned because we were receiving strong indications that this deal would be met with good interest. We had a size of £500m in mind, but with an order book of over £1.4bn, we gave in to the demand and printed £800m.”

In addition to the UK pension fund reforms, other initiatives that are driving interest into the sterling green bond market are the UK’s Green Finance Strategy and the UK’s Green Finance Institute, which the government launched in July.

EIB’s five year CAB was its second ever sterling SRI bond, following its debut in March 2014. But it may not be long before the EIB taps the sterling market again for an SRI bond.

“We will definitely look at issuing another sterling CAB next year,” says Romani. “We could also consider the sterling market for our sustainable awareness bond issuance.”

Green Gilts?

There is also growing interest for the UK sovereign to issue green bonds. In 2019, large asset managers urged the UK Debt Management Office (DMO) to begin issuing green bonds to support the country’s environmental initiatives and to broaden the range of assets they can buy.

“The UK government has committed to reach a net zero carbon emissions target by 2050,” says Joshua Kendall, senior ESG analyst at Insight Investment in London. “This is only achievable by investing in renewable energy and energy efficient infrastructure. It’s going to need hundreds of billions of pounds of investment. The only way the UK is going to achieve this is through a massive increase in public spending and the issuance of Green Gilts would be a transparent way to do this.”

The UK government’s Green Finance Taskforce has also proposed the idea of a sovereign green bond.

But the prospect seems far away — at least for now.

“At present the government does not plan to issue a sovereign green bond, given the absence of significant barriers to market for corporate issuances in the UK,” says a spokesperson at the UK DMO. “In addition, the government does not consider a sovereign green bond to be value for money compared to the core Gilt programme, which remains the most stable and cost-effective way of raising finance to fund day-to-day government activities including existing and new green expenditure.” GC
Adaptable investors

The vibrancy of the market was buoyed by investors’ adaptability. “Investors have come to terms with negative rates, and have become more focused on relative value,” says Heck. “Even when rates were collapsing in the middle of the year, we never faced the threat of a buyers’ strike in the primary market.”

Andreas Tocchio, head of Swiss franc syndicate at UBS in Zurich, agrees. “What was new in 2019 was that we did not just have negative rates,” he says. “Increasingly, in the primary market for emerging market and corporate names we saw negative new issue yields, which in previous years had been confined to public sector and Pfandbrief issues.”

Tocchio adds that a notable trend among investors in 2019 was a preparedness to look at fixed income not through the prism of absolute yields, but performance potential. He says that a visible landmark in this respect was the four-tranche Sfr525m trade from Baloise in September, which was the first time a corporate borrower had priced all tranches of a new issue with 0% coupons and negative or zero yields.

For investors unable or unwilling to stomach negative yields, alternatives were offered — notably at the long end of the curve. “Most investors recognised by July or August that rates were going to stay low for much longer than they had expected earlier in the year,” says Daniel Zubler, head of syndicate at ZKB in Zurich. “They adjusted by going longer or further down the ratings spectrum.”

As an example, Zubler points to the success of Swissgrid’s 30 year in September, which raised Sfr125m at 5bp.

The low-yield environment also enhanced investors’ responsiveness to emerging market supply. “Borrowers from Latin America were regarded slightly cautiously until fairly recently,” says Ronald Hinterkircher, co-head of capital markets at Raiffeisen Switzerland in Zurich. “In 2019 a number of institutions were prepared to adapt their very strict rules to fulfil investment needs driven by redemptions.”

Zurich-based bankers are cautious about making forecasts for 2020. “With Brexit and trade wars likely to be less of an issue in 2020, we will probably see economic fundamentals and corporate earnings have more of an influence on fixed income,” says Zubler. “As those fundamentals don’t look promising, I expect rates to stay low but stable.”

From a structural perspective, syndicate heads point to two themes to watch in 2020. The first is the further development of the green bond market in Swiss francs. This gained encouraging impetus in 2019, notably by the Canton of Geneva, which in October launched a three-tranche Sfr660m issue which was the largest green bond ever printed in Swxis.

A second area that may attract increased attention in 2020 is denominations in new issues for FIG borrowers. Tocchio says that an important feature of UBS’s first AT1 Swiss franc trade in October was the choice of the Sfr200,000 denomination for the Sfr275m non-call six transaction in a market where the standard denomination has traditionally been Sfr5,000.

“The Sfr200,000 denomination has become established in the market for senior non-preferred debt, but UBS was the first to use it in a sizeable AT1 deal,” he says.
Client commitment has made us the No 1 underwriter of SFr bonds since 1991.

In partnership with our clients, we have been setting standards in the Swiss Franc bond market for 29 years* and our commitment is stronger than ever.

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Niche currencies offer alluring alternative for SSAs

For public sector issuers, niche currency deals have offered attractive opportunities for arbitrage funding, with spreads into euros and dollars spurring on demand this year. Meanwhile, strong investor appetite for green paper has seen niche shoots blossom throughout 2019. Frank Jackman reports

Niche currencies have provided fertile ground for sovereign, supranational and agency borrowers in 2019. Norwegian krone issuance climbed to a high of Nkr88.9bn (€9.8bn) by the end of October, up Nkr53bn from 2018, and in Australia issuers have placed A$20.1bn (€13.7bn) into the market, compared to A$18.0bn last year, according to Dealogic. Meanwhile, issuance in Canadian dollars is up by C$2.1bn to C$7.7bn ($5.8bn), according to BMO Capital Markets.

But such opportunities are transient. “It is hard to predict whether we will see issuance as high as this year in 2020, as competitive levels versus issuers’ home currency can quickly come and go,” says Massimo Antonelli, managing director at BMO Capital Markets.

The fortunes of niche currencies are partly dependent on those of the US economy. A slowdown in growth would hurt many of the currencies in which SSAs have successfully played in 2019 as investors seek security and run for the dollar.

“Our expectation is that the US moves into recession next year,” says Jane Foley, head of FX strategy at Rabobank in London. “If that’s the case then there are negative headwinds throughout 2019.

Issuers lean on Maple, Nokkie and Aussie for arb

The Norwegian krone market has been a particular bright spot in 2019. “Many issuers have really rediscovered this market,” says Danske Bank’s Stockholm-based global head of SSA origination Gustav Landström. “As an arb currency, Norwegian krone is functioning very well. I think SSA issuers have done the right thing in taking advantage.”

German agency KfW has had a record year in the currency, issuing Nkr19.5bn, according to data from Dealogic and the issuer itself, up from Nkr3.75bn in 2018.

Good funding levels afforded by attractive basis swaps into euros and dollars helped to drive up non-domestic interest in the currency.

This year, the US dollar/Norwegian krone basis swap has offered “quite nice levels”, Landström says. While euro/Norwegian krone has been less attractive issuers have still been able to print. “With the low yield environment in euros, Nokkie still works despite the basis not being great,” he adds.

Similarly, an attractive basis swap has allowed SSAs to achieve their best year in Australian dollar issuance since 2017, according to Dealogic.

Australian dollar borrowers such as the Inter-American Development Bank offset offshore funding from domestic Australian banks through currency swaps, “creating active basis swap flows,” says Laura Fan, head of funding at IADB in Washington DC.

The Australian dollar was the IADB’s third largest funding currency in 2019 and 2018, at A$1.625bn and A$1.19bn respectively, according to Dealogic.

The IADB “expects Australian dollars to remain [a key part of funding in 2020] due in part to the dynamic basis swap and broad investor interest in the Australian dollar market,” says Fan.

“As an arb currency, Norwegian krone is functioning very well. SSA issuers have done the right thing in taking advantage.”

Gustav Landström, Danske Bank

Over in Canadian dollars, SSAs have once again had one of their highest volume years.

Domestic bank treasuries have “welcomed the yield pick-up of an AAA rated SSA versus Canadian Mortgage Bonds,” says BMO’s Antonelli. “This year it made sense to issue in Canadian dollars given the move lower in US dollar swap spreads.”

Green shoots in niche markets

Canada has proven receptive to green and sustainable issues, with demand coming from “domestic real money,” says Antonelli.

In July, the World Bank made a splash with a C$1.5bn five year sustainable development bond to fund ocean and water related projects. The International Finance Corporation joined in September to launch its first Canadian dollar green bond. The C$750m ($567m) print was the issuer’s largest ever in the currency, as well as the tightest an international SSA issuer has printed against the Canadian Mortgage Bond curve. And in October, the IADB chose Canadian dollars to inaugurate its new sustainable development bond programme.

With swap spreads favourable and demand high, borrowers have also found success printing sustainable finance products in Nokkie and Kangaroo paper. In April, the African Development Bank brought the first social bond to the Norwegian market and that same month the IADB printed its inaugural Kangaroo EYE (education, youth and employment) bond, the product of more than four years of promoting the programme to domestic Australian investors.

Global Capital
Dealers turn to specialisation as MTN volumes slide

For the MTN market, 2019 failed to live up to the promise of a busy 2018. Dealers looking to buck the trend of sliding volumes have had to be creative in order to provide investors with ways of extracting yield and issuers with diverse and esoteric sources of funding of the sort only available in private placement format.

Specialisation in a fragmenting market has helped some dealers dodge the overall decline in volumes, and climb the league tables. This year, Crédit Agricole increased its involvement in SSAs, up $2.2bn from last year, propelling the bank up to second in the SSA MTN league table as of the end of October, up from sixth in 2018. Deutsche Bank has climbed from 22nd in 2016 to fifth in 2019.

“The changes in league table positions are more about where you want to position your business and ensuring you remain flexible to lead the market in new directions,” says Crédit Agricole’s head of MTNs, Toby Croasdell.

But persuading issuers to look at MTNs is no easy task. At the end of October, overall third party MTN issuance was down 17% compared with last year at $160.9bn, according to Dealogic.

Martin Svedholm, a funding manager at Municipality Finance in Helsinki, attributes the decline to the illiquidity of MTNs and low interest rates. “This applies for all our private placements, as many investors are moving more and more to benchmarks with greater liquidity,” he says.

“Compared with the number of enquiries and prints from several years ago we are at very low levels. I think that the reason behind this is the extremely low yield environment. Investors are taking a while to get used to the new yield levels and tenors.”

Scandies surge upwards

Scandinavian banks have benefited from positioning themselves as alternative, local currency dealers for public sector issuers in Norway and Sweden.

Danske Bank has dealt almost $1bn more third-party MTNs in 2019 than it did in the same period in 2018, propelling it up six places to 11th. Meanwhile, Nordea climbed four places on the back of a $564.9m increase from 20th to 16th.

“The move of Scandie banks up the MTN league tables is to a large extent due to the growth of the Norwegian krone market,” says Gustav Landström, global head of SSA origination at Danske Bank in Stockholm.

SSA MTN issuance in Norwegian kroner has more than doubled during the first 10 months of 2019: $7.7bn equivalent sold across 106 deals, compared with $3.1bn in the same period in 2018.

Issuers have also noticed the sharp increase in Nokkie issuance. This year, the krone is the European Investment Bank’s fourth largest funding currency for the first time, having printed the equivalent of €1.8bn — twice as big as its previous record, according to Joakim Tiberg, a funding official at the EIB in Luxembourg.

“It has been a kind of perfect storm,” says Tiberg. “Looking at bond yields across markets, Norway is one of the few markets where yields are higher now than at the start of 2018.”

Rates have risen steadily over the past year as the Norges Bank has adopted a more hawkish tone, with the policy rate moving from a record low of 0.5% in August 2018 to 1.5% in September 2019.

Meeting the challenge of low rates

“Yields are underpinned at very low levels, and it doesn’t feel like that’s about to change,” says Croasdell.

“The challenge remains finding acceptable ways to extract more yield: this is clearly shown by the increase in callable and structured pay-offs seen in recent months and the extension of duration seen throughout the year.”

Issuer and investors are capitulating to the realities of low yields, and there have been stirrings at the long end in 2019. The Federal State of North Rhine Westphalia hit its first century maturity in March, before tapping the line a further 11 times, while SNCF and Ireland returned with their sophomore efforts.

Callable paper increased in the latter half of 2019, with $2.2bn printed during the third quarter, according to Dealogic.

Croasdell adds: “Public trades are being done at very competitive levels with minimal new issue premiums, so MTNs have to keep evolving, offering innovation and diversification. There’s a lot of liquidity out there, further fuelled by the ECB, that helps to drive supply in the public arena and the new issue market has been wide open for most borrowers.” GC
2019 bond deals of the year: financial institutions

Reflecting on 2019, market participants may be surprised to see how things panned out. They went into the year expecting to ride out the end of QE and instead got a new purchase programme, funding scheme and rate cuts from the European Central Bank. This backdrop has given banks and insurers another good opportunity to move towards meeting their regulatory debt requirements, while testing new lows for their costs of funding and capital. GlobalCapital wanted to reward the deals that achieved stand-out results for issuers, in terms of pricing, execution and timing. The winners are presented here.

**NON-PREFERRED SENIOR DEAL OF THE YEAR**

**Svenska Handelsbanken**

€750m 0.05% seven year non-preferred senior, September 2026
Citibank, Credit Suisse, Goldman Sachs, HSBC, Svenska Handelsbanken

It is difficult to see how Svenska Handelsbanken could have timed the sale of its debut non-preferred senior deal any better. The Swedish bank surfaced in the euro market at the end of August, when the pricing available on new bonds was arguably at its most competitive for issuers.

The result was nothing short of staggering. Svenska was two times subscribed for its €750m deal at 50bp over mid-swaps, which at the time worked out as a re-offer yield of just 0.078% and a coupon of 0.05%. The only thing that had saved the bank from printing at a negative yield was its decision to sell a seven year bond rather than a five year — a much more common choice among first-time issuers. It was the perfect start for Svenska in its work to build new buffers of the unsecured debt capital markets amid Greece's economic crisis, "noted Moody's at the time."

**ADDITIONAL TIER ONE CAPITAL DEAL OF THE YEAR**

**Commerzbank**

$1bn 7% perpetual non-call six year additional tier one capital
Barclays, Commerzbank, HSBC, JP Morgan, UBS

This was the deal that everybody in the market had been waiting for. Commerzbank was one of a handful of big banks that were still to embrace the AT1 asset class, which has now been around for more than five years. Commerzbank's mind was finally changed in 2019 after changes to the EU's bank capital framework made it less appealing to call on equity to do AT1's job. When the German issuer did eventually dive into the new issue market, it landed with an almighty splash. Investors greeted the $1bn bond offering with up to $11bn of demand, giving the bookrunners plenty of room to tighten pricing by 75bp and land at a final level of 7%.

One rival banker applauded Commerzbank's choice of the Reg S dollar market over euros, arguing at the time that the decision had helped to increase the AT1s appeal and deliver the issuer "a saving in terms of all-in costs."

**TIER TWO CAPITAL DEAL OF THE YEAR**

**Piraeus Bank**

€400m 9.75%10 non-call five year tier two capital, June 2020 non-call 2024
Goldman Sachs, UBS

Piraeus Bank was not an obvious candidate to re-open the subordinated debt market for Greek banks since the 2008 financial crisis. It is neither the largest of the country’s financial institutions, nor the highest rated.

But, at the end of June, the issuer handled its ambitious capital raising exercise deftly. By starting the pricing process with a coupon in the double digits, Piraeus was able to attract enough demand to pull 50bp tighter and price its €400m tier two at 9.75%.

About 135 accounts participated in the transaction, pledging orders worth €585m combined. Nobody could argue that the debt came cheap, but market participants had nothing but praise for the ground-breaking transaction. "The successful placement shows a renewed investor appetite for Greek banks' unsecured debt, five years after banks were locked out of the unsecured debt capital markets amid Greece's economic crisis," noted Moody's at the time."

**INSURANCE BOND DEAL OF THE YEAR**

**Achmea**

€500m 4.625% perpetual non-call 10 year restricted tier one €250m 2.5% 20 year non-call 10 tier two, September 2039 non-call June 2029
Barclays, BNP Paribas, Deutsche Bank, HSBC, NatWest Markets, Rabobank, UniCredit

It is usual for financial institutions to double up in the euro market and sell two tranches of bonds at the same time. But it is extraordinarily rare to see issuers attempting what Achmea tried in mid-to late September, when it hit screens with two subordinated bonds at different layers of the capital structure.

But the Dutch insurance company pulled it off, strengthening its solvency position with both an RT1 and a tier two in one swoop. Orders for the €750m debt package peaked at about €1.35bn, though Achmea was said to have paid a fair price for its securities. The issuer will have been bolstered by choosing an excellent window, a short time after the European Central Bank's grand unveiling of a big new stimulus package. With its tier two issue, Achmea was also swift to take advantage of a new series of rating methodology changes at Standard & Poor's. The changes allowed issuers to gain equity credit for callable subordinated bonds that have 20 year maturities, rather than the normal 30. 
Banks in 2020: a new world order

GlobalCapital has put together a series of charts looking at the financial institutions bond market in 2019 and beyond.

MREL: a new model for subordination

Lawmakers put pen to paper on a huge package of regulatory reforms for banks in 2019, including important clarifications to the minimum requirements for own funds and eligible liabilities (MREL).

When it comes to the new issue markets, the big question for EU banks has been about how much of their MREL targets need to be met with subordinated liabilities — debt ranking below ordinary senior obligations in an insolvency.

The new legislative agreement has established a minimum subordination requirements for banks, but the maximum level of subordination will ultimately be determined by the Single Resolution Board and national competent authorities.

The 2020s: A decade of deadlines

Bank funding officials have a host of deadlines to think about as they move into the new decade.

Immediate concerns about the need to repay more than €700bn borrowed through the European Central Bank’s targeted longer term refinancing operations (TLTRO) have been brushed aside, given that the cheap funding scheme has been extended for another four years. But banks will still need to think about tapping the market for new sources of long-term financing, which will ultimately be required of them when the net stable funding ratio comes into force in the middle of 2021.

Overarching these considerations is the need to get in line with MREL by January 2024. This new set of EU rules demands that banks have enough bail-inable debt to deal with a crisis.

The Covered Bond Directive

After about five years of political work, the European Union came together to agree on a Covered Bond Directive in April this year. The agreement will act as a single reference point for covered bond rules, effectively harmonising treatment of the asset class within the EU.

It strengthens the definition of covered bonds and cover pools, sets out the responsibilities of supervisory authorities and introduces two new labels for compliant securities: premium and ordinary.

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Riveting year ahead for covered bonds in QE-warped market

Covered bonds performed well in 2019, but yields finished in negative territory and spreads ended at their tightest for the year. The implication is that, despite higher than expected ECB covered bond purchases and a renewal of its ultra-cheap TLTRO facility, investors will struggle to match 2019’s returns in 2020, writes Bill Thornhill.

Agressive covered bond buying by the European Central Bank since November 2019 and speculation of a further 10bp cut in its deposit rate boosted sentiment into the final few weeks of 2019 leaving the market on a high. These key factors will continue to provide support at the beginning of 2020, suggesting spreads could still tighten and yields may yet fall further.

But, with the ECB running out of monetary policy ammunition and a supply splurge likely in the first quarter, a sustained performance matching that seen in 2019 seems highly unlikely. Indeed, it won’t take much for a setback to be triggered.

The combination of central bank and bank treasury buying should mean there is an almost “infinite amount of cash chasing assets, as long as covered bond spreads stay noticeably positive against three month Euribor,” says Florian Eichert, head of covered bond and SSA research at Crédit Agricole CIB in Frankfurt.

However, the moment covered bond spreads get close to the spread equivalent of the ECB’s deposit rate, “banks will quickly switch off buying”. And since it’s highly unlikely any other type of investor would step at that point, a correction would be expected to follow.

Despite a 35bp rise in outright 10 year Bund yields in the final four months of 2019, the market finished around 50bp below where it started the year, leaving almost 90% of euro covered bonds with negative yields. At the same time spreads tightened sharply, with Caffi printing a 10 year in November more than 20bp inside where Crédit Agricole and Crédit Mutuel CIC issued 10 year deals in January.

The steep move down in yields combined with a substantial spread tightening provided ideal investment conditions causing the Markit iBoxx covered bond Total Return Index to jump from zero in 2018 to 3.65% in the 12 months to early November 2019. “I’m struggling to see how investors will repeat 2019’s strong performance in 2020,” says Zuzana Stockton, head of covered bond EMEA syndicate at Deutsche Bank in Frankfurt.

Too tight

Conditions became almost too good — when yields fell to their decade-low in early September 2019 borrowers increasingly avoided the covered bond market as deal execution became less certain. Deeply negative yielding covered bonds issued at that time by Berlin Hyp, at minus 0.588%, and later by MünchnerHyp emerged just when rates were at their low point.

With around 30 to 40 investors on board, these issues and others that came around the same time attracted roughly half the average number of buyers typically expected. Worse still, some deals, such as those issued by Deutsche Pfandbriefbank and Hypo Tirol, were not even subscribed. Fearing the worst, borrowers opted to move down the capital structure and issue higher yielding senior preferred deals.

However, as outright yields subsequently corrected higher, banks were successfully able to issue long-dated covered bonds with only slightly negative yields. With a reoffer yield of minus 0.053% Caisse de Refinancement de l’Habitat brought in 85 investors for its €1.1bn 10 year issued on October 1, and with a reoffer yield of minus 0.069%, BPCE hauled in 84 buyers for its €1.25bn seven year issued on October 30.

Then, in early November, the ECB stepped up purchases, raising the size of its order from 5% of a deal’s size to 40%. The ECB’s eightfold increase in buying was well beyond expectations and gave strong a boost to sentiment. But in the event outright yields head lower and spreads continue to tighten the positive mood could quickly change.

“I think it is likely spreads will grind tighter from here,” says Armin Peter, head of EMEA syndicate at UBS in London. “But investors are sure to step back from books in the event subscription ratios fall to 1.2 times or less and the ECB gets close to a full allocation.”

Deutsche’s Stockton warns that market fatigue is often seen towards the tail-end of the first supply wave in January, saying “there may well be a few bumps of volatility through the year.” She doesn’t expect covered bonds to post anything close to the near 20bp widening seen in the second half of 2018.

Apart from the scale of supply, negative rates and tightening spreads, covered bond bankers will also have to contend with relative
value considerations. Covered bonds offer a good enough spread against other high quality liquid assets, but this margin has come down to the point where interest could quickly disappear. “The real pinch point would come if covered bonds lose relative value at the same time as yields becoming deeply negative,” cautions Peter.

At the start of 2019, Pfandbriefe were delivering a pick-up of 55bp-60bp over Bunds, but the differential fell to around half that level by November. At around 35bp over Bunds Pfandbriefe are still attractive, but getting closer to levels where investors have previously deserted the market. Two years ago, when the Pfandbrief pick-up was only 15bp-20bp over Bunds and German Pfandbriefe traded inside agencies such as KfW, covered bonds were sold.

For this reason Matthias Melms, head of covered bond and SSA research at NordLB in Hanover, is “bearish on covered bonds compared to SSAs, especially at the long end”.

All eyes on the ECB

Conversely, scope for the relative performance of covered bonds against other asset classes could improve in the unlikely but possible event the ECB steps up purchases to an even higher level. The ECB is limited to buying a maximum of 33% of any sovereign, supra or agency bond, which is likely to become insufficient to meet its overall asset purchase target of €20bn a month. As such, at some point in the first few months it will probably need to raise this limit. If not, it will be obliged to look elsewhere, probably by increasing purchases among all its private sector programmes that include covered bonds, securitizations and corporate bonds.

“Should the ECB not manage to raise the ISIN limit on the Public Sector Purchase Programme, it might be forced to step up private sector purchases and [covered bond] spreads could be squeezed back toward the mid-swaps minus 25bp to minus 30bp levels,” says Eichert.

The ECB is able to buy up to 70% of any eligible covered bond so it could easily step up purchases, returning to the peak buying levels seen in 2017. “The ECB have to fulfil their full quota and, if there’s no new issue supply they’ll buy in the secondary, so there’s likely to be a squeeze of one asset class versus the other,” says Stockton.

In such circumstances, the Eurosystem would need to buy covered bonds in much larger size, in which case the market could potentially swallow agencies such as KfW and tighten even further than 15bp-20bp against Bunds. While this is possible, Eichert doesn’t believe it’s likely.

Added to this quagmire of considerations, covered bond practitioners must take account of the ECB’s third Targeted Longer-Term Refinancing Operation (TLTRO). This three year funding should in theory be supportive for covered bonds because it subtracts from banks’ overall funding needs.

“After maxing out on the TLTRO and fulfilling relatively expensive MREL funding, I expect issuers to turn to covered bonds,” says Peter, who thinks this should help lower their overall average cost of funding.

Analysts in Barclays’ research team forecast a much bigger take-up in the December TLTRO of around €300bn, as funding in this operation could benefit from a further potential 10bp cut in the ECB’s deposit rate to minus 60bp.

Barclays analysts say the third TLTRO has been transformed by the ECB from a generous backstop to an attractive funding tool and, at a gross €650bn, they expect almost the entire amount borrowed under the second TLTRO to be rolled into the third.

Italian and Spanish banks are by far the largest TLTRO users with BBVA research analysts estimating the volume of retained covered bonds used by Spanish and Italian banks for ECB liquidity operations at €65bn and €62bn respectively.

Critically however, this TLTRO borrowing is not expected to increase or fall from 2019, which means there will be no net impact on the expected supply of covered bonds in 2020. Eichert says the TLTRO is there merely as a contingency funding tool and he doesn’t believe it will push down covered bond issuance in 2020.

In fact, given heavy covered bond redemptions next year, a number of new entrants to the market and solid mortgage asset production both here and in Stockton are optimistic that 2020’s covered bond supply will increase from 2019.

Source: Crédit Agricole CIB covered bond and SSA research
Covered bonds grapple with QE distorted world

Navigating the covered bond market will not be without its challenges in 2020. The Targeted Longer Term Refinancing Operation (TLTRO), European Central Bank deposit tiering and the Covered Bond Purchase Programme have collectively distorted the market, but added to this concoction is the impact of negative interest rates. Against this backdrop issuers, investors and investment bankers gathered in Munich in November to discuss the outlook for covered bonds.

It is likely that new issue premiums will gradually tighten, but the path is unlikely to be smooth. January is typically the busiest month, but in 2019, issuers that funded this early paid the highest spreads. And, with the ECB expected to buy in the region of €4.5bn covered bonds a month, issuers will not feel compelled to move early. But the ECB monetary policy has unwelcome implications. Covered bonds have begun to lose value against government bonds, and this will extend if the ECB is unable to loosen restrictions on government bond purchases.

Participants in the roundtable were:
- Ger Buls, manager, long term funding and capital, Rabobank
- Florian Eichert, head of covered bond and SSA research, Crédit Agricole CIB, Frankfurt
- Miguel García De Eulate, head of treasury, Caja Rural de Navarra, Pamplona
- Sami Gotrane, head of treasury and financial markets, SFIL, Paris
- Timo Boehm, senior portfolio manager, Pimco, Munich
- Nadine Fedon, global head of funding, Crédit Agricole SA, Paris
- Carlos Martins, senior portfolio manager, European Stability Mechanism, Luxembourg
- Vincent Hoarau, head of FIG syndicate, Crédit Agricole CIB, London

**GlobalCapital:** **How do you expect ECB covered bond buying to pan out over the course of 2020?**

**Florian Eichert, Crédit Agricole:** I expect net ECB purchasing of €2bn a month, plus redemptions of €2.5bn a month next year, which takes gross purchases to around €4.5bn per month. That’s about twice as much as they bought up until November in 2019 and around the same volume as seen in 2017. We’ve already seen on the most recent new issues that the ECB’s order is back to 40% of a deal’s size, though allocations are slightly below 20%. With a 20%-25% overall allocation and around €100bn of eligible issuance next year, the ECB should be able to source about €20bn–€25bn from the primary covered bond market.

**Timo Boehm, Pimco:** An obvious outcome is that real-money investors will be slowly crowded out and the market will become increasingly dominated by bank treasuries buying for their LCR portfolios. Since the ECB restarted buying we’ve already seen some quite strong tightening from initial guidance and, given questions about the limitations on the purchases of sovereign bonds, the ECB’s covered bond buying could become even more intense.

**GlobalCapital:** **Why might the ECB increase covered bond buying further?**

**Eichert, Crédit Agricole:** Unless the ECB are able to increase the purchasing limit (33% of a sovereign deal or ISIN and 50% of an agency deal) they might actually end up raising their covered bond and corporate purchases. They can probably keep going for nine to 12 months, so there’s no immediate need for them to really try and get every last available SSA bond for the time being. But if they don’t increase the ISIN limit...
then the first reaction will, most likely, be to shift more into the private sector programmes because that’s an easier thing to do — they can just do it without any trouble from the Governing Council.

The ECB would need the council’s agreement to increase the ISIN limits on SSAs, and I don’t know whether that’s possible. Though, given the choice between more helicopter money and a higher ISIN limit, the Bundesbank would probably go for the higher ISIN limit. The ECB could also temporarily move away from the capital key without a need to announce anything. But if the ISIN limit on SSAs and govvies is not increased, it potentially means gross covered bond purchases will rise from €4.5bn to €6bn a month. Even though that doesn’t really move the needle for the overall Asset Purchase Programme, it would be quite disastrous for covered bonds. Although increased ECB buying is likely to be good for investors’ existing holdings, it will be bad for any new investment, and bad for new issuance. Along with negative yields, investors could possibly demand substantial new issue premiums of 15bp-20bp… I don’t know. I’m really, really anxious on the ISIN limit — not in the short run, but a good three quarters down the line. In the second half of 2020, after the summer, it could get a little ugly.

**Seqeuncing**

Vincent Hoarau, Crédit Agricole: Pricing flat to the curve is more likely with infrequent quality issuers where the scarcity element is well pronounced. When it comes to core national champions, new issue premiums are still requested. Supply may soon dry up, so I would expect spreads and new issue premiums to drift lower into the end of 2019. Then, depending on whether issuers decide to front-load funding in January, the direction of spreads may evolve drastically. Many borrowers were caught by surprise in January 2019 and issued at fairly elevated levels, so they may become more vigilant, in terms of sequencing issuance in 2020. The ECB is back, pressure is lower, so the supply dynamic could be different in the early part of 2020.

Ger Buls, Rabobank: We’ve issued eight covered bond benchmarks since May 2017 including some dual tranche deals, but going forward we plan to issue once or twice a year. Given our limited needs, we are more flexible with regard to timing. Therefore there’s likely to be no urgent need to rush into the January window. I don’t think there will be a massive spread tightening, but on other hand I don’t see much risk of a spread widening, so there’s no pressure to hit the market early.

Sami Gotrane, SFIL: We expect to carefully manage our balance sheet and optimise our P&L by paying careful attention to sequencing in 2020 to find the best funding window and reduce our liquid assets and cash equivalent. In 2019 we raised €4bn, of which €3.6bn was public, including €1.75bn of sustainable bonds. We issued €1.25bn in January, split over six and 15 years, but as we start 2020 with €4.5bn of cash equivalent, the challenge here will be to optimise our balance sheet. Obviously we’ll discuss the right funding window with our banks and it’s likely we’ll make an appearance in the first quarter, but I’m not sure whether it will be in January. Two-thirds of our global funding is under covered bond format; within that context we intend to be flexible.

Fedon, Crédit Agricole: We have a funding plan which is set for the year and has constraints resulting from the capital key without a need to announce anything.
from financial communication, programme and documentation updates. But within this framework we have some flexibility regarding timing and sequencing.

We have no fixed target regarding the covered bond spread to senior preferred, nor for other instruments, but we try to optimise spreads on higher beta transactions. In January 2019, we thought senior spreads were much too high, and clearly distressed, and thought that they would tighten. Therefore we decided to go for lower beta transactions like covered bonds and short-term euros. In fact, having a funding programme of €17bn for the year means we cannot skip a window completely.

We attach great importance to diversification as well. Having done the largest part of funding in euros this year, we have issued senior preferred in Australian dollars, sterling, Swiss francs and US dollars and we’ve also issued a green senior non-preferred in euros. We generally want to operate in all these markets when the premium is not too high, but if the premium is reasonable.

**Sami Gotrane**
SFL

There is no sense in diversifying in other currencies in covered bonds, except for Swiss francs where we have a natural interest. This year we issued covered bonds twice in Swiss francs, but next year it will be difficult because the spread differential could be higher due to the purchase programme.

**Buls, Rabobank:** The spread differential between covered bonds and the senior preferred markets should be meaningful to issue covered bonds. In general, covered bond issuance is in the medium to longer tenors, versus shorter tenors in the senior preferred market. With short to medium-dated funding you could question whether covered bonds are really the perfect instrument — probably not. But when you look at the differential between senior preferred and covered bonds in the 10 year, for example, it’s quite meaningful. Ideally we’d like to fund our regional branch balance sheets with senior preferred in Aussie dollars and US dollars. So if these markets are pricing relatively competitively to euros we’ll enter them, but if not then we’ll look for alternatives. Ultimately we monitor all the different markets and all the different products. The most important component of our funding mandate is that we need to fill the senior non-preferred part with our MREL needs and the remaining funding, which is between senior preferred and covered bonds, is relatively flexible.

**Hoarau, Crédit Agricole:** Sequencing means it will become extremely important to take a view on the evolution of the rate-spread complex over the year and push one, or the other, part of the liability structure-curve, or just wait. Because, with a deeply negative yield, low beta issuance might not necessarily work. Despite the support of the Eurosystem, we have already seen in recent weeks that the magnitude of the demand and the quality of the order book can significantly vary, depending on the level of outright yields.

**GlobalCapital: What’s your view on rates?**

**Eichert, Crédit Agricole:** The house view is for another cut of 10bp in the deposit rate to minus 0.60% but that’s it. The house view is that the rates market is currently at medium-term peak and that yields will start trending downward again from here.

**Buying below zero**

**GlobalCapital: Are negative yields are a deal breaker?**

**Carlos Martins, European Stability Mechanism:** The fact that investors are not willing to buy securities with yields below zero is understandable. However, expecting covered bonds would not trade below the 0% yield threshold could be wishful thinking. If there is a downward shift in the yield curve due to an economic downturn, or because of another ECB rate cut, all yields will structurally fall, including covered bonds. At first, when overall yields fell below 0%, SSA investors were very reluctant to invest; eventually it became structural and investors had to bite the bullet and start buying at negative yield.

**Buls, Rabobank:** There are some investors that simply can’t accept negative yields and there are also some that are not participating in deals that price through midswaps, or because of the tight spread to govies. For these reasons, the number of investors in the book can be more limited, which means the size of a trade might tend to become smaller. So it won’t necessarily be so easy to get benchmark executions. Obviously, if there’s a reduced group of investors buying it’s going to have an impact, though I expect issuers will try as much as possible to term out funding with longer deals to avoid negative yields.

**GlobalCapital: There doesn’t yet seem to be any sort of precedent in the covered bond market for ultra-long maturities. How far would you extend to avoid negative yields?**

**Boehm, Pimco:** There are one or two examples of ultra-long covered bonds such as CFF’s 50 year. But I would say this is a very illiquid covered bond. But if there were more issuers to come in on the ultra-long end of the curve, then it would make it much easier for investors. The curve now is flat after 23 or 24 years, which makes it very difficult to buy. We don’t want to roll up the curve for no compensation, so if you come with a 30-year covered bond you would need to make sure there is sufficient new issue premium to offset the flatness of the curve in this maturity bucket.
The flattening we saw in the first half of the year was also a function of the very low yield environment. But some of our clients need to pay careful attention to their liability management, so for this reason they buy at the very long end which is much more interesting than the typical five to seven year where we see most covered bonds issued.

**Martins, ESM:** In practice, we mainly invest in the five to 10 year sector as it corresponds to our market risk appetite. Yet, we can theoretically invest in longer maturities. If yields are very low and the only real positive yield is on a longer part of the yield curve, we would then need to reconsider. We would need to be rewarded by some term premium but with a very flat yield curve above the 15 years, there is not much term premium left and certainly nothing above 25 years. On top of that, unless for hold-to-maturity investor types, one has to consider the potential higher volatility for such long duration positions.

**Hoarau, Crédit Agricole:** During the summer it was all about how to avoid negative yields, but since September, we’ve had a dose of evidence that negative yields work. It’s a relative value game in a market where cash is not an asset. Nevertheless, there is still a lot of resistance. And we acknowledge there is a strong correlation between the quality and granularity of an order book and the absolute re-offer yield. We have around this table some extremely diligent investors that have demonstrated that they can be accommodating some of the time, but at other times they can also be extremely sensitive to the spread.

**Boehm, Pimco:** Most real-money investors like us manage our performance against a benchmark such as the Bloomberg Euro index, which has a negative yield right now but it shows a total return in 2019 of 3.3%, which is fantastic. The total return of the Bloomberg covered bond index was also positive in 2018 and 2017, which is proof you can earn money even in a low-yielding environment.

But, what we’ve also seen in the past is that clients might also think about their overall asset allocation and we’ve already seen a trend of clients moving away from covered bonds into bonds lower down the bank capital structure, or into alternative investments like equities or real estate. And if the rates cycle changes and yields start trending higher then it’s likely we’d be looking at a negative total return, in which case even more clients might be motivated to seek other investment opportunities.

**Relative value**

**Martins, ESM:** I think one alternative that we can also look at, within the covered bond space, is outside the euro area, such as issuers in Canada, Australia, New Zealand, and the Nordic countries. They trade at a small discount to euro area covered bonds but the quality of the asset pool is, generally speaking, of very similar quality.

**Miguel Garcia De Eulate, Caja Rural de Navarra:** But before going to real estate or other alternative assets, it’s possible investors will consider peripheral covered bonds which offer higher spread, where of course there is still a lot of room for tightening against core names. What has shocked me is that the rating difference between core and peripheral European covered bonds is only one notch — but when you look at spreads, we are still talking about a large differential of many tens of basis points between some Spanish Cédulas and core European covered bonds.

**Hoarau, Crédit Agricole:** I fully agree with you. Semicore covered bonds are still attractive, but we have not seen the full effect of the restart of the Asset Purchase Programme. When that happens, you can bet on a decent spread convergence.

When I look at the entire credit spectrum in covered bonds, I still don’t understand why there are some jurisdictions and some names where convergence has not been more pronounced — particularly in Italy, where the BTP compressed nicely versus Bunds. In some specific situations, I see a 50bp differential to core names which makes me question the relevance of some levels in the secondary market where the liquidity is — by the way — sometimes non-existent.

**GlobalCapital:** And if yields and spreads are too low, there’s always the senior unsecured market.

**Hoarau, Crédit Agricole:** Indeed, I think there is also room for spread compression versus covered bonds before covered bonds can tighten further. We had a couple of recent senior preferred deals from DNB Nor and Helaba where bookbuilding was booming because of their substantial spread premium to covered bonds. And in recent years banks have been building their capital stacks, reinforcing the safety of the senior preferred layer.

That said, in terms of spread evolution, the outlook will strongly depend on issuers’ behaviour and funding tactics, together with absolute rate levels. As history has demonstrated, a big spread driver for covered bonds is supply. What if, for example, core issuers collectively decide in January 2020 to favour MREL and TLAC issuance and they postpone covered bond issuance because they think conditions and appetite may be better later in the year?

Most bank issuers have funding needs in covered bonds, senior preferred and non-preferred, and potentially tier two or tier one. So you could have a
good part of January that is skewed towards higher-beta instruments in the core markets, which will indirectly support a relatively better performance of the covered bond sector, particularly at the long end where the curve could flatten further.

Boehm, Pimco: We look at the relative value of covered bonds versus senior preferred and if there is enough room we invest in one or the other, depending on the portfolio.

Hoaarau, Crédit Agricole: If you look at the recent performance of covered bond new issues since the end of the summer, everything has worked fairly well. But the performance of recent core senior non-preferred deals has been relatively weak because of the spread compression in non-preferred to preferred senior in the last six months.

Regulatory funding

GlobalCapital: How do you break down your overall funding across the capital stack?

Fedon, Crédit Agricole: We fix our funding programme yearly by looking at the expected evolution of the balance sheet, and at the medium to long-term (MLT) liquidity excess. We target an excess MLT liquidity of above €100bn to fund our High-Quality-Liquid-Asset portfolio, and that essentially defines the entire funding plan for the whole year. In our medium-term plan we also disclosed that our subordinated MREL target for the year ending 2022 is 24%-25%. That includes CET1 of 16%, AT1 of 1%, tier two of 3% and senior non-preferred of 4%-5%.

Those two targets define both the size of the funding plan, and within that, the need for capital stack, split by instruments. As an example, within our €17bn funding programme for 2019 there is €5bn-€6bn of TLAC debt — from tier two to senior non-preferred. The remaining €12bn is funded in senior preferred, covered bonds and securitization. Next year’s figures are not decided.

García, Caja Rural de Navarra: Meeting MREL requirements has mostly been done by Spain’s bigger banks, but medium-sized banks like us will probably need to think about this soon — and we expect to hear more about our MREL requirements in the next few months. Of course we remain committed to the covered bond market but MREL will be key. There is of course a spread relationship between covered bonds, senior preferred and senior non-preferred. As we build out our MREL curve we will see where spreads settle and then we can compare.

TLTRO

GlobalCapital: And when we think about the TLTRO which is the cheapest to deliver, that’s also going to bring down supply, especially now it has been made more favourable in terms of lengthening the duration to three years, as opposed to two, with the option to pay back early. How does that affect your overall funding?

Buls, Rabobank: TLTRO is up to three years, so there is still a need for the alternative longer funding that covered bonds can offer. Obviously the TLTRO stands to reduce our funding need but it’s not yet a given that we’ll participate as we still need to make the calculation and decide whether it makes sense. After fulfilling our MREL requirements with senior non-preferred, we look at senior preferred and covered bonds. The long-dated mortgages on our balance sheet are best match-funded with long-dated covered bonds, which is a market that we are committed to maintaining a strategic presence in. We also want to keep a presence in senior unsecured in US dollars, Aussie dollars and New Zealand dollars, so if it makes sense we’ll prioritise senior supply in these markets too.

Fedon, Crédit Agricole: We increased our 2019 funding programme in comparison to 2018 in order to address the repayment of TLTRO II. But now we have TLTRO III, which has been significantly improved. We expect to use it, probably in the same way as in the past, which is to fund our short-term needs and then go to the market for longer maturities. What we will not do is issue benchmark senior preferred for two or three years, which is what we had intended to do if the TLTRO had been stopped without replacement.

Miguel García De Eulate
Caja Rural de Navarra

García, Caja Rural de Navarra: Three year TLTRO is much cheaper than covered bonds for Spanish issuers and it means banks are not under pressure to issue. So I expect more Spanish banks to refrain from covered bonds in the next year due to the combination of TLTRO and deleveraging.

Deleveraging is key because if you really see growth in mortgage lending then banks will begin to think about covered bonds, which for most Spanish issuers are a strategic funding tool for long-term funding that does not compete with the TLTRO. The Spanish mortgage market used to be a purely floating one, but it’s now half floating/half fixed, and since covered bonds are a fixed rate, they provide a natural hedge for balance sheet.

GlobalCapital: How useful is the TLTRO for Caffil?

Gotrane, Caffil: We are not a bank but an agency, so the way we use covered bonds is a bit different. We have a very conservative approach to asset liability...
matching, with the average duration of our loan portfolio being around 11 years and the maximum allowable duration mismatch being around one year. We’ve seen a lot of municipalities and local authorities extending borrowing in 2019 to the 20 and 30 year level, where rates have become very attractive. We expect to have originated close to €5bn of new loans in a portfolio of €55bn with a small drift to increasing the maturity. For this reason the TLTRO does not fit well with our strategy.

Deposit tiering

Martins, ESM: ECB deposit tiering and the TLTRO, along with the crowding-out effect of the ECB’s purchase programme, should help small and medium-sized bank issuers in semi-core countries to more easily access the senior and subordinated markets to boost their capital buffers and meet the MREL requirements. Therefore, despite some recent criticism about the side-effects of negative rates, this policy should contribute to make the banking system more resilient.

Garcia, Caja rural Navarra: I had the opportunity to listen to Luis de Guindos from the ECB at a conference in Bilbao and my take was that the ECB is very concerned about the viability of the European financial sector in the negative yields environment, especially in countries where the loan book has been repriced aggressively, leading to disappearing profit margins. They know that 12 month Euribor is very important for Spanish banks. In August the 12 month Euribor rate was minus 40bp and now it’s minus 30bp. That’s only 10bp, which may not sound like much, but there’s some research so suggest that this is the difference needed for banks to be profitable.

Eichert, Crédit Agricole: If it helps you guys, that’s great, but there’s a whole lot of German, French and Dutch banks who have excess reserves that are 20-25 times their minimum reserve requirement (MRR). They put six times their MRR to the ECB at zero, but for the rest of their deposits it doesn’t change anything.

Garcia, Caja rural Navarra: That’s true but what I’m saying is that the main benefit of deposit tiering is the effect it has on 12 month rates. Tiering could in effect be used as a tool to put a floor to short end rates and in that sense the ECB has the flexibility to increase the present cap of six times MMR.

Eichert, Crédit Agricole: I agree that the present deposit tiering cap of six times MRR is probably only a starting point, but it cannot go up to the point where it reduces excess liquidity in core European countries substantially. If the ECB were, for example, to increase the cap to 25 times MRR, all excess liquidity would be put to the ECB and money markets would shut down. The ECB needs to keep money markets up and running as smoothly as possible.

Fedon, Crédit Agricole: In June we disclosed that we have €75bn of excess deposits with central banks, so having a part of this charged at zero percent instead of minus 0.50% is a positive. In fact retail customers have increased their deposits with us at 0% as long-term yields have fallen. Deposit tiering goes some way towards compensating our margins. It helps the ECB to pursue a longer-term policy of negative rates, limiting the cost for the European banking sector.

Buls, Rabobank: We park quite a bit of cash at the ECB and tiering has helped dampen the cost but it doesn’t have a direct impact on our funding behaviour. We try to optimise excess deposits above the tiering threshold as much as possible.

Eichert, Crédit Agricole: I’d say so, yes. Quantitative easing adds €20bn every single month, and because you’re adding to the ECB balance sheet, you’re increasing the excess liquidity in the system.

Garcia, Caja rural Navarra: We are an issuer but also buy covered bonds from time to time. The impact of deposit tiering is not really about the overall average cost but what happens at the margin. We invest all we can in the deposit tiering up to the cap of six times our MRR. But we’re generating additional excess liquidity in Spain due to deleveraging, so every euro of excess liquidity that is generated beyond that cap will need to be invested in any bonds that offers a pick-up to the ECB’s deposit rate of minus 0.50%.

Martins, ESM: Tiering at six times the MRR was a prudent first step and the ECB probably still has room to increase the multiplier if needed. Nevertheless, if the ECB had to increase the multiplier significantly, it would be in effect a rate hike, which could be counterproductive from a monetary policy point of view and, eventually, damage the good functioning of the money market.
Eichert, Crédit Agricole: It’s an iterative process. They started at six and will assess how markets reacted. If everything is calm, they might increase it and pause to analyse the impact before possibly moving back if the reaction is too strong. But even if the threshold for deposit tiering is set at 10 times a bank’s minimum reserve requirement, the German banking system will still have an additional €250bn of excess liquidity that will need to be deposited with the ECB at the lower prevailing discount rate of minus 0.50%. So, when it comes to making a decision about where to invest the next euro of excess liquidity, banks will be looking at the deposit rate and not the tiered rate of zero percent or a blended cost of the deposit rate and tiered rate.

GlobalCapital: Why not cut the deposit rate and increase the MRR multiple?

Eichert, Crédit Agricole: That would be the natural thing to do. The ECB should probably try to do something that offsets the hit on banks’ profitability from a further cut in the deposit rate. That could be done by increasing the tiered rate above zero or raising the MRR multiplier. They have a lot of variables to play with.

Garcia, Caja Rural Navarra: We’re running an internal study in our bank to ascertain the positive impacts of deposit tiering and the TLTRO relative to the negative impact of a further 10bp cut in the deposit rate. The negative impact of a rate cut and more deeply negative yields on our loan book far outweighs the two positives.

Performance potential

GlobalCapital: The falling yield and tightening spread trend seen in covered bonds has provided investors with the best absolute returns in years. Realistically, what chance is there of repeating 2019’s performance in 2020?

Martins, ESM: Tariff discussions between the US and China seem endless, while slowing Chinese growth may continue to hit German exports. There is also potential noise from trade negotiations between the European Union and the US, while some uncertainty remains in place regarding post-Brexit reality. We have not yet seen the complete spill-over effect from Germany’s slowdown to the other countries in the euro area — which may take six to 12 months. If this slowdown persists, the ECB may have to continue with its current expansionary monetary policy, implying a lower and flatter yield curve; this means we would still potentially see another positive year for fixed income assets in 2020.

Hoarau, Crédit Agricole: But could credit spreads realistically resist a downturn in equities, because this is precisely what may happen if what you are describing occurs. If you are right about next year I think it should logically translate into a correction in global equities and I don’t see how credit spreads cannot be affected by that.

Martins, ESM: Equity markets may be holding up in anticipation of further easier and, if that’s the case, then spreads should be quite resilient, if not even tighter. Of course, in case we see a meltdown in equities, we can expect a sell-off of risky assets into safe-haven assets. The question then is to assess which assets will the market participants regard as safe-haven. Will higher rated government bonds in the euro be considered more connected to the risk-free area, or the opposite, as occurred during the euro crisis? With the current institutional framework and financial architecture deployed after the crisis — including the creation of the ESM — there is a good chance that the countries in the euro area are now far more resilient to a crisis.

GlobalCapital: Timo, what’s your view on the likelihood that covered bond investors will get remotely close to matching this year’s performance?

Boehm, Pimco: Our target is always to provide alpha versus the benchmark. I wouldn’t go so far as to say we’ll match the 3.3% total return seen this year. But what we will try to do is switch out of our existing covered bond exposure into new issues, which provide a degree of new issue premium and take more exposure to the credits we like. We will also look at the Danish covered bond market, where the yields are much higher relative to euros, as well as Swedish covered bonds. We also might look more closely into new issuers and new jurisdictions such as those in central and eastern Europe.

And what we also see right now is a new development in structured deals which are called covered bonds and included in the covered bond index, but are not backed by a covered bond law. We will try to analyse these and stress the pools to get a feeling on repayment risk. These structured deals pay a higher spread but there can be a dilution in asset quality, which is where we have to be very careful, also as an industry. We also look at special situation programmes where issuers are in run-down mode and we’ll sometimes look at retained covered bonds that are brought back to the market. This is where we can add some basis points to our clients’ portfolios.
the way to where they were at the beginning of 2018. However the impact is going to be smaller because rates are negative. Nevertheless, investors buy covered bonds as a proxy to the domestic benchmark, so this is the relationship that’s going to be key. If the domestic benchmark goes extremely negative then covered bonds will follow, but if they stay where they are the potential tightening for covered bonds is going to remain limited. In a normal rates environment the tightening could be up to 10bp from present levels but some of that has already been seen — and we are not in a normal rates environment, which leads me to think the potential tightening from current levels is going to be something closer to 5bp.

Eichert, Crédit Agricole: I’m struggling to see where there’s any potential for sustained performance from current levels.

Structured covered bonds

GlobalCapital: Timo mentioned that Pimco is also looking into structured covered bonds. Do they give you any cause for concern?

Martins, ESM: It only takes one default to lose a full century of reputation so I think it is very important to still define and distinguish those covered bonds that are regulated under national law from those alternative structured products.

GlobalCapital: But just because it is structured, doesn’t necessarily make it less safe.

Eichert, Crédit Agricole: If you look at deals issued by Deutsche Bank or SMBC they’re both using traditional assets. You can find a lot worse cover pool quality in Germany than the structured covered from Deutsche which, for now at least, is almost entirely residential mortgages.

GlobalCapital: Do you think other issuers, whose senior preferred deals trade with a triple-digit premium, might also be interested in mimicking this trade, or will they prefer to rely on the ECB?

Eichert, Crédit Agricole: Most banks are liquid and do not necessarily need to add yet another product to their funding stack. Deutsche Bank’s senior preferred spreads are wide so it has room to issue a deal mid-way to where its Pfandbrief trade. For most other issuers, such a trade doesn’t make sense because their senior preferred to covered bond spread is not sufficiently wide enough, which means it is probably going to be a niche product. I do not see a lot of issuers and I certainly don’t expect new asset classes to be added.

Hoarau, Crédit Agricole: Investor due diligence should preserve the quality of covered bonds, irrespective of whether they’re legally-based or not. Deutsche Bank’s structured covered worked because some dedicated and committed investors did the analysis and decided it was worth investing in and it’s the same for SMBC. The quality of the bank sponsor also plays a key role.

ESG covered bonds

GlobalCapital: Caffil has always issued hard bullet legally-based deals, but you also issue smaller deals that help cater to issuers’ specific requests, don’t you?

Gottrane, Caffil: We do issue what we describe as lightly structured transactions, which are obviously not the same as structured covered bonds and are for private placement only. The potential here is rather small and it’s not something we’ve done in the last year. It’s good to have new members but at the end of the day what is good is to keep the quality of the product and in this respect I struggle to see much credit spread differentiation. So even if you are really a bad portfolio manager, that probably means you will
be paid the same as your colleagues. Having said that, what we do clearly see is the size of the order book, which in the case of our recent inaugural green deal was four times subscribed with over 100 investors — so here we were able to price with practically no concession.

**Hoarau, Crédit Agricole:** In this market, technicals often play a greater role than fundamentals. For example, conventional bonds and green bonds rank part passu. But that is in contradiction to the fact that a green bond in primary attracts a greater investor base for the issuer, a greater level of granularity in the order book, and ultimately a more positive price traction. This is driven by the fact that there is a significant imbalance in green supply and green demand. And the higher the beta, the more pronounced this phenomenon is. In covered bonds, curves are compressed and supply is scarce, so it is difficult to illustrate what I have just said with specific examples. But if you screen the unsecured market, you will see green curves trade a few basis points tighter.

**Martins, ESM:** The ESG market will become increasingly relevant in years to come, as this component will gradually be incorporated into all investment decisions. However, covered bonds have so far lagged SSAs, in terms of green and social issuance, which means there is a lot of room for this market sector to catch up.

**Garcia, Caja Rural Navarra:** Sami and I have been engaged in this market for several years and since we issued our debut ESG covered bond in 2013 we’ve been able to access more and more investors from the Nordics, the Netherlands, France and Germany of course. But, that said, the covered bond market still lacks ESG supply.

**Eichert, Crédit Agricole:** We’ve seen a fair amount of senior issuance but less so on covered bonds for a number of reasons. One is that issuers can get more benefit by deploying this product to the higher-spread products. Another is that there needs to be a link between what is in the pool and the issuance. On the public sector and commercial mortgage assets it’s easier to identify these assets’ ESG credentials as issuers can go into every single loan almost. On the retail mortgage side, many banks still don’t even have the data — for example, in terms of energy performance certificates linked to the loan. So it’s still a bit of a Wild-West-type of environment in the covered bond space at the moment with different approaches being used.

**Garcia, Caja Rural Navarra:** I must agree with you — it’s a challenge to tag each and every mortgage. However, we have been doing this since May this year and we’ve created four new fields including numerical and descriptive data on CO₂ emissions and kilowatt usage per square metre. These four fields are filled in for each and every mortgage, which is not easy but it can be done.

This data will help investors to accurately gauge our sustainability efforts, though whether we get a regulatory lift remains to be seen. But in any case, I’m convinced something is coming down the line, in terms of differentiating between brown and green assets, at which point there’s going to be a very compelling reason for all loans in the book to have an environmental tag.

**Boehm, Pimco:** Ultimately green and sustainable covered bonds should become the new normal, they shouldn’t be the exception. We have clear guidelines to stick to ESG-compliant issues which shows there has already been huge transformative progress for the whole industry. It shows the ability of capital markets to force progress and bring lenders to account when it comes to funding less sustainable practices like mining, fossil fuels, weapons or slave labour.

**Eichert, Crédit Agricole:** We’ve also been working at the European policy level so see whether a green supporting factor for mortgage risk weights could be something to counterbalance the increase in capital requirements likely to come from Basel IV. This is a long-term process and for new mortgage origination I’m pretty sure that every single bank is already flagging up green mortgage assets in their systems. But since this is for new origination and not existing stock it will take time.

**Martin, ESM:** The market is still developing so there’s a fair degree of freedom. Even if you think about the proceeds of the senior unsecured part of a covered bond, that could be also used for a green project.

**Hoarau, Crédit Agricole:** But that is where investors’ diligence comes to the forefront. And I like that, particularly in the unsecured space. Some investors are already complaining that some frameworks are too weak, that they don’t see any positive impact, arguing that some programmes are merely labelling ‘business as usual’ lending as having an ESG-related impact.

These are isolated cases, but welcome messages. It is instrumental to preserve the hard work done by pioneers to maintain high quality standards and produce positive impact bonds.

**Gotrane, Caffil:** We decided that all the export finance loans should be on the balance sheet of SFIL with nothing in the covered bond programme. It was a key structuring point and now we have a very loyal investment base in Germany. So when we have some turmoil in the market, and I’m convinced of that, I would say that you will attract a better bid for our green or social deals. Ge
Banks contemplate multiple futures ahead of MREL swell

European banks are about as close as they can be to having clarity on their minimum requirements for own funds and eligible liabilities (MREL). Now it’s up to them to figure out what impact the new bond standard will have on their funding plans, annual profits and business models. Tyler Davies reports

A casual follower of European bank regulation would be forgiven for thinking that the minimum requirements for own funds and eligible liabilities (MREL) were pretty much done and dusted.

Conversations about the rules — the EU’s answer to international standards for total loss-absorbing capacity (TLAC) — have been rumbling on since at least 2013.

But the EU financial institutions affected by this debate have effectively been operating in the dark, trying to figure out what is required of them, based on their interpretations of the latest regulatory consensus.

In 2019 policymakers made a big leap forward with the introduction of MREL. They adopted a wide ranging package of banking reforms in May, including a number of very important clarifications as to how MREL should be calibrated and which types of liabilities should be eligible for the requirements.

“It feels as though the process of re-regulating the banking industry has pretty much now been completed in the areas of capital, liquidity, funding and resolution,” says Peter Mason, head of debt capital markets EMEA at Barclays in London.

“Subsequently, for the first time in a very long time, funding officers and treasurers now have much better clarity about how they should budget for MREL issuance over the next few years.”

That does not mean that banks can see the full picture on MREL yet.

In particular, many firms are still uncertain about how much of their targets will need to be met with funds that rank below their operating liabilities in the hierarchy of insolvency.

The legislative changes adopted in 2019 conferred new powers on the EU’s Single Resolution Board (SRB) and national competent authorities to determine this level, which is commonly referred to as the “subordination requirement”.

“MREL is pretty different to capital requirements, so it is hard to say exactly what each bank will have to issue,” explains Axel Finsterbusch, an executive director in European credit research at JP Morgan in London.

“There is a formula that will allow you to have an idea, but the regulator will ultimately determine the degree of required subordination. We have the maximum subordination and the minimum subordination, so we can only really come up with a range of what the banks could end up issuing.”

Higher or lower?

In basic terms, the absolute minimum level of subordination that the largest EU banks will need to meet is a level equivalent to 8% of their total liabilities and own funds.

But EU resolution authorities can require firms to meet MREL with a higher proportion of subordinated liabilities. Where they see fit, they may even demand that banks meet all of their targets with subordinated instruments, which is already the norm in jurisdictions like Norway and Sweden.

Julien Brune, co-head of DCM solutions and advisory at Société Générale in Paris, describes the situation with subordination requirements as being “very diverse”.

“On the one side you have issuers with relatively low MREL shortfalls, who will generally want to show that they are best in class and fully compliant with their requirements,” he says.

“Then you have the issuers with the biggest MREL shortfalls — either because they are global systemically important banks or because they are in jurisdictions that tend to impose high requirements.”

Golden age

By and large, the market has been indicating that it is ready for more supply of MREL securities.
Bonds eligible for the requirement tend to be sold at higher yields than ordinary bank funding instruments, helping them to attract a steady stream of investment from fixed income funds.

Many of these funds have been hunting for ways to boost their returns this year, after the European Central Bank changed its tack on interest rates and cut its main deposit rate further into negative territory.

"Are I concerned about there not being demand for MREL product?" says JP Morgan’s Finsterbusch. "In this rates environment the answer is ‘no’.

"What the banks are going to do is refinance preferred senior into non-preferred senior, which helps the banks make the transition towards MREL.

Even some of the smallest financial institutions with some of the smallest MREL requirements have seen sense in using these market conditions to get their houses in order well ahead of schedule.

"A number of medium and smaller-sized banks have started issuing in the non-preferred senior market this year, having not wanted to accelerate their funding plans in 2018," explains Eric Meunier, global head of debt capital markets financial origination at Société Générale in Paris.

"They have really benefitted from the new issuance conditions and the spread compression we have seen throughout most of 2019."

In April, for example, before it had even received a binding target, Dutch lender NIBC Bank decided to raise €300m of non-preferred senior debt to cover what it thought were likely to end up being its final MREL requirements.

'Haves' and 'have nots'

But the impact of the introduction of MREL is unlikely to be neutral for European banks, notwithstanding the strength of the primary bond market going into 2020.

Whatever their final shape, the new rules imply that financial institutions will be issuing more debt than they would ordinarily have to, often in new and more costly formats.

These additional burdens are feeding into what is already a very challenging backdrop for banks in Europe.

Ultra-low rates are hampering their ability to generate interest income, and the emergence of various neo-banks and financial technology companies is further increasing competition for business in the sector.

"The great concern is not necessarily about funding for European banks, it is more about the sustainability of their business models in the prevailing operating environment," says Mason at Barclays.

There were clear signs during 2019 about how new requirements like MREL could end up exacerbating the problems facing the industry.

The case of Metro Bank was particularly severe. In early October, having failed once to access the bond market and staring down an interim deadline for MREL in 2020, the UK lender decided that it would pay whatever was necessary to get hold of the £330m of non-preferred senior debt that it needed.

The resulting coupon rate of 9.5% meant that Metro Bank would have to shell out £33.25m in annual interest expenditure to remain MREL-compliant — roughly equal to its pre-tax profit for the previous year.

"The coupon on Metro Bank’s non-preferred senior deal was extreme and has ended up becoming a real problem for the bank," says JP Morgan’s Finsterbusch. "We have never seen anything like this before, where the problem is on the liability side."

By requiring banks to market more securities publicly, MREL could end up drawing additional attention to institutions whose business models or profit and loss statements are already under scrutiny.

For Mason at Barclays, there is already a sense of "haves" and "have nots" in the market.

"We are seeing record tight issuances for national champions, but some of the weaker European banks are looking at alternatives to raising funding in the capital markets," he says.

The upshot, according to Finsterbusch, is that some banks may end up feeling more compelled to consider combinations with other banks.

"You need to achieve economic scale if you want to be able to print these instruments without really harming your P&L," he says.

No time to waste

It is hardly surprising that the potential impacts of MREL have started to become clearer throughout 2019, just as the shape of the requirements have also come into view.

The SRB has sought to reassure banks that they will have plenty of time to prepare to meet their end-state targets, whatever level of subordination they are eventually subject to.

In a speech at the beginning of November, for example, Sebastiano Laviola, director of resolution strategy and co-ordination at the SRB, reminded market participants that MREL should feel like a marathon rather than a sprint.

But he couldn’t help confering a sense of urgency on to his listeners.

The board member noted that there was an "opportunity" for financial institutions to take advantage of "favourable market conditions".

The final MREL requirements are almost in place, investors are getting behind new issuances and the ECB is still pumping liquidity through the euro market.
AT1 market peaks as yields verge on record lows

European banks no longer really have to think about building up layers of additional tier one debt. All of the focus has shifted to managing and refreshing this capital layer, and taking full advantage of a ferocious hunt for yield. Tyler Davies reports

When European banks first began selling additional tier ones (AT1s) in 2013 and 2014, analysts were confident that the asset class would eventually grow to a size of $200bn.

It was a simple prediction, mostly based on the fact that EU rules would only allow institutions to use AT1s as regulatory capital for a value equivalent to 1.5% of their stocks of risk-weighted assets.

Fast forward six years and the analysts have been proven almost exactly correct. The market is on the verge of reaching a steady state, with figures from CreditSights showing that there is about $200bn equivalent of capital outstanding from 221 different bonds.

Banks are entering a new phase, where, having built their AT1 capital layers, they will have to start thinking carefully about how best to manage and control them.

“When we get into 2020 it does feel as though the AT1 market will move into replacement issuance mode, where most banks have a 1.5% bucket plus a buffer,” says Peter Mason, head of debt capital markets EMEA at Barclays in London.

“Really they will just be refinancing calls as they come up, subject to regulatory sign off and the refinancing making economic sense.”

This shift was already beginning to take hold in 2019, when banks rolled over about €14bn of AT1 instruments into new securities.

But the whole process will hit top gear between 2020 and 2022, with an average of €21.7bn of debt coming up for call each year.

The Sintra surge

As banks prepare to embark on the first cycle of AT1 refinancing, they can feel confident that new issuance conditions are likely to work in their favour.

Following a few bumpy patches in late 2018 and early 2019, yields in the asset class have once again started falling — encroaching on record lows.

For Sook Leen Seah, head of capital advisory, debt capital markets at Nomura in London, a speech in June by former European Central Bank president Mario Draghi was a “pivotal moment” for market conditions in 2019.

Speaking in Sintra, Portugal, Draghi steered the market to expect the ECB to drop its deposit rate further into negative territory and restart quantitative easing — moves the central bank eventually made in September.

“The speech led us towards the expectation of even lower rates and it drove up demand for subordinated product,” Seah explains. “There was a lot of volatility in the market [in 2018], when it looked as though interest rates might be on the rise again. Now we are in a completely different scenario.”

As AT1 yields have come crashing down, most of the buy-side for bank capital has moved to expect that issuers will be able to call their outstanding securities and replace them at lower costs in the market.

The alternative would be for financial institutions to leave their AT1s — perpetual in maturity — outstanding beyond their first call dates.

In these instances the bonds revert to offering investors what is known as a “reset spread”, fixed at the point of issuance and paid over prevailing mid-swap or treasury rates.

“Banks have issued tier ones at some incredibly tight levels over the last few years, and we wondered at the time if many of them would ever be refinanced,” says Seah. “With the interest rate environment that we have now, you would have to say that banks are going to be able to replace these bonds with even cheaper instruments.”

Learning from Santander

Market participants have already had a taste of what it is like to see a bank extending the life of its AT1s, after Banco Santander became the first bank to miss a call date in the asset class in 2019.

It said on February 12 that it would not be repurchasing its €1.5bn 6.25% notes at the first opportunity following month.

The move stunned some investors, mainly because the Spanish issuer appeared to have refinanced the securities when it sold $1.2bn of AT1 capital in the dollar market on February 6.

But pricing in the asset class was barely impacted by the bank’s non-call decision, and market participants were very quick to move on from the episode.

“The market has been clear in discounting Santander,” says Filippo Alloatti, a senior credit analyst at Hermes Investment Management in London.

Alloatti nonetheless warns against assuming that the market will remain immune to the risk of issuers.
extending the lives of their securities. Deutsche Bank is an obvious candidate to succeed Santander in missing a call on one of its AT1 securities. At the beginning of November, its $1.25bn 6.25% AT1 was yielding 36.5% to its first call date in April 2020 — a clear indication that investors think the German issuer would be best served by leaving the bond outstanding with a reset spread of 435.8bp over five year US Treasuries.

And there could be plenty of other situations in the coming years where banks find themselves in a position where it is not economic for them to replace an old deal with a new one.

“It would be a little too complacent to say that the market will not reassess the likelihood of AT1 calls when another issuer decides against calling — some bonds that are artificially too high may come down in price,” says Alloati.

**Flexibility for nothing, puts for free**

For now though, European financial institutions appear to be dead set on replacing their AT1s, often as quickly as they possibly can.

In certain cases, issuers are acting up to a year in advance of a call date to bolster their capital positions.

BBVA sold a €1bn 6% AT1 in March, for example, with one eye on what it might end up doing with its €1.5bn 6.75% deal, callable in February 2020.

It is not hard to see why banks are getting itchy feet. As the riskiest form of debt on their balance sheets, AT1s are highly exposed to bouts of volatility.

Several instances of rough market conditions have proven in recent years that, when misfortune does strike, the correction can be quick and brutal for the asset class, shutting issuers out of the market or forcing them to pay up considerably.

With this in mind, some banks have embarked on a spot of future-proofing when selling new AT1s in 2019.

An increasingly popular technique, borrowed from the corporate bond market, is for issuers to include an option in their deals that gives them six months to call at par in the run-up to the first reset date.

The feature means that banks can have more control in deciding if and when they want to refinance their AT1s.

It could also limit the practice of doubling up on interest payments, which is rife at the moment as institutions jump into the market early, months ahead of call opportunities.

“The six month par call will become a market standard pretty quickly, if regulators allow,” says Mason at Barclays. “The acceptance of these structural features all comes down to market conditions and the constant tug of war between investors and issuers.”

“For most of this year it feels as though issuers have had very favourable market conditions and have won out on most of these structural points around AT1 issuance.”

The UK’s Nationwide Building Society was the first financial institution to introduce investors to the six month par call in an AT1, when it used the option as part of a £600m deal in September.

It was quickly followed by the likes of AIB Group in Ireland and La Banque Postale in France.

Alloati notes that, by and large, these issuers have not been paying any “premium” to include the new feature in their AT1s.

“That’s a reflection of how the market has been,” he says. “Bondholders are to some extent writing a put option to issuers, and this put option is coming for free. It makes sense for issuers to be exploiting this.”

Towards a new low

Banks have really taken the driving seat in the AT1 market, just as they have ceased to rely on investors to bulk out their total capital ratios.

In recent months, amid a global hunt for yield, they have been pushing funds towards their limits in terms of pricing on new securities.

Norway’s DNB Bank beat the record for the lowest ever coupon for a benchmark AT1 bond in the dollar market in November, for example, smashing through 5% to price an $850m deal at 4.875%.

Earlier in the year Rabobank claimed the same prize in the euro market, raising €1.25bn of perpetual non-call 7.25 year capital at a coupon rate of just 3.25%. Market participants suggest the trend is yet to run its course.

Stellar returns for bank capital funds have helped to attract a mass of new inflows from investors this year. And the monetary policy of the ECB is continuing to drive accounts in search of better returns — something that AT1 securities can still claim to offer.

With the size of the market having pretty much levelled out in 2019, any new demand for the asset class is unlikely to be matched with net new supply. This can only have one impact on the direction of yields.

“The average coupon for an AT1 is probably 5%-6%, which means the market has something like €10bn of coupon payments per year,” explains Axel Finsterbusch, an executive director in European credit research at JP Morgan in London.

“The fact that the AT1 asset class is not growing any more should be supportive for valuations,” he says. “It should be supportive for valuations, without a doubt.” GC
Green capital: a new frontier for banks

Banks and insurance companies are finally straining to turn capital markets greener. With many having realised there are savings to be had in issuing green senior bonds, the idea of them embracing sustainable capital instruments seems to be just around the corner. David Freitas reports

When Assicurazioni Generali became the first European financial institution to sell a green bond in a subordinated format in September, it forced other financial institutions to sit up and take note.

The Italian insurance company was said to have benefited from huge savings with its new deal, suggesting that issuers stand to gain more when combining their green funding plans with traditional capital planning.

French insurer CNP Assurances swiftly followed Generali’s example, selling €750m of green tier two bonds in November. The issuer was also able to secure a stellar result for its socially responsible deal, benefiting from strong demand in a busy market.

But European banks are still lagging behind. Though there has been a rise in the supply of green senior bonds counting towards their total loss-absorbing capacity (TLAC) targets or minimum requirements for own funds and eligible liabilities (MREL), they have yet to take the plunge and issue capital instruments in a green format. The explanation could all come down the question of where banks are putting their priorities.

The general focus for issuance from the region’s lenders has been meeting TLAC and MREL requirements with senior debt, rather than on bolstering their subordinated debt buffers to meet total capital requirements. Many institutions are also still labouring to put the necessary debt issuance frameworks in place to allow them to offer socially responsible investments in the primary capital markets.

Joop Hessels, head of green bonds at ABN Amro in Amsterdam, says that finding cost savings through green bond sales is not the greatest challenge facing borrowers at the moment.

“The issue is not so much the pricing, it’s more the availability of projects, lending and expenditures,” he says. “Sometimes these are difficult to measure and report from current systems as these were not designed with sustainability in mind.”

Taxonomy breakthrough

The problem of identifying eligible green assets for green bonds has been common to all issuers in the capital markets. The EU has been developing a classification system, or “taxonomy”, to help market participants identify sustainable economic activity. The taxonomy, which could be in place in 2020, is expected to help bolster green bond issuance.

“We need to see what the final EU taxonomy on Sustainable Finance will look like, but there also needs to be clarity about how it’s implemented and if more data is provided to support issuers to identify taxonomy-eligible assets,” says Hessels.

Many banks have also been thinking about what they can do on the asset side of their balance sheets to build up a great stock of green assets. Some firms, for example, have started offering favourable rates of financing for projects or clients they consider to be sustainable.

“A better pricing in green loans could trigger a higher demand for green financing instruments and therefore potential new green bond issuances from financial institutions for financing these green loans,” a Technical Expert Group noted in a July report on EU green bond standards.

Hessels says that it is “a matter of how banks can incentivise clients to engage in more sustainable activities such as increase the energy efficiency of their processes and buildings”.

“This could be increased significantly if there would be a differential in pricing, which could be passed on to the customers,” he adds.

Despite the challenges in structuring new deals, there is no doubt that there has been increasing momentum behind green issuance this year.

European banks have raised a record $26.8bn equivalent of green, social and sustainable bonds in 2019, through a mixture of senior bonds, covered bonds and even asset backed securities (ABS). They are expected to further diversify their choices of formats in the coming years.

“Issuers are interested to know if there will be a pricing benefit in comparison with non-sustainable bonds,” says Hessels.

Generali was said to have saved up to 10bp with its €750m tier two in September. This was much higher than the kind of “greenuim” that borrowers have secured through ordinary green funding instruments — typically no more than handful of basis points.

European banks are close to realising that they could also save money by turning some of their most expensive issuances green.

“It’s just going to take one bank to get a green capital deal out the door and then there will be a rush,” says Sean Kidney, chief executive of the Climate Bonds Initiative. “We’ll see that in the next 12 months.”

Joop Hessels, ABN Amro

“The issue is not so much the pricing, it’s more the availability of projects, lending and expenditures”
US, European CLO markets take downturn fears in their stride

The CLO is one of the more transatlantic sectors in securitization, and has grown more so in the past year as US managers make new inroads in Europe. However, both markets grapple with unique issues. In the US, a rocky corporate credit landscape has put the fear of widespread downgrades front and centre, while in Europe, the space is getting crowded and competition for collateral and persistent negative rates weigh on the sector. Both markets in 2020 are headed for an inflection point.

Max Adams and Tom Brown report economic recession, 2019 was a benign one for US markets. Equities at the end of the year were hovering around all-time highs, and consumer and employment fundamentals were strong. But leveraged credit markets are looking at different signals and 2020 could separate the winners and losers in US CLOs.

Bullish sentiment returned at the end of 2019, pushing the Dow Jones Industrial Average close to 28,000. Similarly, in CLOs, returns in 2019 outperformed the year before, with the JP Morgan CLO index returning 4.19% compared to 2018 returns of 2.59%. But CLO market players say that 2020 is a year that idiosyncratic risks will grow, and investors and managers should be looking to shore up their defensive positions.

A number of US managers debuted European CLO programmes in 2019, while European managers were often scouring the US for leveraged loan collateral. This overlap between the US and European markets, both in issuer participation and CLO portfolio make-up, is unique in structured finance.

What's more, both markets share a whale of an investor in Japan's Norinchukin Bank, which is often credited with propping up the market and dictating levels at which triple-A CLO paper prices. Though the bank has pulled back from Europe somewhat under scrutiny from its domestic regulator, Norinchukin is still a player in the US.

The continued success of both markets as the late innings of the credit cycle stretch endlessly on demonstrates their relative value in the wider fixed income universe, as well as investors’ confidence that the sector is holding up even as rumblings of a downturn increase. Even though central banks and regulators around the world sound the alarm around the asset class, it would take a crisis much larger than the one in 2008 for triple-A investors to incur principal losses.

Winners and losers
For a year that began with widespread predictions of an economic recession, 2019 was a benign one for US markets. Equities at the end of the year were hovering around all-time highs, and consumer and employment fundamentals were strong. But leveraged credit markets are looking at different signals and 2020 could separate the winners and losers in US CLOs.

Bullish sentiment returned at the end of 2019, pushing the Dow Jones Industrial Average close to 28,000. Similarly, in CLOs, returns in 2019 outperformed the year before, with the JP Morgan CLO index returning 4.19% compared to 2018 returns of 2.59%. But CLO market players say that 2020 is a year that idiosyncratic risks will grow, and investors and managers should be looking to shore up their defensive positions.

A big part of this has to do with the looming threat of downgrades among leveraged loans — the underlying collateral of a CLO — as US corporate credit weakens in specific sectors such as retail, healthcare and energy. Moody’s and S&P Global Ratings downgraded a combined 421 loans worth $272bn in 2019.

According to analysts from JP Morgan writing at the beginning of November, if downgrades over the next nine months continue at the same pace as the previous nine, the percentage of loans in CLOs rated single-B minus will go from 14.4% to 24.1%, while loans rated triple-C will increase from 10.9% to 17.8%.

This is a big increase and a hugely important number for CLO managers and investors to keep track of. That is because CLOs are structured with “buckets”, or a set limit on how much collateral of a particular rating they can hold at any one time. Most CLOs are capped at 7.5% for their triple-C bucket. After that, certain tests that are built into the deal to monitor its performance are triggered, and failing those tests can lead to cashflows to the equity investors being shut off and diverted to bondholders in the deal.

“We have long thought that the triple-C bucket and triple-C haircuts are the number one vulnerability of the CLO market,” says Ellington Management’s Rob Kinderman, partner and head of credit strategies. “A handful of downgrades could start to impact the overall market.”

Despite some fears that a wave of forced selling could wash over the market in the event of loan downgrades, CLOs are not forced to sell in the event that certain ratings buckets overflow. They are, however, incentivised by the rules governing the CLO

US and European CLO new issuance

Source: JP Morgan
structure to shed lower rated loans. “Downgrades can put a deal at risk of shutting off interest cashflows to the equity and subordinate management fees. The manager is incentivised to shed the assets that otherwise trip these triggers,” says Greg Borenstein, portfolio manager in Ellington’s CLO management group. “When the CLO market went through the crisis, most of what caused interest payments to be shut off was downgrades, not actual loan defaults.”

The fact is that the number of defaults would need to be nearly three times the level observed in the crisis in order for triple-A investors to be hit with principal losses. So the market has rightly shifted much of its attention to the downgrade issue, and the risk that CLOs are exposed to lower rated collateral has grown as CLOs become the primary buyers of leveraged loans.

As the US Federal Reserve changed course in 2019 to embark on a path of interest rate cuts, floating rate products became less attractive, and outflows from loan mutual funds and ETFs accelerated. According to Maureen D’Alleva, global head of performing credit at Angelo Gordon, CLOs account for as much of 70% of the buyer base for leveraged loans at the end of 2019. “Because what we find is ETFs are not buyers, it is the CLO warehouse, which ultimately becomes the CLO, which is the primary buyer,” D’Alleva says.

Loan pickers are the new stock pickers

Picking and moving out of credits that are likely to underperform, then, will be of heightened importance in the coming year. Rather than simply trading in and out of loans that overflow a ratings bucket or breach certain tests in the CLO, managers are going to need to identify risks among loans that may have the same rating.

“We really think having a very close eye on risk is extremely important,” says Rizwan Akhter, managing director and head of CLOs at York Capital in New York.

“There are a lot of questions around triple-C downgrades, but we take a little more nuanced view because not every B3/B- loan is created equal. Some are exposed to cyclical risk and some others are doing fine.”

Akhter goes on to say that the disconnect between the upward trajectory of US stocks and the widening of CLO debt points to something amiss in the markets. The US stock market is trading at or around all-time highs, but certain tranches of CLOs, particularly double-Bs are at their cyclical wides. “That is very disconnected, and investors are rightly concerned,” Akhter says. “We think that we are coming into a period where CLO managers will have to be very strong on picking out fundamentals and strong on risk management. You need both.”

Similarly, high yield bonds are at post-crisis tight levels, while the mark-to-market value of loans has lagged. This goes against conventional wisdom, as the loans are senior secured in a company’s debt structure, but it is a technical quirk of the current market that points to investor preference for fixed rate product over floating in a falling yield environment.

All of the mixed and confusing signals flashing across screens in 2020 will make picking winning credits all the more difficult. A combination of high corporate leverage and the enduring trend of cov-lite loan documentation will reduce recoveries compared to previous credit cycles, according to Steve Vaccaro, CEO and CIO of CLO management firm CIFC.

“We are also very actively risk-managing our portfolios and looking to sell positions that we see underperforming. We believe it is better to actively manage risk manage versus blindly holding underperforming loans through defaults and restructurings,” he says.

The bad eggs in leveraged credit will be familiar to anyone paying attention to markets in the past few years. Energy has had issues since the oil and gas market seized up in the summer of 2016 and oil collapsed from a high of over $100 per barrel. Retail is also ailing, and has been for some time, battered by headwinds coming from e-commerce.

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Similarly, high yield bonds are at post-crisis tight levels, while the mark-to-market value of loans has lagged. This goes against conventional wisdom, as the loans are senior secured in a company’s debt structure, but it is a technical quirk of the current market that points to investor preference for fixed rate product over floating in a falling yield environment.

All of the mixed and confusing signals flashing across screens in 2020 will make picking winning credits all the more difficult. A combination of high corporate leverage and the enduring trend of cov-lite loan documentation will reduce recoveries compared to previous credit cycles, according to Steve Vaccaro, CEO and CIO of CLO management firm CIFC.

“We are also very actively risk-managing our portfolios and looking to sell positions that we see underperforming. We believe it is better to actively manage risk manage versus blindly holding underperforming loans through defaults and restructurings,” he says.

The bad eggs in leveraged credit will be familiar to anyone paying attention to markets in the past few years. Energy has had issues since the oil and gas market seized up in the summer of 2016 and oil collapsed from a high of over $100 per barrel. Retail is also ailing, and has been for some time, battered by headwinds coming from e-commerce.

“We are definitely not ignoring the ratings issue, but the types of situations we are trying to avoid are ones in which there are credits with very little cashflow,” Angelo Gordon’s D’Alleva says, adding that in addition to energy and retail, she is also paying close attention to healthcare, which is pressured by a wave of political and regulatory changes proposed by lawmakers in the past year.

Ultimately, times like this end up being a proving ground for CLO managers, and they come around only a few times in a cycle. Investors will be watching closely for performance issues among managers and will end up more carefully deciding who to park their money with.

“We view this period of stress as the third major opportunity to assess manager performance in the last 10 years,” Vaccaro says. “The first two periods of stress during this time were the financial crisis that broadly ended in 2009, and the oil and gas stress that broadly ended in 2016. We believe CLO investors will be closely monitoring manager performance in the coming months and potentially changing who they want to invest with.”

The view from Europe

Europe has a related, but also unique, set of issues. While the US market deals with credit issues, the European market is dealing with an influx of new managers piling into the space, among them many established US managers looking to import their brand to
European investors. And while the US market lags behind in the realm of environmental, social and governance criteria (not just in CLOs, but across fixed income), European managers more and more are making this a marketable part of their business.

The European CLO market is getting crowded. As of 2019, there are more than 50 managers issuing CLO deals, all scrambling to put together collateral, which is non-totalitarian compared to supply in the US.

The increased number of CLO managers in Europe has resulted in more competition for collateral, contributing to a compression in asset spreads, says Charles Kobayashi co-head of CLOs at BlueMountain Capital Management, a unit of Assured Guaranty.

"Given low default rates in Europe over the past couple of years, performance across managers has generally been good," he says. "Unlike the US loan market, we haven’t seen dispersion on the spread between BB and B assets in Europe. As a result, there has been less of a basis for tiering CLO managers in Europe."

Before the fourth quarter of 2019, syndicate bankers said that there was around 5bp worth of pick-up on the triple-A spread for top tier managers, but now the lines between established and newer names have started to blur.

"In Europe managers are very disciplined with portfolio selection," says Florent Chagnard, head of syndication and origination for new issue EMEA CLOs at Credit Suisse in London. "A lot of them have a decline rate of over 50%, and they are willing to take their time to ramp the right portfolio."

Equity has been notoriously difficult to place as the arbitrage becomes squeezed. Some equity investors were given an incentive by having a “turbo feature” inserted into the deal structure — often disguised as single-B notes — which essentially act as a buffer for the junior tranche by reallocating money to repair the principal of any loss experienced on the bottom-most tranche.

These features were largely absent from the post-crisis market, with only a few deals including them in 2014 and 2015, but they have now resurfaced in order to placate equity investors.

But above all, traders and syndicate bankers highlight concerns over the credit cycle. Individual portfolio performance within CLOs has come under increased scrutiny in recent months.

"The credit standards seem to be worse than what they were five years ago," says Emanuele Tamburrano, senior director and analytical manager for EMEA at S&P Global Ratings in London. “But the pools are growing larger, as there are more borrowers coming to the market than in 2017.”

There she blows
The market was heavily propped up by Japan’s Norinchukin Bank at the beginning of the year, anchoring triple-A CLO tranches and forcing them into its preferred price target of 108bp. Things have changed since the summer though, with triple-A tranches now landing at 90bp-95bp since the bank pulled back abruptly as scrutiny from its domestic regulator intensified. This left space for new triple-A investors to fill the Norinchukin-shaped hole.

Previously sidelined investors were also lured by another change in the asset class; the drop in Euribor rates and increased benefit of the Euribor benchmark floor embedded in deals.

"We have seen strong demand from investors in the senior tranche," says Chagnard. "Investor demand from Asia, but mostly from Europe and the US, across banks, asset managers, pension funds, insurance companies and also a few hedge funds.”

Another change is that the centre of gravity around rating agencies has shifted. Kroll Bond Rating Agency (KBRA) launched its European CLO platform in June with a rating provided to Carlyle Euro CLO 2019-2, competing with the traditional big three rating agencies: Moody’s, S&P and Fitch.

Kroll has since rated five European CLOs in total. Writing to GlobalCapital, DBRS said that this a positive development and indicates that there is space and market acceptance for a credit opinion beyond the largest rating agencies.

ESG criteria also took prominence in European CLO language in 2019 with Fair Oaks’ debut CLO, specifically constructed to avoid collateral which would go against UN principles. That deal was followed by Capital Four in Europe, which also rolled out its CLO debut with ESG investment criteria. Permira’s Providus CLO I, a €362.5m deal that was priced in March 2018, is widely credited as the first ESG CLO.

"Over the past year we’ve received a growing number of ESG queries from European investors,” says Kobayashi. "This comes at the same time as asset managers are making a stronger push toward considering ESG criteria. We’ve recently seen more deals impose a limitation on investing in sectors which present ESG risk and have included a similar limitation in our most recent CLO transaction.”

Syndicate bankers say they have not yet received specific requests for ESG deals, which tend to exclude collateral which would blatantly fall outside ESG criteria rather than actively seeking collateral which falls inside it, but it has become a big discussion between market participants in the last year.

"It will become the market standard at some point for sure,” says Chagnard. GC
Asset managers muscle into financial sponsors’ territory

Where securitization was once a prime hunting ground for financial sponsors and hedge funds, some of the largest asset management houses are now setting up units to beat the top predators of the capital markets at their own game, taking the other side of the securitization arbitrage. Owen Sanderson reports

W hatever happened to Northern Rock? That’s easy — it collapsed and had to be bailed out by the government. If you pressed a little further, some people might remember that much of it ended up as Virgin Money, and, with a new lick of paint on the branches and bracing “challenger” status, is back writing new loans and securitizing them again.

But a part almost as large as the bit that went to Virgin ended up in the hands of the world’s biggest bond fund, Pimco’s $250bn Income Fund complex, as the West Coast investor bought some of the largest privatisations in recent years from the Northern Rock ‘bad bank’.

In buying these assets, it had to win auctions against some of the world’s biggest private equity firms.

The first sales of Northern Rock mortgages went to CarVal Investors, a distressed debt specialist. Subsequent deals went to the likes of Blackstone and Cerberus, investors with return targets well into double digits.

But since 2018, Pimco has dominated. It won the £5.3bn Project Durham, in April 2018. A year later, it won the £4.9bn Project Chester. It bought control rights for the very first block of Northern Rock mortgages from CarVal, financing them in September 2019.

Tot up the fund’s UK mortgage exposures, and you have a figure that would make it one of the UK’s largest challenger banks. For big portfolios of performing prime mortgages, Pimco will probably win the bidding.

But Pimco, in winning Project Chester, also had to beat M&G, the asset management firm originally set up to manage the investments of insurer Prudential, while in Durham it worked alongside M&G.

M&G has a long track record in buying securitization bonds, largely at the senior end of the capital structure, but just over two years ago, it hired Jerome Henrion and Vaibhav Piplapure, both senior Credit Suisse bankers, to set up a private equity-style operation within

"If you buy platforms and buy NPLs, you get higher returns if everything is going well but you are taking more risk — operational risk too”

Jerome Henrion, M&G

M&G, known as M&G Specialty Finance. One fund was seeded by Prudential, while the other raised pension fund money.

This unit has enough firepower to tackle the likes of UK Asset Resolution’s £4.9bn Chester portfolio (with external leverage), as well as taking, alongside Pimco and Barclays, the €4bn sale of Lloyds’ Irish mortgage book, Project Porto. Just like a financial sponsor, M&G’s unit kept just £36m of residual notes on its €1bn piece of the deal — on which, according to the fund’s marketing documents, it expects to make a 9.5% IRR.

The funds are also investing in the equity tranches of already-issued RMBS, in capital relief transactions, cash risk transfer, and student loans.

“It used to be a pure PE market, but we have taken some share away from the PE funds, who have refocused a bit more on platforms and NPLs,” says Henrion.

“It’s a function of risk and return targets, which pushes them towards different asset opportunities, away from the performing space.”

Market split

The rise of these asset manager-sponsor hybrid strategies is part of a cause and part of a symptom of a split in the market. Four or five years ago, when European banks started to sell what they called “legacy assets” in earnest, the buyer base was similar, whether these assets were Italian non-performing loans (NPLs), German shipping loans or UK mortgages — predominantly US-based private equity firms which raised money specifically to target these opportunities.

Now, there is a wide gulf between performing loans in creditor-friendly jurisdictions, and harder-to-solve non-performing assets. Handling assets that aren’t performing means a very different investment style, requiring much more control over the entity that collects the money.

Servicing a performing portfolio can be as simple as collecting the direct debits, but servicing loans that aren’t performing is much more intensive and expensive. NPL servicing can therefore command up to 30% of collections, in some circumstances, and are often bought up by the major sponsors looking to maximise their control over NPL investments.

Lone Star, for example, services its NPL books through its Hudson
SECURITIZATION
Asset managers as sponsors

Advisors unit, while KKR bought Pepper’s European operations. Fortress Investments owns Italy’s doBank (the former UniCredit Credit Management).

Even a market such as Italian NPLs is becoming saturated, and the funds that were first into the market are now exploring the likes of Greece, Cyprus, the Balkans, and even Turkey.

That’s not the approach favoured by the asset managers, and comes with its own risks, which LP investors demand they get paid for.

“If you buy a platform, you need to sell it at some point, and you need to sell it at a higher price than you bought it,” said Henrion.

“At some point you might become a forced seller. If you buy platforms and buy NPLs, you get higher returns if everything is going well, but you are taking more risk — not just credit but operational risk too.”

If you are buying performing loans from originators that are still in good shape, it can help to be a part of a large investing institution such as M&G or Pimco, with a lot of relationships up and down the capital structure. M&G’s regular bond funds own capital instruments, covered bonds, unsecured bonds and everything else from banks across Europe — giving a range of strong institutional relationships with treasury teams.

“Being sponsor as well as bond buyer to bond issuer was TwentyFour Asset Management, the fixed income boutique formed by the asset managers, and comes with its own risks, which LP investors demand they get paid for.

Management still owns a large chunk of Charter Court Financial Services, recently buoyed by its merger with OneSavings Bank, originally a JC Flowers investment. Chenavari Investment Managers, started by former Calyon credit head Loic Fery, owns Belgium’s Buy Way and Italy’s Creditsis, both consumer lenders, and has a large stake in Ireland’s Dilosk — all of which lever their portfolios in the securitization market.

But M&G, for example, is more likely to hold bonds or offer warehousing than to buy institutions outright. In Ireland, the specialty finance unit is funding Finance Ireland’s expansion from commercial into residential lending, for example.

Making the journey early on from bond buyer to bond issuer was TwentyFour Asset Management, the fixed income boutique formed in the depths of the crisis. It listed its UK Mortgages closed-end fund in 2015, and has been sponsoring securitizations ever since, leveraging the fund’s purchases of performing mortgage portfolios.

But in 2019 the asset manager has had to go back to its investors and ask to add more leverage. UK Mortgages was initially able to sell only senior tranches to the market — now it can sell down the structure to a maximum of 20 times levered.

Bargain deal
Like M&G, the fund’s relationships extend from bond buying to capital instruments and future originations — Coventry Building Society sells some of its buy-to-let loans to UK Mortgages, while TwentyFour’s other funds were able to lock in a bargain with a privately placed AT1 note from the UK lender in March.

Being a fund manager focused on performing credit, rather than a hedge fund focused on a quick return and aggressive management of portfolios, helps these relationships flourish.

“Every originator has its own approach to servicing — for Coventry, it’s important to take a conservative, customer-focused non-contentious approach,” says Rob Ford, partner and portfolio manager at TwentyFour in London.

“They wouldn’t want to be involved with a more aggressive institution. From our perspective, we want them to manage the servicing with that type of approach. Their customers shouldn’t know or notice a difference whether their mortgages are in an Offa bond, in a Godiva wrapper or in one of the UKML vehicles.”

Diversification play
Being sponsor as well as bond buyer is a specialist model, but that hasn’t stopped other asset managers from eyeing up the business, especially if they have a track record in buying securitization debt.

“The risk return is very interesting, it’s a good diversification play,” says Henrion.

“A lot of real money investors have exposure to real estate, to corporates, to infrastructure, but very few have an exposure to consumer assets.”

Hermes Investment Management, which began as the British Telecom pension fund, has been building out its securitization business, hiring Andrew Lennox and Stephan Michel in 2018. Their mandate was partly to build out the public ABS business — but also to explore illiquid loan portfolio opportunities.

However, this isn’t easy. Henrion says: “The barriers to entry are pretty high. Even if you build the teams out, every deal can take months to do, and you need the expertise to do it properly. There’s also tons of historic data you need — not just the data on the portfolio to be sold, but on the rest of the seller’s origination and comparable assets. We have that, other portfolio buyers have it, but not every asset manager has it.”

“Customers shouldn’t notice a difference whether their mortgages are in an Offa bond, in a Godiva wrapper or in one of the UKML vehicles.”

Rob Ford, TwentyFour
Q&A with Freddie Mac’s Mike Reynolds

Freddie Mac’s single-family credit risk transfer program, including its STACR® (Structured Agency Credit Risk) offering, hit some key milestones in 2019. For one, the firm surpassed the $50 billion mark for total issuance since the inception of the program in 2013. Second, Freddie Mac introduced a REMIC structure, helping make CRT bonds more attractive to existing investors while appealing to new ones. With the U.S. housing market and macroeconomic environment continuing its strong performance, even in the late stages of the credit cycle, Freddie Mac experts see a lot of opportunity ahead for STACR. Mike Reynolds, vice president of single-family credit risk transfer, gives thoughts on the growth of the program in 2019 and expectations for the coming year.

Q: What were some of the highlights of Freddie Mac’s STACR program in 2019?

Mike Reynolds, Freddie Mac: In 2019 we had a very robust execution in both our STACR and ACIS® (Agency Credit Insurance Structure) programs. Probably the biggest development in 2019 on the STACR side was that we started to issue REMICs, which has expanded investor appetite.

We also launched our data intelligence portal, Clarity, this year. Not only does Freddie Mac lead the industry in credit standards, but we also lead in data disclosures. However, for some of our investors, working with such large data sets can be cumbersome or costly if they have to outsource it to third parties. We developed the Clarity portal as a free tool on our website, allowing investors to look at transactional data across both STACR and ACIS platforms and easily analyze deals.

Q: With regards to the STACR program, could you talk about what you observed in the investor base in 2019 and how you expect it to evolve in 2020?

Reynolds, Freddie Mac: The REMIC structure generally makes STACR more appealing to REITs, and we saw interest from REITs investors in our first transaction, as well as some non-REIT entities—the favorable tax treatment being the big driver there. I would say overall, that the investor count was flat. A big factor is that spreads have decreased throughout the year, and some investors may be looking for minimum returns and finding those opportunities in other asset classes, and that is all just a natural part of the relative value picture.

Going into 2020, fundamentals for the fixed income market remain very attractive, specifically within the U.S. residential housing market. We are a consistent issuer in this space, and we are offering the ability to take down new paper where some other asset classes tied to legacy mortgages continue to shrink. Asset managers, hedge funds, REITs and insurance companies will look to this space as an opportunity. We’ve been printing our deals at historically tight levels, and we think there is really strong demand for CRT, and I expect that to continue in 2020.

Some players who have been sitting on the sidelines should become more active in 2020, though I think most of the investors who are interested in the program are already participating. I also think there will be growth on both the reinsurance and capital markets sides. The bigger picture is that the capacity within our current investor base is very large, and we placed approximately $10 billion in 2019. In 2020, that number is expected to be in the $12-$16 billion range, and I believe the capacity to absorb that supply will be there.

Q: How has liquidity of CRT improved, and do you expect it to continue to deepen in the coming year?

Reynolds, Freddie Mac: We closely monitor liquidity, and a liquid secondary market for STACR is very important to us. We’ve had great success—average trading per month is $2.1 billion, up from $1.7 billion a year ago. In addition to the traditional STACR liquidity providers, two new broker dealers have recently entered the market. That is a very positive sign and helps investors get comfortable that there is a vibrant and liquid secondary market for CRT. We closely monitor liquidity, and a liquid secondary market for STACR is very important to us. We’ve had great success—average trading per month is $2.1 billion, up from $1.7 billion a year ago. In addition to the traditional STACR liquidity providers, two new broker dealers have recently entered the market. That is a very positive sign and helps investors get comfortable that there is a vibrant and liquid secondary market for CRT.

Q: Are there any structural changes or developments that Freddie Mac will make to the CRT program in the coming year?

Reynolds, Freddie Mac: Our number one goal is to prepare to exit conservatorship, and as the Federal Housing Finance Agency (FHFA) lays out those milestones, we will execute them in a safe and sound manner. We do expect FHFA to propose new capital rules in 2020, and those rules may affect our credit risk transfer program. So, we will look at that and make any necessary changes. We will also continue to move away from LIBOR. The STACR program is currently a LIBOR-based structure, and we will work with the industry to migrate toward SOFR-based issuances. We’re also looking to reduce the amount of time between when we issue the MBS guarantee and when we issue CRT. We call that time period “the pipeline,” and we will focus on reducing our credit exposure there.

Q: Can you talk about what you saw in 2019 with regards to housing fundamentals and how you see the sector developing over the course of 2020?

Reynolds, Freddie Mac: We think fundamentals are firm. We have historically low unemployment at 3.6%, inflation remains subdued, and our forecast for the mortgage rate at the end of 2019 is 3.8% and expected to remain low. This will lead to a surge of refinancings, which should continue into 2020. The performance of the credit markets is solid, and we have low delinquencies and net losses. The credit fundamentals are there and attractive, so we think the combination of increased refi volume and a reduced pipeline will bring higher volumes of CRT to the market in 2020.
RMBS revs up as reforms loom

While the outlook for a long-awaited reform of mortgage finance and the government-sponsored enterprises is uncertain in an election year, non-agency residential mortgage-backed securities (RMBS) are clawing their way back into US capital markets. Max Adams reports

In July the Consumer Financial Protection Bureau (CFPB) announced that it will allow the so-called ‘QM patch’ to expire in January 2021. This will affect the RMBS market regardless of mortgage finance reform’s slow progress. The patch created an exemption for Fannie Mae and Freddie Mac from the CFPB’s ‘ability to repay’ rule. This stipulates that lenders verify certain criteria before originating loans. Allowing the GSEs to ignore parts of the qualified mortgages criteria when purchasing loans to package into MBS has given them a $260bn opportunity, equivalent to 16% of all new mortgages annually, since the patch was introduced in January 2014.

Now, with the patch’s end looming, sentiment is a mix of excitement at the potential opportunity for private capital and fear of potential unintended consequences. While lenders are hungrily eyeing the $260bn hole in the market that will need to be filled, there are potentially negative consequences to eliminating the patch altogether.

In particular, this might allow many borrowers who would not have otherwise qualified for a mortgage to obtain one. The fear is a return to pre-crisis indiscriminate lending.

There are also questions around investors’ ability to absorb the inevitable surge of new private label RMBS supply. “Unlike GSE reform, the end of the QM patch is a done deal,” says the head of mortgage finance at a bulge bracket bank. “So how do we deal with that? Where are we supposed to find the $245bn of RMBS a year? Last year was the biggest since the crisis and it was $25bn. Non-agency issuance has just been squeezed down tremendously.” Marlatt reports.

Even so, non-QM RMBS — a term interchangeable with non-agency or private label — has doubled in size every year since 2014 even with the QM patch in the background. The market is set to nearly double again, from about $25bn in 2019 to more than $40bn in 2020.

“We used to do $750bn of RMBS a year. Last year was the biggest since the crisis and it was $25bn. Non-agency issuance has just been squeezed down tremendously.” Marlatt reports.

Jerry Marlatt, Mayer Brown

“We used to do $750bn of RMBS a year. Last year was the biggest since the crisis and it was $25bn.”

“Actual dollars of new mortgage origination is about $1.5tr annually, so if non-agency comes to comprise even 10% of that, it would still be bigger than most other securitized asset classes,” the mortgage banker notes.

Disclosure debate

The Securities and Exchange Commission (SEC) is also looking to reassess disclosure requirements for RMBS originators put in place as part of the Dodd-Frank legislation. This has the potential to boost issuance further, as the Regulation AB II disclosure regime has been cited as a reason for the lack of publicly registered RMBS in the post-crisis era.

“Since the rule came into effect, no one has done an SEC-registered deal,” says Jerry Marlatt, partner in the corporate and securities practice at Mayer Brown, in New York. “Now [the SEC] is asking for input on loan level disclosure and why there haven’t been any registered deals, and generally rethinking the extent of the disclosure regime.” Marlatt adds.

The issue has been taken up by the Structured Finance Association, the US securitization market’s main industry group. The rule could be recast in 2020, sources say.

Private label push

This seems unlikely to stop the private label RMBS sector’s expansion, however. ‘Hybrid RPL’ securitizations will be to the fore here, the mortgage banker believes. These re-performing loan deals are backed by collateral that has been rehabbed from non-performing status but may still have issues or is slightly behind on payments.

“The other area is non-QM. Origination continues to increase, and there has been a significant amount of equity attracted to the mortgage space because of nationally improving home price appreciation,” the banker adds. “This drives a lot of interest in mortgage credit. When you think of the lack of housing supply in the US, this is also where we see a lot of interest in the fix and flip and investor space in 2020.” GC
STS: the long and winding road

Meant to bring about a new era for European securitization a decade after the financial crisis, the ‘simple, transparent and standardised’ framework actually stifled issuance in the first quarter of 2019. But a year on, STS is on its way to delivering what it had promised. Tom Brown reports

The ‘simple, transparent and standardised’ framework for securitization was first proposed as a means of regulating a market which came close to being killed completely by regulators for the role it played in the 2007-2009 US subprime crisis. The label, which puts forth a set of standardisation and disclosure criteria for issuers to comply with, allows for lower capital charges on bonds that carry the label.

First proposed by European regulators in 2014, STS was launched on January 1, 2019. But when the first issuer, Crédit Immobilier de France, set out in October 2018 to tick the boxes to issue the first STS-compliant deal, it encountered three problems.

One was that it did not have a third party verifier licensed by the Autorité des marchés financiers, the French regulator, meaning that investors would have to take a leap of faith in order to allow CIF to issue in the first place.

The second, which became apparent upon the launch of STS, was that almost none of the level two legislation released alongside STS was ready.

The third was that the ABS market saw next to no issuance throughout the entire first quarter of 2019, leading to the issuer deciding to issue the deal on the private side.

“We planned to issue the first RMBS at the beginning of the year,” says Clotilde Bouchet, who was at the time of the deal deputy CEO of CIF Euromortgage and group CFO of Crédit Immobilier de France. “It was a bet, for sure, but investors agreed to do it.”

After a tricky beginning the pace picked up and by September the majority of ABS issued in Europe carried the STS framework. Indeed, only six months after CIF placed the first STS deal, another 87 were listed alongside it.

“It has been a long and bumpy road, because of losing the first quarter of the year,” says Miles Hunt, head of securitized products and alternatives syndicate at NatWest in London. “But towards the end of the year we are seeing that it has achieved what it set out to achieve.”

Traders say that STS paper in the secondary market is in great demand. Syndicate bankers are starting to note a difference in pricing between STS and non-STS deals, while issuers are retrofitting legacy deals with the STS framework before the liquidity coverage ratio (LCR) benefit for non-STS deals ends in April 2020.

Other jurisdictions are already looking at STS as a template, with Japan adopting the Basel-equivalent regime ‘simple, transparent and comparable’ (STC) for Japanese securitizations in May 2020. Australia is also gathering market feedback with the aim of implementing its own STC framework.

“I would call it a qualified success — with still great potential yet to be realised”

Ian Bell, PCS Secretariat

So far, so good. But while the new market has taken over a decade to emerge there is still work to be done to make sure STS is fully accepted. As 2019 draws to a close, templates on risk retention and data disclosure are still outstanding, with regulators set to leave key market issues unclarified until at least February 2020. “The lack of certainty has been difficult for market participants and it would be good if there are no surprises and they are finalised soon,” says Merryn Craske, partner at Mayer Brown in London.

Brexit also looms large over the framework. Under current rules, sterling STS can only be recognised as STS in the European Union if the UK is part of the block — but the reverse is not true, meaning that UK banks would be the ones to benefit should a speedy exit leave securitization regulation unchanged.

While some claim the regulation has done its job, others say it has failed to reform the securitization market the way regulators intended. “I was quite surprised, and I am not the only one surprised, that people have said STS has not quite delivered what we expected it to do, and we need to fix it fast,” says Ian Bell, head of the Prime Collateralised Securities Secretariat in London.

Regulators for their part have said they are looking at ways to improve the framework ahead of the STS review scheduled in 2022. One of the battles the market is preparing to fight is over synthetic STS, or STS for risk transfer securitizations. Banks under Basel IV will be required to raise up to 25% more capital, the majority of which are struggling to make profits as it is. An STS designation for synthetic securitization could give the market the boost it needs to meet its regulatory aims.

Bell says that “those of us with a bit of ambition” are looking for STS regulation to be “aligned with covered bonds”. The market as a whole is looking for better LCR treatment for STS deals, as well as better capital treatment under CRR and Solvency 2 rules.

“I wouldn’t call STS a failure, I wouldn’t call it a roaring success,” concludes Bell. “I would call it a qualified success — with still great potential yet to be realised.”

GC

Esoteric ABS boom fuelled by move beyond fast food

Esoteric ABS is not quite so esoteric in the era of low interest rates. With anaemic yields and low economic growth expected to continue, more investors have turned to the asset class over the past few years, and issuers are locking in the lower cost of capital while it lasts. Jennifer Kang reports

While plain vanilla asset classes, such as auto and credit card ABS, still make up a larger portion of the US securitization market, esoteric asset classes have grown in number and variety, exceeding $61bn in issuance in 2019.

Many once-niche asset classes are hitting the market more regularly. In 2019, aircraft leasing, whole business, marketplace lending and small business loans all saw more issuance in terms of both deal count and size.

Low interest rates have pushed issuance volumes up, says Philip Armstrong, senior portfolio manager at Invesco’s structured investments team in Atlanta.

"There was a desire for issuers to come to market or refinance this year, just to lock in that lower cost of capital," he says. "That definitely drove some degree of issuance. It was also a function of firms or issuers looking to grow their business."

A number of the ABS sub asset classes did not even exist 10 years ago and the use of big data analytics was not part of the process, says Manish Kapoor, managing principal at West Wheelock Capital.

Because of the structural protection offered by securitization, ABS allows issuers to bring in a new asset type and obtain an investment grade rating where they would otherwise be rated junk in the corporate debt market.

"Imagine you’re an unsecured debt research analyst. If you went to sleep for 100 years and woke up today, some mechanisms may have changed but the fundamentals of how things get done would be similar," says Kapoor. "But if you were an ABS research analyst and you went to sleep for just 10 years, you would not recognize the market, the tools or the way analysis is done nowadays. The sheer amount of innovation in ABS is stunning."

The possibility of such innovation, in the ways that deals are structured and engineered, has allowed new asset classes to emerge, and as the asset classes diversified, a growing number of new investors entered the space. Compared to 10 years ago, large endowment or pension fund investors who were once absent from the securitization market are dedicating a “fairly decent chunk” of their books to ABS as they look for yield and to diversify their fixed income books, says Kapoor.

"In the ‘other’ category, we’ve definitely been competing for that risk against a much bigger universe of investors than in 2016 or 2017," says Dave Goodson, head of securitized and portfolio manager at Voya Investment Management. "We’ve seen this trend in the making for last couple of years. The buyer base has been snatching up this risk. What I’m looking at next is, will there be more new technology that will enable other asset classes to be securitized?"

The mix of issuance will become more diverse as ABS provides a low grade issuer with an opportunity to achieve an investment grade rating

Philip Armstrong, Invesco

Burgers, babies and bonds

Whole business and franchise ABS was a sector that boomed in 2019, and promises further growth in 2020 following the successful debuts of several second and third tier franchisors, say market participants.

From the buyside, investor sophistication and comfort with whole business assets is set to increase, says Tom Rutledge, head of fixed income originations at alternative asset manager Magnetar Capital in Boston.

"Alternative asset investors are often the first movers when it comes to esoterics," he says. "The investors and firms that don’t have strict limitations of credit ratings will often jump in first and get paid in return for being flexible and doing the underwriting work. That lifecycle trajectory you see now in esoterics will continue."

The growing speed with which investors are understanding new structures is evident in the wide range of whole business transactions seen in 2019. Along with the typical fast food chain offerings, the market also saw a pre-school education franchise deal from Primrose Schools and a music licensing agreement deal from SESAC.

"The big difference in 2019 was the mix of what’s been issued," says Armstrong at Invesco. "Going forward, that mix of issuance will become more diverse as ABS provides
a low grade issuer with an opportunity to achieve an investment grade rating.” Compared to unsecured corporate debt, the cost of funding is notably lower in the whole business securitization market, Armstrong adds.

**Aircraft ABS flying high**

Aircraft ABS flew beyond its 2018 record to reach $8.79bn in 2019, driven by a similarly expanding investor base. Aircraft ABS transactions were more popular and moved faster than any other transportation ABS sub asset classes when it entered the primary pipeline, says Caroline Chen, senior vice president at Income Research + Management in New York.

“It was amazing to see the aircraft deals move much faster than other transportation asset classes, like railcar,” she says. Investors seem to like the yieldier nature of aircraft ABS and appreciate the deeper liquidity that exists in that sector, as opposed to other commercial ABS paper.

More banks are arranging deals, alongside the proliferation of first-time issuers and interested investors. Deutsche Bank was dominant in the sector in previous years, but other names such as Goldman Sachs and Natixis are dedicating more resources to aviation, says Doug Trevallion in Boulder, Colorado.

“We have been attracted back to the ABS market by the new technology of the transaction structure, especially the tradeable ‘E’ notes,” says Timothy Ross, head of investor relations at Singapore-based lessor BOC Aviation. “We expect to see more investors attracted to aircraft ABS in the future.”

**Drilling for yield**

Despite an increased focus on ESG strategies, oil and gas royalties emerged as an attractive securitized asset class at the end of 2019, and a wave of deals is expected to hit in 2020, as more traditional sources of funding, such as reserve-based lending, becomes more expensive for oil and gas producers.

Historically, oil and gas companies have always been big consumers of capital, but given where oil prices are — WTI has hovered between $55 and $60 for much of the year — and leverage in the industry, it has been tough for these companies to raise equity or unsecured debt. There are consistent market participants in the bank space active in reserve-based lending, but that volume is not growing.

It’s an interesting time for such a product to hit this market, says Goodson, since a lot of people are making the argument that oil production is becoming less valuable. Some investors say they won’t be interested in oil and gas royalties even if it hits the mainstream market because there are a lot of idiosyncratic risks involved.

“My guess is that oil and gas companies saw the success that whole business ABS has had with getting low cost of financing,” says Goodson. “The oil and gas companies may be seeing the high yield bank loan market becoming choppier.”

**High return, high risk**

However, reaching too far for yield may come with consequences.

“If you’re reaching too much for a new realm of collateral, there’s always a chance you could miss something when doing the underwriting — and underwriting is even trickier with esoterics,” says Rutledge. “That potential is something that could slow the growth of esoteric ABS.”

Even the most popular forms of whole business ABS — fast food franchise concepts — are at risk, especially because of their ties to the corporate unit. For example, Applebee’s has a very different business strategy to Domino’s Pizza, even if at first glance they both appear to be similar companies in the same sector.

“On the surface, you may think all fast food franchises are more immune from the recession, but if you look closely, each individual company is different,” says Tracy Chen, portfolio manager at Brandywine Global. “You have to do your due diligence — get all the related documents, read it and do the work to make sure the company is steady and strong.”

With global liquidity drying up, it “doesn’t make a lot of sense” to be investing heavily in esoteric ABS, says Brandywine’s Chen. Whole business ABS bonds have been enjoying decent liquidity over the last few years, but the current situation is not ideal because of slowing growth and fierce competition among fast food brands.

Although aircraft ABS has been highly popular, there is a substantial group of investors who question the structural integrity and fundamentals of the sector.

“So much money has been pushed into non-benchmark types of risk, like aircraft ABS, because of the yield offering,” says Goodson. “I don’t think it’s because people have a particularly bullish view on the industry — because it’s been train wreck after cyclical train wreck. It’s more of a function of an incredibly generous monetary policy.”

Those who do participate in aviation ABS are very selective in the investment process. For example, Barings makes sure that it invests in transactions with strong servicers that have a long track record, says Doug Trevallion, head of global securitized and liquid products at the investor. Trevallion does not participate in inaugural deals or off-the-run aircraft types, paying special attention to the equity alignment and skin in the game for the different parties of the transaction. GC
Investors seek ABS protection against turning macro cycle

As the late stages of the economic cycle drag on and uncertainty around the next recession grows, investors are turning to securitization as a shield against headwinds from other parts of the market, loading up on ABS to insulate portfolios from gyrations in corporate credit. Jennifer Kang reports

Since the financial crisis, investors have been drawn to securitization by the embedded protections in the structures, many of which were a response to the subprime mortgage debacle. At the same time, underwriting standards have tightened, risk retention and incentive structures have improved and rating agencies have become more conservative, making securitized products more likely to outperform other sectors when markets come under stress.

"During and right after the crisis, no one wanted to trust securitized products, but the table has turned," says John Kerschner, head of US securitized products at Janus Henderson in Boulder, Colorado. "People are getting the message that what caused the last crisis isn't going to cause the new one."

Barings, the investment arm of insurer MassMutual Life Insurance, is one example of asset managers going overweight on securitized products. It has increased allocations to ABS, CMBS and RMBS to 30% in its Global Investment Grade Strategy Fund, and has allocated another 30% to CLOs. The remaining 40% funds emerging market debt, corporate bonds and other assets.

This allocation is a big increase from late 2018, when the fund was launched. At that time, about 20% was allotted to securitization, says Yulia Alegseeva, head of securitized credit research and portfolio manager at Barings in New York.

"We made that determination because we are seeing good value in the securitization space," she says. "We look at securitized products as a more defensive place to stay as we feel some more recessionary-type sentiment."

Compared with corporate or high yield bond markets, securitization outperformed in 2019 and is expected to continue to do so in the coming year, according to Barings' global IG strategy fund team. "What we are hearing from the consulting community broadly is that the special purpose vehicle, bankruptcy remote feature is valuable today, as well as the seniority structure," says Doug Trevallion, the firm's head of global securitized and liquid products. "I hadn't heard that in a long time. Securitization is becoming quite attractive and accepted as we move into the late cycle climate."

ABS is also seeing more cross-over issuers, both from different regions and those crossing over from other sectors.

"There's more street participation and also more international investors — not just European, but also Asian investors," says Trevallion.

Issuers that used to participate in the corporate space are tapping ABS via asset classes such as whole business loan securitizations or cell tower deals. ABS has proved to be a cost-efficient form of capital, with the added benefit of ratings that are often higher than an issuer's unsecured corporate rating.

"We have seen some movement into the securitized products space," says Geoff Caan, managing director of public fixed income, at SLC Management in Boston. "Investment banks continue to expand in the ABS area and work with originators to source more products and co-ordinate securitization of new assets."

"No one wanted to trust securitized products, but the table has turned. What caused the last crisis isn't going to cause the new one."

John Kerschner, Janus Henderson

Several asset managers have been particularly active in increasing RMBS exposures, attracted by continuing house price appreciation across the US and a benign interest rate environment for refinancings and new mortgage production.

Overweight in RMBS

"Going heavy on securitized products is the right way to approach this market," says Dave Goodson, head of securitized products and portfolio manager at Voya in Atlanta. "In our dedicated securitized products fund, we definitely pointed risk towards real estate — RMBS are benefiting from higher prepayments."

For Income Research + Management, the big change has been to increase agency RMBS as well, the "third leg of [their] value stool," says Jake Remley, senior portfolio manager at the firm in Boston. Janus Henderson has also added more agency RMBS to its multi-sector income strategy fund, because it looks relatively cheap versus corporate debt, says Kerschner.

However, pockets of risk still exist in the subordinated tranches of most securitized asset classes. Especially in esoteric ABS, now is not the time to buy anything and everything, says Philip Armstrong, senior portfolio manager at Invesco’s structured investments team in Atlanta, Georgia. For Invesco, that means sticking to higher quality names with a track record of issuance.

"The theme is to get defensive and to buy securitized [product] in lieu of corporates," says Remley. "But if you are not differentiating what your manager is buying, you could end up with securitized products that are riskier fundamentally and technically than even a triple-B or double B corporate bond." GC
Corporate bond deals of the year

It was a year when the corporate bond market first had to get used to a world without QE — and then digest its return. Spreads tightened sharply after the summer following the ECB’s decision to restart its Corporate Sector Purchase Programme. But that did not mean all the best deals came after September. Far from it.

### MOST INNOVATIVE CORPORATE BOND OF THE YEAR

**Enel**  
$1.5bn 2.65% September 2024 sustainability-linked bond  
Bank of America, BNP Paribas, Citigroup, Crédit Agricole, Goldman Sachs, JP Morgan, Morgan Stanley, Société Générale

Though it is easy to forget, with the end of Libor and the birth of green finance, it is rare for something truly new to happen in the investment grade bond market. Italian utility Enel, rated Baa2/BBB+/A-, created a genuinely innovative structure when it printed a $1.5bn five year bond in September that had a coupon linked to whether the company hit a target for raising the percentage of its power generation that comes from renewable sources. Bringing a structure first seen in the loan market to bonds gives green investors the chance to be part of a company-wide change towards sustainability goals, rather than just get the one-off feelgood hit of financing a green project. The structure lets any company from any sector, not just ones that can build wind turbines for example, link their financing directly to becoming more sustainable, and for that, Enel should be applauded.

### DOLLAR CORPORATE BOND OF THE YEAR

**Anheuser-Busch InBev**  
$2.5bn 4.15% January 2025  
$4.25bn 4.75% January 2029  
$750m 4.9% January 2031  
$2bn 5.45% January 2039  
$4bn 5.55% January 2049  
$2bn 5.8% January 2059  
Bank of America Merrill Lynch, Barclays, Citigroup, Deutsche Bank, JP Morgan, Mizuho, MUFG, Rabobank, SMFG

Brewer AB InBev blew away the cobwebs from the high grade corporate bond market in January with a $15.5bn scorch that ended as the fourth biggest dollar corporate bond of the year. The deal was a huge test for the issuer after being downgraded by Moody’s a month earlier, partly for its high debt load. The Baal/A- rated name paid up for the size, around 100bp over where it had printed $10bn nine months earlier, but there was no better way to show market participants that the rocky end to 2018 was over and deals were ready to go.

### HIGH YIELD BOND OF THE YEAR

**Altice France**  
€550m 2.5% January 2025 NC2 senior secured notes  
€1bn 3.05% December 2028 NC3 senior secured notes  
€11bn 5.5% January 2028 NC3 senior secured notes  
Goldman Sachs led left euros  
Citigroup led left dollars  

Patrick Drahi’s telecoms empire Altice knows its way around the European high yield bond market and it knew how to seize a good market window when it saw one, with a refinancing for its French business in September. The August redemption of Wind Tre’s bonds and the imminent repayment of UnityMedia’s bonds left high yield investors keen to put cash back into telcos, the original heart of the European HY market, and that gave a strong technical backdrop. Bond buyers appreciate large and liquid capital structures, and an approach to documentation that prioritises long term corporate relationships over short term, financial sponsor-style flexibility.

But the syndication wasn’t without risk – an issue for Altice’s Luxembourg holding company had struggled in May, and the French refr deal was announced the day before Mario Draghi’s final press conference as European Central Bank president. Expectations were high for more easing, but it was far from a done deal, and debt markets were on tenterhooks waiting for the statement.

In the end, the central bank went Altice’s way. An extra €550m five year tranche was inserted during syndication, and the eight year tranches were increased, taking the total deal size from €1.1bn to €2.5bn. Despite the larger size, all tranches were priced through the tight ends of talk and tightened further on the break.

### STERLING CORPORATE BOND OF THE YEAR

**Berkshire Hathaway**  
£1bn 2.375% June 2039  
£750m 2.625% June 2059  
BAML, Goldman Sachs, JP Morgan, Wells Fargo

Sterling is the little sibling of the euro and dollar markets, so it was a special moment when US conglomerate Berkshire Hathaway ditched the euro part of its June bond to raise only sterling. Warren Buffett’s Aa2/AA/A+ rated company raised £1.75bn of ultra-long term debt, perfectly hitting the part of the curve that sterling is renowned for to bag 40 year money with a coupon below 2.75%. This is the biggest sterling bond ever at this maturity. The trade ticked a lot of investors’ boxes: double-A rated sterling paper, debut issue, a company that does not need to raise debt. It’s little wonder the leads said virtually every investor that buys long dated sterling was in the book.

### CORPORATE BOND OF THE YEAR

**Medtronic**  
€500m three month Euribor plus 20bp March 2021  
€1.5bn 0% March 2021  
€1.5bn 0.375% March 2023  
€1.5bn 1.25% March 2027  
€1bn 1.625% March 2031  
€1bn 2.25% March 2039  
Bank of America Merrill Lynch, Barclays

US-Irish high-tech medical device maker Medtronic made a storming euro bond debut in March. The A3/A rated issuer proved that jumbo deals are not just the domain of M&A financings when it drew an eye-popping €2.5bn. Despite the larger size, all tranches were priced through the tight ends of talk and tightened further on the break. Spreads tightened around 100bp over where it had printed $10bn nine months earlier, partly for its high debt load. The Baal/A- rated name paid up for the size, around 100bp over where it had printed $1bn nine months earlier, but there was no better way to show market participants that the rocky end to 2018 was over and deals were ready to go.
Innovations shake green bond market out of its comfort zone

For several years, the green bond market has spread geographically, attracted new kinds of issuer and new assets — but structurally, it has remained stable. Now that is changing. The urgency of climate change has made swathes of the economy realise they must go green. New products — transition bonds and sustainability-linked bonds — have been devised to help. But as Jon Hay reports, they will not be easy for the market to digest.

Should a company that transports oil buy greener ships? Should a Brazilian beef producer try to source cows that have not been grazed on deforested land? Should responsible investors finance their efforts to do so?

These are some of the tough questions participants in the green bond market are starting to face — questions that will become more common and insistent as the transition to a greener economy gets under way.

In 2019 the market was hit by two product innovations, which have become its hot topics. How it reacts to them will determine its future.

Transition bonds and sustainability-linked bonds contrast with each other, but share a common root: they are attempts to apply the concept of labelled bonds, which has proved so popular, to the sweeping change the whole economy must go through in the coming decade.

They also address two of green bonds’ main weaknesses. First: market participants and their body, the Green Bond Principles, have ducked the question of defining green. Second: green bonds only relate to a specific pool of the issuer’s assets. They do not give the investor any handle on what the rest of the organisation does.

Neither new product fits into the GBP’s self-regulatory framework and the organisation is debating how to respond, and whether to create new categories. Sustainability-linked bonds are particularly tricky for the organisation, which has made trackable use of proceeds its raison d’être.

“You can expect guidelines for sustainability-linked and transition bonds to be published [by the GBP] quite soon,” says a leading green bond banker.

Leaders and laggards

It was the EU’s drive for a Taxonomy of Sustainable Economic Activities that prompted the idea of transition bonds. Having begged for it for so long, market participants are pleased that an authority is about to settle the question of what is green. But the Taxonomy will leave out much of the economy, including highly polluting industries and service sectors with light environmental impact.

“The only way we are going to reach Paris is to allow an inclusive transition,” says Christopher Flensburg, head of sustainable products at SEB in Stockholm, referring to the goals of the Paris Agreement.

“’The transition will have three kinds of participants. The first are at the destination — most green bonds are Paris-aligned. But whether it’s housing, transport or energy, there are a lot of industries that need to catch up to get up to a transition line. The second group is the leaders who are going to take us to the next stage. Then there is the old economy, which is far behind the leaders and needs to catch up. We’re not going to succeed unless we can create an embracing transition for all three.”

Many want labelled bonds to be available to organisations whose activities may not be considered green, but which are making an effort to improve. Enter transition bonds.

Unusually, the theory has arrived before the deals. The conversation was catapulted forward in June, when Yo Takatsuki, head of ESG research and active ownership at Axa Investment Management in London, published a paper arguing for transition bonds and sketching how the market could be governed.

While everyone is talking about transition bonds, the range of views is wide, from enthusiastic support to suspicion that they are unnecessary, or a means of greenwashing.

“Green bonds are transition bonds already,” says a green bond fund manager. “The risk is you allow some sectors and companies to change from dark brown to light brown, when maybe you want them to disappear. It allows a lot of companies to stay around and pretend they are moving in the right direction. That’s why we are not in favour of another label.”

Johanna Köb, head of responsible investment at Zurich Insurance Co, says: “We believe that some improvement is better than none.”

Johanna Köb, Zurich Insurance Co

“We believe that some improvement is better than none.”

The fact that transition bonds need defining carefully is probably the main reason why only a handful of deals have been issued.

In 2017 Hong Kong’s Castle Peak Power issued a $500m bond, whose
Cattle grazing on deforested land in Amazonas, Brazil. When Marfrig issued a transition bond, investors had to decide whether there was a risk of being exposed to this kind of activity.

Proceeds are used to “develop gas-fired power plants to support the transition from coal-fired power”. CPP has coal and gas plants.

An ESG investor at a major global asset manager said: “This debt issue is a pernicious influence on debt capital markets. ‘Sustainability’ should be reserved for issuers whose commitment to alternatives and/or green projects is clearly demonstrated. The very nature of their business is neither sustainable nor green.”

Marfrig’s ability to check how its farmers behave is slight.

The deal achieved Marfrig’s tightest pricing ever, with demand from investors following environmental, social and governance strategies. But many were appalled.

The key question is: transition towards what?” says Joop Hessels, head of green, social and sustainability bonds at ABN Amro. “There needs to be a definition of where you are going as a sector. Just to do something better — that is not transition. You’ve got to ask what is the desired outcome for the sector and then decide on the intermediate steps.”

Some argue the assets financed by some green bonds are not green at all, which need to change significantly to be in line with the Paris goals. There, a transition bond could potentially work.

Strategy, not assets

In fact, the person most influential in creating the concept, Takatsuki, rejects the common description of them as a misunderstanding.

They should not, he argues, be a second tier of the green bond market for brownish issuers trying to go green. “For transition bonds, the focus is not really on the use of proceeds, but on what is going on at the issuer level,” he says.

Takatsuki sees them as a way to broaden the investor-issuer discussion from just the use of proceeds, to the issuer’s whole activities.

This kind of investment approach has always been possible, since long before green bonds were invented. However, the green bond movement ignored this and pursued transparency about a segregated asset pool.

What we are saying with transition bonds is: ‘What are you doing as an issuer — do you have a board level commitment to stringent, sector-specific targets?” says Takatsuki. “This is now forward-looking scenario analysis.”

If Takatsuki favours the whole company approach to ESG, it is surprising he is trying to build it out to a sustainable future, such as a carbon-neutral economy by 2050.

But any bond that meets such a standard would arguably qualify as a green bond. In fact, it is a higher standard than many green bonds are held to. Energy efficiency investments, commonly found in green bond asset pools, might achieve a 30% energy saving. Is that on the path to zero carbon? The issuer’s green bond framework probably does not tell you.

It may turn out, then, that while investors would be willing to buy transition bonds, not many issuers actually find it attractive to issue them.

If you ask an issuer: ‘would you like to do a transition bond or a green bond?’ the answer most likely is a green bond,” says Hessels. But he still thinks it makes sense to have a new category: “There are certain sectors you would not automatically identify with green which are still necessary for the transition, or sectors which are not green at all, which need to change significantly to be in line with the Paris goals. There, a transition bond could potentially work.”

Clear pathway

Many see transition bonds’ appeal and purpose, but do not want the present formless market, full of controversy. They crave some kind of order.

Clear pathway

Transition and sustainability bonds
Transition and sustainability bonds

of the labelled bond market. Takatsuki is disillusioned, however, with the results from techniques such as shareholder motions. He dismisses as “rose-tinted” the view that engagement by bondholders could persuade companies to improve their ways.

The transition bond, in his mind, is a carrot — a way for investors to open the door to issuers whose environmental challenges are more difficult, and beckon them forward. Tempting issuers like this might work — but the problem of how to do so Acceptable transition will remain, and is more difficult than defining a standard green bond.

Help may be coming from the EU. In the twin track process of developing the Taxonomy — one track political, the other run by the Technical Expert Group — the drafters have thought more deeply about it. It has become apparent that there will need to be explicit recognition for transition activities. That means the Taxonomy will contain definitions.

Aiming for a target
Sustainability-linked bonds are completely different. Rather than stretching green bonds’ uses of proceeds to more difficult areas, they dispense with a specified use of proceeds altogether. The issuer can use the money as it likes — but the coupon will step up if it misses a sustainability target, on a whole company basis.

Reversing the situation with transition bonds, this product has deals, but no theory. Even though the technique is popular in syndicated loans, the bond market was startled when Enel, the Italian power and gas company, launched a €1.5bn deal in September. Participants are still getting their heads around it.

Enel’s coupon will rise by 25bp if, by the end of 2021, it fails to increase the renewable share of its generation fleet from 46% to 55%.

A €2.5bn deal in October also included a longer-term target to cut generating emissions to 125g of CO₂ a kilowatt hour by 2030. Most dedicated green bond funds could not participate, but other issuers, including ESG funds, over-subscribed them heavily, pushing the spreads tighter than normal bonds.

“It’s a nice development of the sustainable fixed income market, though we need some time to have a strong conviction of how to use this investment and how to price it,” says an SRI bond investor in France.

Many are baffled by the product, or unimpressed. Some want to estimate the probability that Enel misses its targets, so they can value the step-up coupons. Others see the bonds as lacking “impact” because the use of proceeds is not tracked.

“For us the whole green bond concept is about transparency, reporting,” says the green bond fund manager. “You just don’t have all these features. It opens the door for less green and less credible issuers. It’s a lighter version of green bonds, an inferior structure.”

Many are anxious about whether Enel is doing anything different from what it would otherwise do; or are concerned to ensure that targets on such deals are really stretching.

“The innovation is a very interesting one for the overall sustainable investment market,” says Köb. “We believe it is important in such cases that the triggers be linked to core sustainability features of the company, and ones they primarily control — such as in Enel’s case — rather than external ESG ratings.”

Enel’s triggers were 2 degree-compliant, she says, making them credible and relevant for the company type. This was “a strengthened signal of the ambition and seriousness of ESG integration of the issuer,” she adds. But unlike green bonds, Zurich does not see them as impact investments.

“It’s frustrating because the green bond concept is really going mainstream,” says the green bond fund manager. “By over-innovating this market you are creating confusion.”

The right conversation
So far, no other issuer has followed Enel. “It took a number of corporates by surprise,” says the green bond banker. “Many are looking at it and seeing if it makes sense for them. You will see more. Whether it will be the same type of explosion that we have seen on the loan side is a question — clearly the investor base is different — but there is a potential. Any sector should have a climate-related or transition-related objective and should be able to do it.”

For issuers, the structure is much simpler than a green bond. There is no need to find, tag, track and report on specific assets. “We have some issuers which work very much towards certain specific sustainability targets, but might have difficulties to add up all these incremental small investments,” says Hessels. “For these issuers it could work.”

And — the main attraction for Enel — it focuses the conversation with investors on exactly what the management wants to talk about: its core sustainability strategy.

For issuers, it ought to work well too: the bonds give them an opportunity to talk to the issuer about its transition and ask whether it is going fast enough.

“Green bonds really answered the request from a lot of investors, who want to have a clear idea about how their money is used,” says the French investor, “So we have lost some transparency but the good news is we have a better idea about the long term strategy of the issuer.”

Green bonds are not saving the world. They rarely finance green activities that would not have happened anyway, and their price advantage is small. Transition and sustainability-linked bonds, for the foreseeable future, will be no different. Organisations will not change their strategies because they can issue a different kind of bond.

What labelled bonds have done extremely well is get people talking in ways they had not before. Transition and sustainability-linked bonds can stimulate more detailed conversations about how the economy can be wrangled from its wild ways and taught more civilised habits. And both products will lay more emphasis on analysing the whole organisation, not just a section the issuer highlights. They are the next stage of expansion the green bond market has been looking for.
ECB set to become long term fixture in corporate bonds

The European Central Bank opened its wallet again at the end of 2019 and started buying corporate bonds, but its largesse is a shadow of what it was. With inflation still a long way below target, it is expected to ramp up its buying in 2020. Michael Turner reports

Europe’s high grade companies had plenty of time to prepare for the second bout of quantitative easing from the European Central Bank after it floated the idea over the summer of 2019.

But the market was still surprised at the early pace of the second Corporate Sector Purchase Programme. Many had forecast that the ECB would follow what it had done before, and spend about 10%-15% of its Asset Purchase Programme on corporate bonds, with the whole APP now to run at €20bn a month. But the ECB came out swinging, buying around €2.8bn of bonds in the first days of November.

Market participants make confident predictions for the ECB in 2020. “The rationale is there for more stimulus, with the ECB’s 2021 inflation forecast at only 1.5%,” says Matthew Bailey, European credit strategist at JP Morgan in London.

This is some way off the ECB’s target inflation of “below, but close to 2%”. One way to bridge the gap between target and reality is to buy more bonds. Some estimate it would take around €600bn of purchases to achieve every 0.1% rise in inflation. Though getting inflation to the 2% target this way is impossible — it would take €3tr of asset purchases to move the dial the 0.5% — there is clearly room for the APP to grow.

Market consensus has the APP increasing early in 2020, so that the CSPP expands to around €3.5bn-€4.5bn a month.

“They are also undertaking a strategy review,” says Bailey. “Our expectation is they are going to formally codify a symmetrical 2% target, rather than the ‘below, but close to, 2%’ target they have now, so they need to do more.”

A symmetrical inflation target would tilt the ECB further towards trying to raise inflation.

Get used to tightness

The ECB, then, is likely to be a long term fixture in the corporate bond market. This is a good sign for issuers wanting to print debt anywhere along their curves.

“We are positive and bullish on credit markets and conditions in general,” says Giulio Baratta, head of investment grade finance at BNP Paribas in London. “Companies are using the market wisely, taking advantage of lower rates. At short to medium terms you get lower coupons, and borrowers have been taking advantage of the very long end, which is very open in Europe. That is a comforting signal.”

The short end can suffer when the ECB becomes a bond buyer, as spreads and yields compress so much that issuers cannot find anyone to buy their short dated debt. This is a particular issue for very highly rated issuers, such as sovereigns, supranationals and agencies or the rare triple-A company.

But even though corporate spreads have moved in about 70bps from their widest point in 2019, and will probably tighten another 10bps in 2020, Bailey at JP Morgan says the market expects the short end of the curve to remain open to issuance. In the second half of 2019 the level of the corporate short end was determined more by ultra-low swap rates than ECB munificence, but this trend was easing up at year end.

“The push towards zero [percent yield] was helped a lot by the very fast decrease in swap rates in the latter part of July and August,” says Baratta. “Around four to five years was the sweet spot for a triple-B frequent borrower to target the 0% yield space. In the past 15 days, swap rates on five years is -17bp. It got to -28.9bp a few weeks ago.”

With 0% yields at the short end and issuers able to stretch out their euro curves, it would be logical to think that investors could at least expect to pick up a concession over the secondary market for buying new issues. Logic tends to vanish, however, when there is a buyer like the ECB warping Technicals. Investors may find few of the bargains they can usually pick up around swings in the market.

“During periods of weakness, primary markets shut down or slow substantially,” says Bailey. “CSPP will buy more in secondary as there is less available in primary. That helps prevent spreads going much wider, but it creates an element of removing first seller advantage [for an investor selling ahead of the crowd] when the market starts to turn [negative].”

He adds: “New issue premiums will move towards zero or slightly negative as there is so much liquidity in primary.”

Euro corporate bond maturities lengthening

Source: Dealogic

The 17th Syndicated Loan and Leveraged Finance Awards nominations

In November, GlobalCapital polled loan market participants for its 17th Syndicated Loan and Leveraged Finance Awards. The nominations are listed below, in alphabetical order. We will reveal the winners at the Awards Dinner, to be held on February 12, 2020, in London.

For details on attending the event, please contact Daniel Elton at delton@euromoneyplc.com or by calling +44 20 7779 7305.

DEALS OF THE YEAR

- **Infineon Technologies**
  - $10.83bn June 2019
- **London Stock Exchange Group**
  - $13.27bn September 2019
- **Merlin Entertainments**
  - $4.49bn October 2019
- **ZF Friedrichshafen**
  - €7.3bn March 2019

EMERGING MARKET DEAL OF THE YEAR

- **Czech Gas Networks Investments**
  - €194bn April 2019
- **IHS Holding**
  - $1bn September 2019
- **Public Investment Fund**
  - $10bn October 2019

LEVERAGED LOAN OF THE YEAR

- **BCA Marketplace**
  - $1.74bn September 2019
- **MasMovil Holdphone**
  - €1.7bn May 2019
- **Merlin Entertainments**
  - $4.49bn October 2019
- **Nestlé Skin Health**
  - €415bn July 2019

INFRASTRUCTURE LOAN OF THE YEAR

- **Beatrice Offshore Windfarm**
  - £2.54bn July 2019
- **CityFibre Infrastructure Holdings**
  - £820m December 2018
- **SFR FTTH**
  - €193bn March 2019

M&A LOAN OF THE YEAR

- **London Stock Exchange Group**
  - $13.27bn September 2019
- **Infineon Technologies**
  - $10.83bn June 2019
- **ZF Friedrichshafen**
  - €7.3bn March 2019
### Regional Deals of the Year

#### UK and Irish Deal of the Year
- **GlaxoSmithKline**: $9.49bn January 2019
- **LGC Science Group**: $1bn July 2019
- **London Stock Exchange Group**: $13.27bn September 2019
- **Merlin Entertainments**: $4.49bn October 2019

#### German, Swiss and Austrian Deal of the Year
- **Axel Springer**: €850m November 2019
- **Infineon Technologies**: $10.83bn June 2019
- **Wintershall**: $7.35bn March 2019
- **ZF Friedrichshafen**: €7.3bn March 2019

#### Middle Eastern Deal of the Year
- **Emirates Global Aluminium**: $6.545bn January 2019
- **Mubadala Investment**: $2bn May 2019
- **Public Investment Fund**: $1bn October 2019
- **White Sands Pipeline**: $3.275bn February 2019

#### Iberian Deal of the Year
- **Cellnex Telecom**: €2bn November 2019
- **Grifols**: $4.504bn November 2019
- **Testa**: €194bn May 2019

#### French Deal of the Year
- **Capgemini**: €5.48bn August 2019
- **Dassault Systèmes**: €4.75bn July 2019
- **EssilorLuxottica**: €8bn July 2019
- **Publicis Groupe**: $3.5bn June 2019

#### Nordic Deal of the Year
- **Ahsell**: €2.06bn March 2019
- **Amer Sports**: €2.01bn March 2019
- **Fortum**: €8.3bn October 2019
- **Sector Alarm**: €690m June 2019

#### Italian Deal of the Year
- **CNH Industrial**: €4bn March 2019
- **Fiat Chrysler Automobiles**: €3.25bn March 2019
- **Prysmian**: €1bn April 2019

#### Benelux Deal of the Year
- **ArcelorMittal**: $7bn June 2019
- **Solvay**: €2bn January 2019
- **UCB**: $2.07bn October 2019

#### Central and Eastern European Deal of the Year
- **CTP Industrial Property**: £1.89bn June 2019
- **Rusal**: $1.085bn October 2019
- **Sazka**: €1.4bn July 2019
- **Uralkali**: $1.45bn May 2019

#### African Deal of the Year
- **Ghana Cocoa Board**: $300m sustainability-linked March 2019
- **IHS Holding**: $1bn September 2019
- **Sonangol**: $1.5bn February 2019

#### Turkish Deal of the Year
- **Akbank**: $812m October 2019
- **Türkiye Varlık Fonu**: €1bn March 2019
- **Ziraat Bankası**: $1.423bn March 2019

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### Corporates

Loans awards nominations

#### Bank Awards

**Loan House of the Year**
- Bank of America
- BNP Paribas
- Crédit Agricole
- Goldman Sachs
- HSBC
- JP Morgan

**Best Arranger of M&A Loans**
- Bank of America
- Citi
- Deutsche Bank
- JP Morgan
- Morgan Stanley

**Best Arranger of Mid-Cap Loans**
- Bank of Ireland
- Commerzbank
- Lloyds
- UniCredit

**Best Arranger of Western European Loans**
- BNP Paribas
- Crédit Agricole
- Credit Suisse
- JP Morgan
- UniCredit

**Best Arranger of Project Finance Loans**
- BNP Paribas
- Crédit Agricole
- Mitsubishi UFJ Financial Group
- Natixis
- Santander
- Sumitomo Mitsui Banking Corporation

**Best Arranger of Trade Finance Loans**
- ABN Amro
- BNP Paribas
- Crédit Agricole
- HSBC
- Natixis
- Standard Chartered

**Best Secondary Loans House**
- Barclays
- Citigroup
- Credit Suisse
- JP Morgan

**Best Arranger of Leveraged Loans**
- BNP Paribas
- Deutsche Bank
- Goldman Sachs
- JP Morgan

**Best Arranger of Western European Loans**
- ABN Amro
- BNP Paribas
- Crédit Agricole
- HSBC
- Natixis
- Standard Chartered

**Best Arranger of Green and ESG-Linked Loans**
- BBVA
- BNP Paribas
- ING
- Natixis

### Regional Bank Awards

**Best Arranger of UK and Irish Loans**
- Barclays
- HSBC
- Lloyds
- Natwest

**Best Arranger of German, Swiss and Austrian Loans**
- Commerzbank
- Deutsche Bank
- JP Morgan
- UniCredit

**Best Arranger of Iberian Loans**
- BBVA
- ING
- Santander
- Société Générale

**Best Arranger of French Loans**
- BNP Paribas
- Crédit Agricole
- Natixis
- Société Générale

**Best Arranger of Italian Loans**
- BNP Paribas
- Intesa Sanpaolo
- Mediobanca
- UniCredit

**Best Arranger of Benelux Loans**
- ABN Amro
- ING
- KBC
- Rabobank
EMERGING MARKETS

Latin America

CORPORATES

Loans awards nominations

BEST ARRANGER OF NORDIC LOANS
Danske Bank
DNB
Nordea
SEB

BEST ARRANGER OF LOANS IN TURKEY
Bank of America
Emirates NBD
HSBC
Standard Chartered

BEST ARRANGER OF AFRICAN LOANS
Absa
Nedbank
Standard Bank
Standard Chartered

BEST ARRANGER OF LOANS IN CENTRAL AND EASTERN EUROPE
Citi
Commerzbank
ING
Unicredit

BEST ARRANGER OF LOANS IN THE MIDDLE EAST
Citi
Emirates NBD
First Abu Dhabi Bank
HSBC
Standard Chartered

BEST CORPORATE FINANCE ADVISER
Goldman Sachs
Lazard
Rothschild

BEST LOAN RESTRUCTURING HOUSE
Houlihan Lokey
Lazard
Rothschild

BEST SUBORDINATED DEBT INVESTOR
GIC
Goldman Sachs
MV Credit
Park Square

BEST LAW FIRM FOR SYNDICATED LOANS
Allen & Overy
Clifford Chance
Latham & Watkins
Linklaters

BEST INSTITUTIONAL LENDER
Alcentra
Ares Capital Management
Barings
CVC

BEST DISTRESSED LOAN INVESTOR
Anchorage
CVC
Davidson Kemper
SVP

LAW FIRMS, ADVISERS AND INVESTORS

Libor transition adds to loan market’s relentless struggles

Battling against falling volume, the loan market also has to work out how to replace Libor. Loan market life will surely get more stressful as the clock ticks down to December 2021, when the rate is due to be phased out, although distractions might come in the form of sustainability-linked structures. Mariam Meskin reports

The loan market faces its largest and most challenging transformation for decades: the elimination of the scandal-hit Libor (the London Interbank Overnight Rate), the benchmark rate for more than $300tr of financial products, from derivatives to loans to bonds, across the world.

Two years have passed since Andrew Bailey, chief executive of the UK Financial Conduct Authority, announced the planned phasing out of Libor by the end of 2021. Yet little progress has been made in the syndicated loan market to install a universally accepted alternative. The clock is ticking, as trade associations and banks search for the loan market’s golden ticket: how to tease a forward-looking term rate out of a backward-looking overnight risk-free benchmark.

As it stands, the transition away from Libor is set to put yet another obstacle in the way of banks trying to grow their lending in coming years. The challenge overwhelmed them in 2019 as investment grade loan volumes in Europe fell drastically. The year looks likely to end up as the quietest for the market since 1998. By November 11, there had been $543bn of deals, down 24% from $710bn in the same stretch of 2018.

Agent banks’ to-do lists will be far longer and more complicated post-Libor, bankers predict. In dual currency deals, the sizes of euro and sterling tranches may need to be set from the beginning to make the transition easier for lenders to process, removing the flexibility that many companies turn to the loan market for. Transactions that can be drawn in different currencies — for example, in euros and later in sterling — will be more complicated for agents as they co-ordinate with lenders, calculate backward and forward-looking rates, and work out potential changes to tenor, and more.

“The market will roll back 30 or 40 years, to when single-currency, bilateral deals were the default product,” says Sarah Boyce, associate director, policy and technical at the Association of Corporate Treasurers in London.

The likelihood of multi-currency transactions dwindling is a growing concern. Lenders have long prided themselves on offering borrowers as much flexibility as possible in lieu of other benefits more commonly found in the bond market, such as longer tenors.

“It is probably going to be increasingly complicated to run a multi-currency deal as we move away from Libor,” says Clare Dawson, chief executive of the Loan Market Association in London. “Borrowers will have to get their heads around Euribor existing alongside another potential benchmark for their dollar or sterling funding.”

Laurent Vignon, head of EMEA loan syndicate at Société Générale in Paris, agrees. “Calculating the different margins for each currency on a multi-tranche revolver will be more complex than before, given the different nature of the new benchmark rates (i.e., term rates versus overnight, secured versus unsecured) and the different times of publication of the benchmarks. The single currency documents are less of a concern.”

The uncertainty around the transition may push even more borrowers into the bond market, a trend that was in clear evidence in 2019. “Borrowers could possibly be put off from the loan market amid the transition disruption, particularly smaller, less sophisticated companies in the midcap space — the systems are not in place to switch over existing loans yet,” adds Vignon.

Reluctance turns to acceptance
Sonia, the Sterling Overnight Index Average, is the Bank of England’s preferred ‘risk-free’ interest rate benchmark to replace Libor. However, some participants have resisted adopting it — because it is backward-looking — and are insisting on a forward-looking term rate. Sonia supporters advocate compounding the rate to simulate the upward-sloping shape of a term curve.

“So many borrowers see Sonia as a workable alternative and may decide that compounding in arrears may work for them, but others want a forward-looking rate,” says Dawson.

“But I do not see how you could use anything other than a forward-looking rate in a trade finance deal based on discounting, for example. There will not just be one solution used by everybody.”
Associated British Ports captured the attention of lenders in May and June 2019 when it obtained bond investors’ consent to switch an existing £65m floating rate note to Sonia. Though that move was considered a feat, it highlighted the lack of preparedness in the loan market. “We are comfortable with raising a Sonia-linked syndicated loan now — but it is the banks that aren’t ready to lend,” says Shaun Kennedy, group treasurer of ABP. “Their internal systems aren’t ready for the transition, and that is what is holding issuance back. Once they sort themselves out, we will enter the market.”

The Libor transition has put a hold on some borrowers’ plans. “The uncertainty around Libor has certainly held some corporates back from doing more in the loan market,” Kennedy adds.

Though lenders are eager to do what they do best — lend — a Sonia-linked syndicated loan remains in the future. Libor continues to dominate transactions.

“Banks are not refraining from signing loans linked to Libor — there is caution around banks individually deciding on a replacement without a consensus on a new benchmark, but banks are still ready to lend,” says Jon Abando, managing director in loan capital markets at JP Morgan in London.

The transition away from Libor is making more progress in the bilateral lending market, where National Express raised the first Sonia-linked loan through NatWest in June. “We took the view that this would enable us to fully understand Libor transition and have an active say in how the marketplace develops, without exposing ourselves to too much risk,” says David Daniels, group treasurer at National Express.

But the difficulties of linking even a bilateral loan to an overnight rate do not bode well for Sonia becoming the benchmark in the syndicated market.

“Being the first to market always comes with its challenges,” says Daniels. “In the absence of final guidance from ISDA [the International Swaps and Derivatives Association] or the LMA, few IT providers have updated their systems and so booking and confirming the loans have been a challenge. We had to build our own ‘five-day compounding in arrears’ spreadsheet model to validate the bank’s quoted rate — in fact we managed to get the bank to amend their calculations when we identified they had a rounding issue. Additionally, accruals over a period end have been calculated manually as the rate is not finalised until a week before maturity.”

**Trouble after trouble**

Lenders are questioning what will happen to pricing after the computation of interest has been agreed for a new benchmark rate. “The pricing on a sterling deal linked to Libor today will be different on the same deal but linked to Sonia, as the internal refinancing costs of a lender vis-à-vis the benchmark rate will be different,” says Vignon of Société Générale.

But finding a new alternative and figuring out pricing are not the only burdens on lenders’ shoulders — they will also need to grapple with the logistical mountain of adjusting their legacy books of billions of dollars worth of Libor-linked loans. Some are looking into artificial intelligence to aid the process, but the colossal scope of the shift threatens to swamp syndicated loan desks worldwide.

“It looks extremely difficult, if not impossible, to come up with a solution to transfer loan contracts from Libor to a risk-free rate wholesale in batches, and then be confident that everyone would sign up to it,” says Dawson. “It is very likely that loans will have to be amended on an individual contract basis.”

Though some banks have already begun amending some documentation, a market-wide move away from Libor cannot be comprehensively done until participants are comfortable with a new benchmark.

“There will be a significant amendment and repapering process, and inevitably it will be a tremendous drain on resources,” says Paul Gibbs, managing director, loans and acquisition finance at Citigroup London.

And time is passing. Though the market is working overtime to figure out the transition, the Bank of England warned markets in October that more needed to be done to prepare for the end of Libor, due by December 2021 in the UK and the US.

Lenders know they need to hurry. “There is still time to address these industry-wide issues and develop solutions, but the pace needs to be picked up with the transition,” says Abando. “It needs to be broadly discussed in open forums. We will see an acceleration of work around the transition in 2020.”

**Back to 2003**

The stressful move away from Libor coincides with a tough period in Europe’s investment grade loan market. Loan markets have contracted globally in 2019, thanks to a lower than expected volume of mergers and acquisitions and political uncertainty, including international trade disputes and Brexit.

But for lenders in Europe, the situation has been made worse by global interest rates declining and the European Central Bank restarting its quantitative easing programme, which has made the bond market increasingly attractive to borrowers. And that is not set to change any time soon, much to lenders’ dismay.

“There is no rosy outlook for 2020, and therefore some companies will continue to hold back, not on the revolving credit facilities or refinancings, but on their mergers or M&A-linked loans.”

**Investment grade loans in Europe**

![Investment grade loans in Europe chart](chart.png)

Source: Dealogic


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IG loans and Libor transition

Among bankers is loan linked to environmental, social and governance (ESG) criteria.

Since the first sustainability-linked loans (SLLs) hit the European syndicated market in 2017 — deals for Unibail-Rodamco and Philips came in the same week in April that year — ESG-linked loans have been gathering momentum and sparking life into what is historically one of the more traditional and slow-moving financing markets.

Green and sustainability-linked loans swelled in 2019 to a remarkable 72 deals by November, totalling €62bn — 11% of loans signed in Europe in 2019. Optimism about the product’s trajectory is abundant.

German energy company E.On raised a €3.5bn sustainability-linked facility in October. The margin can be varied according to its ESG performance, as determined by ratings agencies including Sustainalytics.

Prada, the Italian fashion house, signed a €50m five year SLL in November, a first for the luxury goods industry, through Crédit Agricole. The margin will fall if Prada hits certain sustainability targets, such as a certain number of stores being assigned a LEED Gold or Platinum certificate; employees completing a number of training hours; and the company using Re-Nylon, a sustainable substitute for nylon.

"Sustainability-linked loans will be the area of the loan market where we see a lot of growth, despite the market still being in its infancy," says Gibbs at Citi.

European lenders are confident that green and sustainability-linked financing will soon extend to all corners of the corporate market. "In most of our discussions with our large clients, and now with mid-caps too, there is always a discussion about sustainability-linked loans," says Vignon. "Not all do it, but all are asking about it."

In March 2019, the European, US and Asia Pacific loan associations issued Sustainability-Linked Loan Principles, in a bid to guide and stimulate issuance. But some say hindrances remain, for both lenders and borrowers.

"The pricing differential is currently less meaningful when you are only going up or down by 2.5bp on the margin," says Gibbs. "The evolution of the product lies in the question: should the pricing differential be more beneficial, and also more punitive, to the borrower as targets are met or missed?"

Vignon at SG agrees and says banks might need help from their regulator to grow the market further. "Margins in the IG market are already extremely thin," he says. "A tightening of 2.5bp is significant when initial margins are 17.5bp-20bp. In order for this sustainability margin improvement to grow, banks would need to get a benefit on the liability side, which they don’t have for the time being. There is talk that the ECB could provide incentives to banks to do more green/sustainable business, for example by providing those banks with better refinancing costs or a reduced capital allocation, but nothing is expected in the near future.”

**Green the new black?**

One part of the market that is generating hope and excitement among bankers is loans linked to environmental, social and governance (ESG) criteria.

**Clare Dawson, LMA**

"It looks extremely difficult to come up with a solution to transfer loan contracts from Libor wholesale in batches, and then be confident that everyone would sign up to it."

...
US PP market flourishes in UK as investors eye councils

A rich variety of UK borrowers including a football club, two airports, the City and a clutch of FTSE 250 firms turned to US private placements in 2019. UK local authorities remained absent, but a surprise from the UK Treasury in October may be a game-changer. Silas Brown reports

Long dominated by industrial companies, the UK’s US PP market is opening up to the wider world. “The volume we’ve seen in the market this year has actually been really, really pleasing,” says Steve Valvona, London-based head of private placements at Lloyds Banking Group, which internally has noted over £1bn-equivalent of UK issuance of US PPs this year. “There’s been a real mix of issuers, with variations of structures and tenors.”

North London football club Tottenham Hotspur took £525m US private placements with 15, 20, 25 and 30 year tenors in late August, to pay off banks loans that funded its new stadium. UK coach operator National Express sold $500m-equivalent seven, 10 and 12 year US private placements in dollars, euros and sterling in October.

Cadent Gas sold one of the UK utility sector’s largest private placements in March, placing £680m-equivalent of US private placements across several tranches, in dollars and sterling: Bristol and Birmingham airports tapped the market in the second half of the year, and Lloyd’s of London was marketing a debut US private placement as the year drew to a close.

“Once there’s a buzz in the market it’s easier to convince other borrowers to tap it,” says Tony Fordham, head of private placements at Santander in London. “The investor base has demonstrated its ability to be open to new borrowers, and not sentimental — around Brexit among other things — while committing serious credit work to find the right value for the borrower.”

UK borrowers in 2018 accounted for roughly 15%-20% of overall US PP issuance, and market players are confident this year will certainly match that amount, if not top it. “We’re constantly on the hunt for new sectors and growth potential,” says the UK investor.

The council floated by the market so far are mostly in London — Camden, Kensington, and Westminster for example. Akshay Shah, managing director at New York Life Investors in London, would like to learn more. “I don’t know what types of structures, covenants or security UK local authorities are interested in,” he says. “It’s not clear how the financing would work but it’s exciting, and we’re all ears.”

The investor base has demonstrated its ability to be open to new borrowers. 

Tony Fordham, Santander

The PWLB’s lending margins were 80bp over Gilts, and even the keenest institutional investors could only reach roughly 100bp over Gilts. However, this may have just changed, as on October 9 the Treasury announced the PWLB would immediately increase its lending margins to local authorities to 180bp over Gilts — a level well within the reach of institutional investors.

Already there’s been an impact. Redbridge Council, in northeast London and by no means the largest or most lucrative borough, sold £75m of lengthy debt at 126bp over index-linked Gilts in early November. Antoine Pesenti, managing director at advisory firm TradeRisks, that arranged the deal, said: “Our funding solution allowed Redbridge to secure debt which is RPI-linked and has a deferred structure, both features are not available with the PWLB, and at a price significantly cheaper than PWLB.”

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Schuldscheine in rude health as market breaks new ground

The Schuldschein market is touching records for overall volume and number of deals in 2019, and in any normal year that would be what excites the market most. But instead, most pride comes from the progress made in Asia as well as innovations in sustainable financing.

Silas Brown reports

It might be hard to find anyone in the centuries-old Schuldschein market disgruntled with the instrument’s progress in 2019. Perhaps there is a dark and dusty Sparkasse somewhere in Bavaria, dismayed by the brightness of it all.

For the grand majority of market participants, the last 12 months look excellent from all angles. "I was quite sceptical for 2019 at the end of 2018," says Andreas Petrie, head of primary capital markets at Helaba. "But the second, third and fourth quarters have been tremendous."

Arrangers have brought a record number of deals into the Schuldschein market in 2019. The 150-odd transactions contain some stand-out deals which have helped the year seriously challenge the €27bn record set in 2017.

German car parts maker ZF Friedrichshafen closed its Schuldschein in late September at just over €2bn — the second largest Schuldschein (it had set the record in 2015 with a €2.2bn deal) ever to grace the market, Indian conglomerate Reliance Industries sold a €405m Schuldschein in May — the first borrower to issue a Schuldschein via a non-European entity, and the likelihood that it was Extraordinary reliance

In one of the most extraordinary deals ever to reach the market, Indian conglomerate Reliance Industries sold a €405m Schuldschein in May 2019. Given the origin of the company and the likelihood that it was first time round to issue a Schuldschein in Asia, there was great interest in how the market would react.

But according to sources close to the deal, soft orders swelled to €600m and arrangers KfW Ipex-Bank and LBBW received interest from a wide variety of Schuldschein lenders.

One banker who was not involved in the trade was excited by the deal. "What this shows is that there are investors out there with a taste for regions that haven’t yet come to the market. It’s India now, but it could be China, or Hong Kong, or Malaysia later. Who knows?"

Before Reliance, there had been some exotic borrowers. Etihad Airways — which became the first Middle Eastern company to raise Schuldscheine, in 2016 — issued €209m in euros and dollars in late 2016. The International Investment Bank, a multilateral development agency headquartered in Budapest, launched a €30m Schuldschein in March 2017, while Israel Chemicals and Brazil’s Petrobras have also issued.

Around the same time as Reliance, Tianjin Railway Transit Group, 100% owned by Tianjin and China’s central government and rated A3/A-/A-, raised €200m of 10 year Schuldschein notes in May via Deutsche Bank — the first deal from a Chinese issuer.

But in each of these cases, the deals were smaller and bought by clubs of commercial banks in Europe and Asia. To many, Reliance’s larger and broadly marketed transaction offers a more hopeful illustration of the market’s expansion.

"We can’t underestimate the significance of this trade," says one Schuldschein arranger, from a rival bank. “Finally, we have an example of a non-Western company coming with a widely sold trade.”

One Schuldschein investor from an Asian bank, who didn’t participate in Reliance’s transaction due to country limits, says: “Large non-European borrowers looking for euro debt need to have signs that the Schuldschein market will be very interesting.”

Matthias-Wolfgang Hoffmann, LBBW
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Values with impact.
The roots of green sustainability-linked Schuldscheine

<table>
<thead>
<tr>
<th>Green issuer</th>
<th>Sector</th>
<th>Amount</th>
<th>Date</th>
<th>Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>FrieslandCampina</td>
<td>Food</td>
<td>€300m</td>
<td>Apr 2016</td>
<td>Netherlands</td>
</tr>
<tr>
<td>TennetTec</td>
<td>Automotive</td>
<td>€400m</td>
<td>Oct 2017</td>
<td>Germany</td>
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<tr>
<td>Repower</td>
<td>Energy</td>
<td>€50m</td>
<td>Jan 2017</td>
<td>Switzerland</td>
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<tr>
<td>Mann+Hummel</td>
<td>Real estate</td>
<td>€107m</td>
<td>Apr 2018</td>
<td>Germany</td>
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<tr>
<td>Volkswagen Immobilien</td>
<td>Building &amp; construction</td>
<td>€88m</td>
<td>Feb 2019</td>
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<td>Volkswagen Immobilien</td>
<td>Real estate</td>
<td>€60m</td>
<td>May 2019</td>
<td>Germany</td>
</tr>
<tr>
<td>Dürr</td>
<td>Automotive</td>
<td>€200m</td>
<td>July 2019</td>
<td>Germany</td>
</tr>
<tr>
<td>Porsche</td>
<td>Automotive</td>
<td>€1bn</td>
<td>August 2019</td>
<td>Germany</td>
</tr>
<tr>
<td>Maire Tecnimont</td>
<td>Manufacturing</td>
<td>€200m</td>
<td>November 2019</td>
<td>Austria</td>
</tr>
<tr>
<td>Lenzing</td>
<td>Infrastructure</td>
<td>€100m</td>
<td>November 2019</td>
<td>Italy</td>
</tr>
</tbody>
</table>

Source: GlobalCapital records

The market for green sustainability-linked Schuldscheine is interested. Now they have an example — so why not other issuers, like Samsung?”

But there was another example of promising new territory for Schuldschein participants to pore over in 2019, which is perhaps even more substantial for the market’s growth.

**Sustainable momentum**

This development however was not regional, but conceptual. In 2019 there was a marked increase in green issuance in the Schuldschein market, with a single under €2bn of green and sustainable debt placed by a clutch of borrowers.

“After the innovation and incubation phases [in the past few years], we are now seeing acceleration,” says Klaus Pahle, head of Schuldscheine at ING in Frankfurt, the bank that has arranged the majority of green Schuldscheine.

The first two companies to issue green Schuldscheine were FrieslandCampina and TenneT back in early 2016, and many in the market expected this would spark a wave of green issuance over the next few years.

But only a drip feed of green and sustainable debt was sold in 2017 and 2018, and it was not until 2019 that momentum started to pick up. Volkswagen Immobilien closed a green Schuldschein via BayernLB, ING and LBBW this summer for €1bn. The order book far exceeded that, according to sources familiar with the deal, and the proceeds will go to research and development into electric cars, among other green projects.

But beyond the good public relations and marketing, there has been little incentive for borrowers to engage with sustainable Schuldscheine. For straightforward green deals, treasurers should still not expect much pricing advantage, according to one Schuldschein specialist in Frankfurt.

“There’s very few dedicated green funds in the Schuldschein market,” he says. “So there has been very little reason for a borrower to switch on a purely price basis.”

However 2019 saw signs of real change in this regard. Dürr, a German company that makes industrial machinery, raised €200m in an innovative deal led by ING and LBBW in May in which the margins can ratchet up and down, after the deal has settled, depending on the issuer’s environmental, social and governance (ESG) performance.

Dürr’s deal, like many ESG-linked loans, is tied to its ESG rating, in this case from EcoVadis. It scores 51 out of 100, putting it in the top 30% of companies EcoVadis reviews. It marketed five, six, eight and 10 year tranches of fixed and floating rate debt at respective margin ranges of 70bp-80bp over Euribor and mid-swaps, 80bp-90bp, 95bp-105bp and 105bp-115bp.

The coupons can be reduced by 2bp if Dürr can achieve a score of 62 from EcoVadis. If the score falls by an equal number of points, to 40, the coupon rises by 2bp.

Sustainability-linked debt burst on to the scene in the syndicated loan market in 2017, when Unibail-Rodamco and Philips became the first companies to raise revolving credit facilities (RCFs) with this feature.

The structure has proved very popular with companies — almost every week now in Europe, another company converts either an RCF or a term loan to this form, and the technique has spread to Asia and the US.

But the Schuldschein market is different to the loan markets. Although Schuldscheine are loans, they are placed with a diverse group of lenders, which often have no relationship with the borrower.

Dürr proved that such investors would tolerate a sustainability-linked interest rate, even if they had no incentive to please the borrower, and that borrowers in the Schuldschein market could find tighter margins with green and sustainable issuance.

It was not long after Dürr’s deal that others began to replicate it. Austrian cellulose fibre maker Lenzing entered the Schuldschein market in November, offering investors five, seven and 10 year euros, and five and seven year dollar tranches in either fixed or floating rate formats. There is a 2.5bp margin step-up if Lenzing’s MSCI ESG rating is lower than A, and a 2.5bp step down if its higher than A.

Italian infrastructure engineering firm Maire Tecnimont followed in the same week via Banca IMI and UniCredit, but with a margin rise or fall larger than the previous two transactions, making it an interesting test for investors.

There is a 10bp step down if the firm makes CO₂ savings of at least 10% for 2021, at least 15% in 2022 and at least 20% in 2023. But if Maire Tecnimont does not achieve these targets, it will pay 10bp more.

Given the progress in 2019, many in the market believe 2020 will be rich with sustainability-linked Schuldschein issuance.

“We’ve had a lot of conversations with corporates after Dürr,” says Hoffman. “Listed corporates with a ready need to publish sustainability reports, for these borrowers sustainability linked Schuldscheine will be very interesting. There will certainly be many more to come.”

**GC**
Recent Schuldcschein Solutions inspired by RBI:

- **FRESENIUS**
  - EUR 700,000,000
  - Schuldcschein loan due 2023/2026/2029
  - Bookrunner
  - Sep 2019
  - Germany

- **AGRA**
  - EUR 200,000,000
  - Schuldcschein loan due 2024/2026/2029
  - Bookrunner
  - Jul 2019
  - Austria

- **Rail Cargo Austria**
  - EUR 251,000,000
  - Schuldcschein loan due 2024/2026/2029/2034
  - Bookrunner
  - Jul 2019
  - Austria

- **SALZGITTER AG**
  - EUR 313,000,000
  - USD 56,500,000
  - Schuldcschein loan due 2022/2024/2026/2029
  - Bookrunner
  - May 2019
  - Germany

- **ANDRITZ**
  - EUR 175,000,000
  - Schuldcschein loan due 2023/2026/2027
  - Bookrunner
  - May 2019
  - Austria

- **BOREALIS**
  - EUR 140,000,000
  - USD 70,000,000
  - Schuldcschein loan due 2024/2026/2029
  - Bookrunner
  - Apr 2019
  - Austria

- **EP Infrastructure**
  - EUR 182,500,000
  - Schuldcschein loan due 2024/2026
  - Bookrunner
  - Apr 2019
  - Czech Rep.

- **O2**
  - EUR 160,000,000
  - Schuldcschein loan due 2024/2026
  - Bookrunner
  - Mar 2019
  - Czech Rep.

- **s&t**
  - EUR 160,000,000
  - Schuldcschein loan due 2024/2026
  - Bookrunner
  - Mar 2019
  - Austria

- **DORR**
  - EUR 98,000,000
  - Schuldcschein loan incl. Green Tranche due 2023/2024/2026
  - Bookrunner
  - Feb 2019
  - Austria

- **CPI Property Group**
  - EUR 170,000,000
  - Schuldcschein loan due 2023/2025/2027
  - Bookrunner
  - Feb 2019
  - Czech Rep.

- **SenteCura**
  - EUR 53,500,000
  - CZK 240,000,000
  - Schuldcschein loan due 2024/2026/2029
  - Bookrunner
  - Feb 2019
  - Austria/France

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Mega funds muscle into European leveraged market

After assembling mega funds that can commit loans of €1bn and more, direct lenders are gaining ground in leveraged finance at notable speed. Besides size, firms such as Alcentra, Ares, BlueBay and ICG offer borrowers privacy, speed, fixed terms and long-term commitment. But are they all equipped for the torrent of distressed situations the next downturn is likely to bring? Karolliina Limatalainen reports

A res, the alternative asset manager with $144bn under management, set the pace in 2019 by providing more than €1bn of debt to British telecoms company Daisy in February. Blackstone’s credit division GSO went even larger with the offer of a €1.5bn loan to back Advent’s takeover of Eurofins’ direct lending business — although Advent eventually opted for a traditional syndication.

Jumbo loans reflect the credit funds getting larger. This year BlueBay closed a new €6bn fund, while Alcentra, Tikehau and Pemberton followed with respective €5.5bn, €2.2bn and €2bn funds of their own. Ares massive €5.5bn fund from 2018 still leads the pack in Europe.

Overall, Europe-based private debt assets grew from €24bn in 2008 to €135bn in 2018, according to data company Preqin.

These entities are “100%” becoming serious rivals to more traditional financing, says Chris Skinner, head of UK debt and capital advisory at Deloitte in London.

“In terms of deployment of capital, European direct lenders are not that far away from the high yield bond market any more. Looking at the first half this year, you are comparing €23bn against €30bn. The size of those deals and target markets are quite different, but the direct lending market is definitely growing faster than any other class in leveraged finance,” he says.

Credit funds can increasingly compete with banks even on pricing, notes Christian Savvides, co-head of debt advisory in Europe at Rothschilds. “The premium for a direct lending solution versus the capital markets solution has narrowed, and the potential deal size has increased significantly. A credit fund solution can be difficult to beat for sectors and deal structures that not everyone in the broader market is going to get on board with.”

He cites retail, construction, automotive and real estate as examples.

In response to the growing competitive threat from private debt, multiple banks — including Citibank, Deutsche Bank and Goldman Sachs — have established their own in-house credit funds. Others have paired up with direct lenders.

“RBS is an interesting example of this in the mid-market, with Hermes, AFG and M&G coming on board as direct lending partners,” Skinner comments.

Credit funds promise a higher degree of privacy and less bureaucracy than their alternatives. For one thing, borrowers are not required to provide financial details to a large group of leveraged loan or high yield bond investors.

“There are lots of borrowers who don’t necessarily want their potentially sensitive trading information circulating around the market,” says Skinner.

A further reason for direct lending’s rapid growth is its certainty of funding. “Borrowers ultimately have a choice — they either want day one lenders, capable of taking and holding the borrower’s debt, or they want an underwritten structure which will be sold into the market. There is a time and place for both approaches, but in their target markets direct lenders have been extremely effective in explaining some of the downsides of the latter — not least flex provisions,” he adds.

Bread & butter

While jumbo deals allow the largest funds to deploy a significant volume of capital in one go, the mid-cap market remains the bread and butter of direct lending.

“We will continue to opportunistically lend to the Daisies of this world, and we have a number of assets in our portfolio to which we have lent north of €500m. That said, we’re absolutely not moving from our core strategy,” says Michael Dennis, co-head of European credit at Ares in London. “By backing middle-market companies and providing additional capital to them...
as they grow, we are future-proofing deployment opportunities for us.”

The direct lending market is dividing in two, reports Neale Broadhead, head of European private debt at CVC in London. “There are some funds with significant amounts of assets under management who are doing a great job on large-cap deals, going elephant hunting Then you have other funds like us who are firmly entrenched in the mid-market and quite like remaining there.”

Pemberton, a direct lender backed by Legal & General, does not venture into the large-cap market either. This is to avoid being forced to compromise on loan terms and pricing, as in the currently borrower-friendly syndicated leveraged loan market.

“I’m sure the managers doing large-cap deals are making arguments that they’re getting good terms because they’re providing simpler execution and so forth. But fundamentally we view the large-cap market as a less attractive space,” says Mark Hickey, portfolio manager and one of three founding partners of Pemberton in London.

“The core mid-market space is the most-attractive from a risk/return perspective,” he argues, contending that small companies’ greater vulnerability to financial and operational shocks leads to higher loss rates.

**Downturn softening**

The next downturn will be the first test of the funds’ resilience. “We talk to our investors about that a lot,” Broadhead says. “We have a big team dedicated to private debt but we also have other analysts across CVC looking at the syndicated loans and a large and successful team looking over credit opportunities and special situations funds. It’s their lifeblood to deal with distressed companies.”

Dennis has seen no “cracks” so far in Ares’s direct lending portfolio in Europe and does not foresee an immediate downturn in the region. However, the firm is preparing for the end of the cycle by making the “vast majority” of its investments in senior secured debt, with covenants giving the lender extra protection. “We also have a dedicated team of 12 investment professionals whose job is to monitor closely the performance of the portfolio. A lot of our competitors haven’t made that same investment. If assets underperform we have the requisite experience and skill sets to ensure we protect our investors’ capital.”

About a quarter of Pemberton’s mid-market portfolio would have to default annually before investors lose any principal, according to Hickey. He argues strongly for the resilience of direct lending as an asset class. “I predict this product will outperform all other credit products in a downturn. Most of the public credit is unsecured and covenant-lite, and the losses in those asset classes are going to be huge in the next downturn. We have that downside protection in the form of much stronger credit agreements, and in the meantime, we’re making higher yields and fees on our asset class.”

Nonetheless, Deloitte’s Skinner anticipates harmonisation in private and public debt documentation stripping the funds of extra covenant protection. “Ten years ago, the high yield market, the US term loan ‘B’ market, the syndicated European loan market and what we now know as the direct lending market were offering relatively distinct products,” says Skinner. “Today harmonisation continues at pace. There is still some way to go, but it would not be that surprising if it were hard to tell the key commercial differences apart over the next five years.”

Jeremy Duffy, partner at White & Case in London, agrees. “In order to break into bigger and bigger deals, many direct lenders have had to effectively accept the covenant-lite terms, bring down their pricing and lower their fees. Their pricing is still above the banks’ in general but the documents are becoming more generic,” he reports.

A downturn may offer mega funds a chance to solidify their position at the top. Those with strong underwriting discipline gained after the 2008 financial crisis, notes Ares’s Dennis. “We made a couple of acquisitions and consolidated the US direct lending market on the back of the cycle. Something similar might happen in Europe in the next downturn. Winners will become consolidators and the losers consolidated,” he adds. Already, in Europe, the top 10 private debt managers are raising ever-bigger funds and deploying more capital, leaving only scraps for the remainder.

“The biggest teams can provide the best coverage and expertise to the private equity client base,” Hickey says. “Also, this year about a third of our investments are re-financings or add-on financings for companies that are already in our portfolio. There’s a virtuous circle which brings in more deals the bigger you get.”

Although the idea is untested in Europe, some analysis suggests credit funds may help soften economic downturns. This is because they are incentivised to keep the debt taps flowing in tough economic times, providing their portfolio companies a counter-cyclical source of credit even when banks are turning their backs, a recent study by the University of Pennsylvania’s Wharton School points out.

This model’s catch may prove fatal for weaker funds, however. “Raising committed capital should be a long-term game. Some funds will have problems in their portfolios — plenty of them already do. The question will be how they react,” Deloitte’s Skinner says.

Smaller funds in particular may end up “pouring good money after bad” if one of their limited number of portfolio companies struggles, he adds. And because they are paid based on deployment of their limited partners’ funds, it is in their interest to keep the taps open.

Nor is selling troubled assets viable, comments CVC’s Broadhead. “The sharks would smell the blood a mile away. For an illiquid asset class like that, the price would be devastated,” says Broadhead. “Instead, you need to look after the assets well and choose them carefully. We kiss a lot of frogs before we make our decision.”

CVC reports only lending to 3% of the borrowers it reviews in this area.

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“A credit fund solution can be difficult to beat for [some] sectors and deal structures”

**Christian Savvides, Rothschild**
Germany disappoints levfin market as volumes slump

Volumes in European leveraged finance took a dive in 2019, leaving leveraged credit investors struggling to find value. A string of take-private attempts, especially in Germany, had lenders and banker salivating, but fell apart before coming to market.

Owen Sanderson reports

New money supply in European leveraged loans has been disappointing in 2019, at net supply of €29bn, against €42bn in 2018, according to JP Morgan. Gross loan supply was €65bn, down from €79bn in 2018, and €101bn in 2017, and high yield proved even worse, despite a late surge. The CLO market, meanwhile, continued to bring new deals, worsening the technical squeeze.

“Simply put, investors needed to put cash to work in a market that wasn’t growing,” said JP Morgan.

Steve Vaccaro, chief executive of CLO manager CIFC, which did its debut European deal in 2019, says: “The process of launching our debut European CLO took a little longer than we had hoped, as the loan market saw relatively little activity, quality collateral was in short supply and we wanted to be patient and avoid doing something we would regret. We did not expand our business into Europe for a trade — it’s a long-term build.”

But much of this is a result of luck — if just a handful of LBOs, primarily in Germany, had swung the other way, European loan bankers might be toasting a vintage year, with net supply closer to €40bn than the €24bn recorded so far.

Take-private deals, especially in favour for under-loved sectors this year, are always uncertain — but Germany’s takeover rules must take much of the blame. Sponsors need 75% of capital to get paid. But whichever sponsor wins a deal, leveraged credit investors hope they have the chance to participate in the syndication. But 2019, unfortunately, saw too many slip-ups. Here’s a review of take-over attempts, especially in Germany, which owned the company before it was floated in 2015, wanted to buy it back — ideally through a full take-private, which their advisers prepared funding for but never used.

Acknowledging the challenges in Germany, however, the pair were willing to keep it listed, writing a larger equity cheque and using a financing package that fell short of the leverage levels for a classic LBO.

Nonetheless, shareholders didn’t bite — even to the 50% level required to get a decent foothold — and a $1.96bn-equivalent of new leveraged credit supply fell by the wayside.

Roll forward to the summer, and Metro AG, one of the largest basic goods chains in Germany, was in play. Czech and Slovak entrepreneurs Daniel Kretínský and Patrik Tkáč had lined up a financing package featuring more than €3bn of drawn leveraged loans for their €3.8bn offer.

Lighting manufacturer Osram, spun off from Siemens in 2013, and Bayer’s Animal Health unit also tantalised bankers and investors with chunky buy-outs — Osram’s board accepted a €4bn offer for 70% from Carlyle and Bain, before Austrian trade buyer AMS dived in with a higher bid. AMS fell foul of the same takeover issues that sunk Scout, with the 51% take-up for its tender proving inadequate to take control.

Bayer Animal Health, meanwhile, a spinout from Bayer, had private equity firms jockeying for position during the summer, hoping to win a deal whose value was talked up to about $8bn — likely to come with enough euro leveraged loan supply to ease investors’ issues around spending their cash. But the deal instead went to US trade buyer Elanco. The $5bn or so of debt expected to be issued by Elanco is still welcome supply for credit investors (the deal will take it from around four times levered to six times) but will probably lean more heavily on dollars than if a sponsor had won a standalone trade.

Still in play is another giant German deal — ThyssenKrupp’s spinout of its lifts business. By late November, private equity groups including Blackstone, Carlyle, Advent, and Cimven were in the running, alongside partners such as Abu Dhabi Investment Authority and CPPIB.

But the deal could still end up in the arms of Kone, a trade buyer from Finland, if European competition authorities bless the tie-up.

By its nature, M&A is always uncertain. Banks back bidders with financing, hoping they choose the right horse and get paid. But whichever sponsor wins a deal, leveraged credit investors hope they have the chance to participate in the syndication. But 2019, unfortunately, saw too many slip-ups. Here’s to a stronger 2020.

Source: JP Morgan
Derivatives • LevFin • Asia • Equity • Syndicated Loans
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Sponsors try to tame net short activists with covenant magic

Lawyers in the US have had a busy 2019 drawing up tough documentation to protect borrowers and sponsors from CDS investors — net short activists — trying to get their say on the future of a company. With these provisions spreading to Europe, 2020 could be an even busier year. Karolinya Liimatainen reports

Sponsors and borrowers are increasingly worried over the power wielded by credit default swap investors who buy into bonds or loans to get their say on the future of a company. These net short activists have an incentive to vote against a restructuring plan or call a default, potentially pushing a viable business into bankruptcy.

In May this year, the fears were realised when the first provision designed to curb net short activists appeared in a loan document for Sirius Computer Solutions, a US data services company which was being acquired by private equity firm Clayton, Dubilier & Rice. The advisor was advised by lawyers from Kirkland & Ellis, which is widely seen as one of the firms associated with the erosion of investor protections in leveraged loans and high yield bonds.

Since then, net short provisions have been appearing regularly in the US and making their way to Europe too — including in Merlin Entertainments’ buy-out financing in October.

“The net short provisions are here to stay,” says Todd Koretzky, a partner at law firm Allen & Overy in New York. “Conceptually, they are a justifiable attempt to dig a moat around a company. But it’s an elaborate process between the lawyers, arrangers, sponsors and the companies to ensure that a balance is struck so that lenders won’t shy away from the credit.”

The net short provisions were born out of the bankruptcy of US telecommunications company Windstream. It lost a court battle in February against hedge fund Aurelius, forcing Windstream to default on its bonds. Aurelius is reported to have pocketed about $310m over the collapse of the company.

John Williams, a partner at law firm Milbank, now sees net short provisions “a couple times a week” in the US — either in leveraged loans, direct lending or high yield bonds.

“About two-thirds of the time the provisions get taken out. The remaining third of the time our comments are ignored, and the provision stays. It’s very rare that people actually try to engage and improve the language,” Williams says.

Creditors’ upper hand

The provisions are much more likely to clear in the loan market than in the bond market. Williams says — adding that they are almost always removed in the direct lending space, where the creditors still maintain an upper hand over the covenants.

Broadly syndicated loans tend to be bought by passive institutional investors who are often not invested in CDS instruments at all, explaining why the provisions have the easiest time clearing in this market. However, according to Koretzky, some of the loan investors dislike the provisions because of the additional work they cause.

Koretzky and Williams have worked on different modified versions of the net short provisions that would provide clearer definitions on what qualifies as “net short” and a simpler way for the investors to prove that they are long on the company. This includes tough calls on which affiliates of the investor will be included into the calculation.

Williams has so far seen 30-40 deals in the US with a proposed net short provision in them, and he’s not happy with the muddled language of the documents. His suggestions include limiting the consequences of the provisions to just disenfranchising the net short investors — in other words, taking away their voting power in creditor decisions.

“We are adamant that any further consequences, like triggering a default or forcing [the company] to sell, should be removed from the documentation,” Williams says.

“The net short provisions are here to stay. Conceptually they are a justifiable attempt to dig a moat around a company”

Todd Koretzky, Allen & Overy

For lenders that are already inclined to be passive, net short provisions give them an additional reason to avoid voting — which in certain situations could harm the borrower.

In Europe, net short provisions are still exotic visitors. Bain-backed market research company Kantar and Apax and Warburg Pincus-backed satellite operator Inmarsat were forced to flex the terms of their buy-out bonds this autumn, after the investors pushed back on net short and other covenants.

UK theme park operator Merlin, which is being bought by Blackstone, Lego billionaires and Canadian pension fund CPPIP, managed to squeeze through net short provisions for its bonds and loans in October, in addition to a laundry list of other aggressive covenants — slammed by analysts as the worst ever.

Merlin is not necessarily representative of the European sentiment, says Jane Gray, head of European research at Covenant Review. “Investors spend more time on documentation concerns than ever before,” she says. “Unless the credit is really well liked, investors are consistently pushing back on the terms. But Merlin was so heavily oversubscribed on the bond and the loan that there was no bandwidth to push back.”

The bond investors see the CDS market as “integral to the success of the functioning bond market,” says Shoshanna Harrow, a senior analyst at Covenant Review.

“Because net short provisions are so new, they are very close to the top of the list of things that the investors want to push back on,” she says. “The problem is that lawyers can now say there’s a precedent with Merlin.”

GC
Demerger and direct-listings in focus as alternative to difficult IPOs

The European IPO market ended 2019 in soul-searching mood, following a tremendously problematic year. Issuers may look for alternatives should market conditions persist through to 2020. Sam Kerr reports

A wave of postponed transactions because of tricky market conditions points to a difficult truth for those involved in the European, Middle East and Africa equity capital markets: that for many companies the IPO process is not working because investors are refusing to participate in deals at what the sellers deem a fair price.

Volatility has undoubtedly played a part — investor risk appetite has been low all year — but even when market conditions have been benign or positive, the mismatch between what buyers want and sellers are willing to countenance has, more often than not, been too great.

As the IPO price discovery process faces scrutiny, there are discussions about whether issuers can find alternatives to the traditional IPO in 2020 and beyond.

Could Europe go direct?
The difficulties in the IPO market have caused many companies to postpone or cancel listings in 2019. Across the EMEA, IPO volume is down by 44% from 2018, which was also a quiet year, according to Dealogic. As of November 15, 2019, there were 110 fewer deals done across the region than in 2018.

The problems in the IPO market have prompted some to consider whether the European market might begin to see privately owned companies attempt to list on a stock exchange directly, without an IPO.

A direct listing allows a company to go public without the hassles and pressures of an IPO. Existing shares held by private company owners are sold directly on the public exchange, with the price being determined by an opening auction.

It is a model that was used in the US by Spotify in 2018 and Slack in 2019.

“I do not think direct listings are a solution for everything, but the way that the pendulum is moving is interesting and these are being given more airtime than they have been before,” says Richard Brown, a corporate financial partner at Baker Botts in London. “The debate remains US focused, but most of the features being talked about apply to London as well.”

Direct listings are not an option for all companies and are only applicable in specific conditions. However, the flurry of pulled transactions in 2019 might give companies grounds to give this listing method greater consideration as an alternative.

“People are questioning the way things are done and are moving to a more engaged approach, where we are all questioning the traditional IPO process and asking whether there are better ways of doing this,” adds Brown. “This all involves addressing different issues and making the listing process more efficient. “You need a broad shareholder base which generates liquidity on day one and if you have that, you can list without taking the risk on the day-one IPO pop and let the market find the price.”

However, veteran European ECM bankers are sceptical that there are enough European companies with the broad number of shareholders required to do such a deal.

“We have been fielding a number of questions about direct listings and I think the answer is relatively simple,” says James Manson-Bahr, head of the EMEA equity syndicate at Morgan Stanley in London. “You need a very big register to do a direct listing; one with multiple shareholders.

“If you think about the way the US and EU dynamic works, in that the start-ups here are funded by venture capital money compared to institutional money in the US, it isn’t obvious that there are many EU assets with the necessary
shareholder dynamic.”

Along with a large pre-existing shareholder register, companies seeking to list without an IPO need to have a profile high enough to attract public attention and have support for the stock on day one.

The two largest examples of US direct listings, Slack and Spotify, were both well-known long before becoming publicly traded companies, with vast pools of potential retail buyers awaiting their floats.

“You need a well-known company with a history of successful private market transactions and marketing, and a large enough pre-IPO shareholder register willing to sell stock,” says David Koch, head of southern European equity capital markets at Barclays in London. “A prospective issuer will also need to enlist the help of banks to prepare the company for the listing, and to help ensure there is a functioning aftermarket and a potential research following. [Prior to their listings Spotify and Slack] benefited from multiple rounds of private capital raising.”

**Poor performance**

The two US tech unicorns have not traded well since their direct listings, which might deter other potential issuers. Slack has fallen 42% since it started trading on the New York Stock Exchange in June. Meanwhile, Spotify has experienced bouts of volatility since it listed in 2018.

While tech IPOs have also have had a mixed performance, the fact direct listings have not fared much better might persuade Europeans that an IPO is still the way to go.

“People are assessing how to access capital and it might be that direct listings are the answer, they might not be,” says Daniel Burton-Morgan, head of UK equity capital markets at Bank of America in London. “However, people are happy to ask the question and do the analysis.”

“One of the challenges is that the sample set of big direct listings is small versus, say, the number of tech IPOs that on the whole have made investors good money.”

Corporate simplification — where businesses spin off divisions they no longer deem core — continues to be a popular activity and is a driver of ECM activity. While in previous years this would have meant a host of IPOs, difficult conditions might persuade some issuers to de-merge through spin-offs instead.

“De-mergers/spins next year will depend on the IPO market and broader sentiment,” says Manson-Bahr. “The Prosus listing was a great example of the natural next step for Naspers to take in its continued efforts to realise fair value [for their asset base].”

**Continental prospects**

Continental was expected to be an IPO seller in 2019, with the company keen to carve-out its powertrain division. After tricky markets and a disappointing set of financial results delayed an IPO in April, in September it announced that it was considering to spin-off up to 100% of its powertrain division, as an alternative to a partial flotation. That will likely go ahead in 2020.

Spin-offs do not mean less work for investment banks, however.

“The spin-off process tends to be coupled with an intensive marketing plan. Much like an IPO, you take the company out on the road and meet with existing investors of the parent company and the new potential investors which would be interested in the company being spun-off,” says Koch. “So when you actually list, you have a market which is waiting for it.”

“You often have flow back from the parent company shareholders who are not interested in the new entity and are sellers, and you aim to match that selling with new investors from the marketing process to buy it, creating a more stable aftermarket.”

*You need a well-known company with a history of successful private market transactions and marketing, and a large enough pre-IPO shareholder register willing to sell stock*  
David Koch, Barclays

*“Similarly, we have line of sight on corporate spin-offs for the first quarter of next year. Sub-IPOs can be very successful, but if you don’t need to raise capital, as was the case with Prosus, the more sensible thing is to do a spin or a separate listing to achieve your objectives.”*

Because the reasons for a spin-off tend to be strategic in nature, rather than an issuer just seeking to profit from the sale of shares in an IPO, a spin-off makes sense in order to get a deal done, as Naspers proved.

“We were a financial adviser on Naspers’ spin-off of Prosus, which was the biggest spin-off this year and the largest global listing this year, a roughly €100bn deal which we did in September,” says Koch, adding that Barclays is in conversation with a number of prospective spin-off issuers. “It is now the largest listed consumer internet companies in Europe by asset value and one of the largest technology companies in Europe.”

“That process is something we would expect to see far more of, given we have a number of diversified conglomerates in Europe that could look to create value enhancement for shareholders by creating a reference price for a subsidiary, are transforming corporate strategy and have businesses which have taken on a life of their own after growing considerably.”

One prospective issuer has already decided that a spin-off might be a more attractive option than an IPO.
Prospects grow for a brighter year for Russian ECM

Russian issuance has been a success story in what has otherwise been a largely disappointing year for the EMEA equity capital markets. Positive momentum should carry through into 2020 with hope that IPOs will follow a good year for blocks and beef up the Russian stock market. Sam Kerr reports

Primary equity market activity in Russia in 2019 has followed a strong year in secondary equities, which if sustained through to 2020, should continue to drive ECM. Russia’s benchmark MOEX Index had grown by 30% between the start of the year and the end of the first week of November. The top two performers year-to-date have been industrial holding company Sistema and energy firm Gazprom, up 82% and 74% so far.

When combined with strong fundamentals, Russia’s outperformance relative to other indices, has made it one of the most popular regions among EM equity fund managers.

“We see equity investors as being positive on Russia — by our calculations, Russia is the largest country overweight for actively managed global EM funds,” says Ruslan Babaev, co-CEO of Renaissance Capital in Moscow. “Investors like the de-risking of the Russian economy that they have seen in the past four or five years: floating the rouble, adopting inflation targeting and the budget rule, rebuilding FX reserves and the budget surplus funds, as well as companies paying much higher dividends now than in the past.”

Oligarchs come to market

The growth in the value of listed Russian stocks in 2019 has prompted a resurgence in equity capital markets issuance, after a dire 2018.

According to Dealogic figures as of the end of the first week of November, Russian equity capital markets volume was up by 336% in 2019 compared with same period in the year before.

The increase in Russian equity capital markets activity is astounding given total EMEA volumes declined by roughly 18% and overall emerging market EMEA equity capital markets volume is down by 7.8%.

The $3.2bn of Russian issuance was the most from a single country in EMEA EM equity capital markets as of the beginning of November, although it will almost certainly lose its crown should Saudi Aramco list on the Saudi Tadawul exchange in December.

Most Russian volume emanated from secondary accelerated trades, with shareholders, often wealthy oligarchs, taking advantage of warmer investor sentiment towards the country and rising stock markets to monetise some of their holdings.

Two of the most prominent sellers in Russian ECM in 2019 were billionaires Roman Abramovich, who sold shares in Evraz and Norilsk Nickel, and Oleg Tinkoff, founder of Tinkoff Credit Systems.

According to Babaev, secondary blocks should “continue if the market rallies during next several months”.

Rising markets incentivised sellers to bring block trades but these transactions could not have happened without the investor demand.

The market was devastated in April 2018, following US sanctions against Russian oligarchs, particularly aluminium magnate Oleg Deripaska.

However, better relations between Russia and the US, or certainly less noise about further sanctions, spurred ECM in 2019 and should provide a solid base for deals in 2020 if political volatility remains muted.

“One of the reasons behind an increased ECM activity this year is a deferred demand, i.e. some of the deals that we have seen in the market this year were planned back in 2018, but were postponed,” says Boris Kvasov, co-head of equity capital markets at VTB Capital in Moscow. “Additionally, the market has adapted to the geopolitical risks, although they remain to an extent.”

Russian risk though has by no means subsided. The US enters a presidential election year in 2020 and there could be further action in the form of sanctions, like those
in April 2018. For some investors Russian risk remains acute. “In our inactive portfolio we have a very modest amount of money in Russia and the reason for that is quite clear: the overarching risk factors behind Russia has not really changed and it is no less easy to quantify,” says Edward Evans, portfolio manager, emerging markets equity at Ashmore Group in London. “Given I am a global emerging market portfolio manager I can look across a huge universe that, on a balance of relative attractiveness, is more straightforward than parking my money in Russia and running the risk that I can wake up tomorrow and not be able to give you your money back.”

However, should political pressure on Russia remain muted while geopolitical tension around the rest of the world increases, there will be more deals and more growth for Russian equities. “On the equity side Russia seems to be a good story, but it’s probably far less to do with Russia itself and more to do with the rest of the world becoming more problematic, on growth and geopolitical risks,” says Vladimir Tikhomirov, chief economist at BCS Research. “Three or four years ago Russia was a standout example of a negative equity story given sanctions, but now all regions are exposed to geopolitical risk, Russia is no longer a unique story. “Peak Russian geopolitical risk appears to have past and Russia is no longer the top story in the US election cycle after the Mueller investigation, which did not find a lot of evidence of huge Russian interference in elections, meaning it is less of a geopolitical concern for investors.”

Investors speaking to GlobalCapital throughout the 2019 have also highlighted Russia’s low GDP growth as another potential barrier to investment, but with global growth expected to slow in 2020, an improvement in Russian fundamentals might tempt equity investors to support Russian issuance. Russia is expected to grow more in 2020 with President Vladimir Putin’s government expected to kick-start Russian growth and boost the popularity of his ruling United Russia Party through fiscal spending. “We estimate GDP growth won’t hit even 1% in 2019 (0.9% versus consensus of 1.1%) tamed by an unfavorable combination of a VAT hike, tight monetary/fiscal stance, and lower export flows. However, all these short-term headwinds dissipate already next year,” says Anna Vyshlova, co-CEO at Renaissance Capital in Moscow. “In 2020, we expect growth to rebound to as much as 2.6% (versus 1.6% consensus), with consumer and investment demand up by 2.9% and 3.6%, respectively. “Broad-based recovery will be driven both by cyclical and structural factors: a long-awaited easing of both fiscal and monetary policies (75bp of rate cuts left) and effects of pension reform and national projects implementation. In 2021, we see Russian growth at 2.2%.”

IPO supply needed A resurgent Russian block market buoyed investors in 2019 but masked a more fundamental problem for Russian equity investors, which was a lack of new deals to broaden its stockmarket. There has been only one Russian deal year-to-date in 2019, the $253m IPO of recruitment IT services firm Headhunter Group on the US Nasdaq. Investors are hoping that 2020 can be more like 2017 when four new Russian companies were brought to market, contributing almost $2bn of issuance volume. “We know that quite a few companies are considering placements and Headhunter’s IPO earlier this year evidenced that investor demand is in place,” says Vyshlova. “However, investors remain very selective in their demand and a strong equity story is key.”

A number of large Russian companies are considering IPOs again. The biggest deal in the pipeline is a listing of Russian petrochemicals company Sibur. A Sibur IPO would likely be a Moscow listing, at least primarily, with shares sold by its largest shareholder Leonid Mikhelson, Russia’s richest man according to Forbes, owns 57.5% of Sibur and is understood to be keen to put a value on the asset after first buying a stake in 2017.

Gennady Timchenko, and Kirill Shamalov, Russian president Vladimir Putin’s former son-in-law, also have stakes in Sibur. Alongside Sibur, Burger King Russia and taxi-app company Yandex Taxi are thought to be considering IPOs for 2020. “After a volatile 2018, the market is currently reaching a certain balance, and this translated into a number of deals, primarily ABBs, being closed this year,” says Kvasov. “At the same time, any IPO requires significant time for preparation, usually at least six months. In this regard, the most likely window for initial public offerings may be March or April next year on the back of FY 2019 financial results.”

Muted IPO activity in the past two years has come at the same time as Russian companies de-listing from public markets, thereby reducing the number of tradeable Russian equities that investors can buy. One of the best examples of this trend is Megafon, one of the top mobile providers in Russia, which delisted in 2018. This spate of delisting means that although many investors want to take advantage of Russian equities, the tradeable securities on offer remains small, making new listings an imperative.
Investors get behind primary capital raising technique

Europe’s equity capital markets bankers are looking at 2020 with an eye on jumbo equity capital raisings to fund merger and acquisition activity, building on the momentum behind such trades in 2019. 

Sam Kerr reports

This year’s form bodes well for 2020 primary raises; the two largest European deals of 2019 were capital raises carried out to fund M&A activity.

The largest European ECM transaction of 2019 was a £2.7bn block traded by AstraZeneca to part-fund a transformational oncology collaboration with Japanese pharmaceuticals company Daiichi Sankyo. The runner-up was a €2.5bn rights issue undertaken by Cellnex to fund the acquisition of the telecoms division of Arqiva. Both deals were wildly popular at the time of execution — Cellnex, for example, attracted almost €100bn of orders for a €2.5bn deal.

Banks are using the success of growth capital raises in 2019 to try to encourage other clients to take advantage of the market in 2020.

“Corporates are aware of the strong investor interest backing primary equity capital raises — not least given the multiple transactions we have done this year,” says James Manson-Bahr, head of EMEA equity syndicate at Morgan Stanley in London. “They are a very successful way to raise capital, and are fair for shareholders. Doing a rights issue or a wall-crossed block trade is an inclusive way of ensuring your existing shareholders get a look in alongside a broadening out to the market.”

The Cellnex transaction in particular was notable, because it came at a time when IPOs were struggling to attract enough demand to get deals across the line. Banks are aware that equity investors will likely continue to be far happier investing in established listed companies, where capital spend has been minimal recently, particularly in the form of M&A.

The UK held a general election on December 12, and there is a strong feeling among both investors and bankers that the result of the poll will likely lead to a resolution over the UK’s exit from the European Union in 2020.

A Conservative Party majority result should lead to more M&A, but as companies such as Cellnex and AstraZeneca proved in 2019, investors are happy to back solid corporate stories, even if the world looks less than favourable.

“Investors typically have a view on related M&A targets — while they might not know the specifics, they will have already done some work and articulated internally their views around that target,” Manson-Bahr adds. More M&A will drive more companies to raise equity capital and much of this activity could come from the UK.

The surprise agreement reached between the UK government and the European Union in October 2019 over the terms of the UK’s exit from the EU, led to renewed optimism for the country’s capital markets.

There is hope that an orderly Brexit will lead to an increase in investment from UK companies, where capital spend has been minimal recently, particularly in the form of M&A.

What are the things you most fear could derail the ECM market in 2020?

Source: GlobalCapital

Convertibles start rolling again as share prices soar

Europe’s convertible bond market enjoyed a modest recovery in 2019, even though interest rates stayed low, reducing the market’s appeal as a cheap funding source. Going into 2020, there is cautious optimism that the revival will continue, helped by issuers monetising stakes in other companies. As Aidan Gregory reports, the asset class should attract investors worried about an economic downturn.

After 2018, which was one of the quietest years for new equity-linked issuance since the financial crisis, Europe’s convertible bond market bounced back in 2019.

Sustained low interest rates had held back the market for some time. However, equity markets worldwide hit new highs in 2019, prompting many companies to re-examine the terms that can be achieved on convertible and exchangeable bonds. This led to more new issuance, which Armin Heuberger, head of equity-linked debt at UBS in London, says has been driven by a couple of factors: “Share price levels have recovered strongly and have provided a strong base to strike premiums off,” he says. “Secondly, the market has continued to be starved of new paper, hence the investor bid remains extremely strong, both from hedge funds and outrights, allowing issues to price very successfully.”

There was €16.4bn of new issuance in EMEA in 2019 (up to November 25), according to Dealogic, up from €11.6bn in the whole of 2018. But these volumes are still not large. A £3.4bn mandatorily convertible bond from Vodafone, the UK telecoms firm, formed a quarter of the volume and one from Swiss building materials company Sika another.

“It is coming off a low bar and around £5.2bn is mandos, which have a more limited audience in Europe, but it is still helpful,” says Jon Murray, head of EMEA equity-linked origination at Mizuho in London.

New issuance in the US — $53bn this year — still puts Europe in the shade.

“‘The US [stock] market has outperformed Europe and most of the other global markets,’ says David Hulme, managing director at Advent Capital Management in New York.

“Strong equity performance tends to beget issuance because companies are more likely to sell convertibles when their stock prices are high. The interest rate profile in the US is a bit different to the rest of the world. Extremely low interest rates in Europe mean companies are more inclined to borrow in the straight debt market.”

European equities underperformed during 2016-2019, up only 23% against 42% for the US. However, in 2019, Europe has been running almost as fast: as of November 25, the S&P 500 had risen by 25% and the EuroStoxx 50 by 24%.

A persistent structural reason why convertible bond issuance in Europe lags the US, is that Europe has fewer fast-growing tech companies, which are the biggest source of supply in the US. Some 47% of US equity-linked issuance in 2019 came from computer and electronics companies, according to Dealogic, but only 16% of European issuance.

How low can you go?

If there is one thing that market participants agree has been holding Europe’s convertible bond market back, it is ultra-low interest rates.

There is an interest cost saving for companies when issuing convertible bonds. Equity-linked investors are willing to accept much lower coupons than those on straight bonds, in exchange for an option to convert the bonds into cheap shares if an issuer’s share price rises above the strike price for conversion. However, the bull market for credit and low government bond interest rates have enabled European companies to raise large amounts of capital at extremely cheap costs with ordinary bonds, which do not risk diluting their shareholders.

“In the absence of M&A or refinancing of existing convertibles to drive new issuance, corporates have sometimes struggled to get to grips with potential dilution, given where rates and spreads are currently,” says Murray.

Many have therefore shunned convertible bonds.

“European issuance has been better than last year but it is still not looking fantastic,” says Tareen Carmichael, head of convertible bond sales at UniCredit in London. “The negative yield environment isn’t going away. We are talking about years now. It is the new normal.”

2019 will be remembered as the year when euro government bond yields hit record lows, amid small spikes
in equity volatility, as a result of trade tensions between the US and China and fears of a slowdown in global growth.

The European Central Bank restarted quantitative easing in the autumn, depressing the region’s bond yields still further. It now has a new president, former IMF managing director Christine Lagarde, but there is unlikely to be any substantial hardening of monetary policy in the near future. Few expect a rate rise in Europe in 2020 or even the following year.

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Despite the ready availability of cheap money in the conventional bond market, a good range of issuers, both investment grade and unrated or high yield companies, did come to the equity-linked market in 2019, particularly in France.

While convertibles issued for conventional financing purposes have not been common in 2019, there was a rash of European firms issuing bonds exchangeable into shares of companies they own. At its simplest, this technique monetises a stake, obtaining a higher price for the shares than the market price. This form of issuance is likely to continue or increase in 2020.

“Considering the solid performance of stock markets and low rates, it makes sense for exchangeable bonds to be compelling instruments,” says Xavier Lagache, head of EMEA equity-linked debt at Deutsche Bank in London. “Convertible bonds will more rarely be seen as the most attractive debt financing alternative by CFOs, especially for investment grade issuers, but exchangeable bonds are a different story.”

Issuers such as Group Bruxelles Lambert, LVMH and Atos issued large exchangeable bonds in 2019 with aggressive terms. In October, Atos, the French IT services company, issued a €544m five year bond exchangeable into some of its non-core stake in payments group Worldline at a negative yield of minus 1.68%. It struck a conversion premium of 35% above the price achieved in a concurrent block trade, which was 27% above where the stock began the year.

When investors buy exchangeable bonds, they take credit risk on the issuer, but are exposed to the share price volatility and performance of the underlying. This mix is often highly attractive for investors, particularly if the underlying is from a sector under-represented in the convertible bond benchmark indices. Issuers, meanwhile, secure extremely cheap financing on a stake that may be non-core.

“Exchangeables make a lot of sense and will continue to do so for a while,” says Murray. “The redemption schedule [of equity-linked bonds] remains high and as long as fund flows hold, it is clear we are going to have a supportive landscape for these trades, especially when there is a strong credit, coupled with an interesting underlying. Whether as part of a disposal strategy or purely for opportunistic financing, it is probably the best time ever to be proactive and think about making your stakes work for you.”

Investors see this kind of activity continuing into 2020, as long as stock markets remain buoyant.

“The convertible market is a unique way for a company to monetise a strategic stake,” says Hulme. “If they wanted to unload that type of stake into the equity market they would generally have to sell it at a discount. By issuing a convertible they can effectively sell the stake at a premium. I would anticipate more of that kind of activity as companies try to simplify themselves.”

**Seller’s market**

The prolonged shortage of new issues in Europe and a steady flow of redemptions has created a seller’s market, in which issuers can achieve stellar terms on convertible bond offerings. This is unlikely to change going into 2020.

More money is expected to flow into the asset class because many investors are conscious that the cycle is old, with stock markets at record highs but still rising further. Even though there are fears that an economic downturn is approaching this is creating an even stronger bid for convertible bonds, which offer the combination of equity upside and debt-like downside protection.

“The equity-linked market has been consistently a very friendly issuer’s market, a seller’s market, whereas if you compare it across to equities via IPOs and blocks, on balance that is probably more a buyer’s market,” says Heuberger.

“Good performance of the asset class, coupled with defensive characteristics into a more uncertain and more volatile environment going forward, has helped with fundraising.”

2020 promises to be just as volatile than 2019, with the Brexit deadline, the continuing trade war between the US and China, US elections, and more tensions in the Middle East. This dynamic is fuelling interest in convertibles, even though many believe a correction is coming.

“A lot of people are coming round to the idea that equities will be more volatile going forward, so convertible bonds make sense as an alternative,” says Tarek Saber, head of convertible bond strategies at NN Investment Partners in London.

“In our sphere there are good returns to be made. If equities sell off, you don’t lose as much and then you will be better placed for a recovery.” GC
After the Federal Reserve’s hawkish attitude in 2018, a more dovish mood at the US central bank meant that 2019 was smooth sailing for many emerging market borrowers. However, political storms meant the turbulent asset class still threw up its share of rocks for borrowers to navigate.

The *GlobalCapital* editorial team selected the best deals of the year, considering not just the eventual result of the trade, but the backdrop against which the deals were sold.

The winners are presented here. Congratulations to those involved.

2019 bond deals of the year: emerging markets

**Egypt**

$500m 4.55% four year, $1bn 7.05% 12 year, $500m 8.15% 40 year

BNP Paribas, Citi, JP Morgan, Natixis, Standard Chartered

Egypt has had a remarkable economic turnaround over the past couple of years. After an austere IMF programme, it has become a popular credit in emerging markets. Its aggressive programme of economic reforms has left investors keen to participate in funding infrastructure developments.

Nowhere was that made clearer than in its triple tranche bond issue late in 2019, particularly when it made its debut at the 40 year part of the curve.

Coming in November, when many investors were moving away from risky assets to lock in returns, the deal did not have the easiest market backdrop. However, the tricky conditions clearly did not hold Egypt back — the deal received $14.5bn of orders and was priced 10bp inside the curve on all three tranches.

**Ukraine**

$500m 8.25% five year

JP Morgan, Dragon Capital

Ukraine Railways might not have been able to access the bond market a year before, but thanks to the election of President Volodymyr Zelensky and his market-friendly policies, attitudes to Ukraine had improved by July.

Ukraine Railways was also helped by the prevailing environment of low yields, which left investors hungry for riskier credits such as Ukraine Railways. The yield was 8.25% — a stiff 40bp inside where some EM investors put fair value and one of its tightest ever spreads to the Ukrainian sovereign.

But even with the favourable environment, the deal still impressed. While some investors balked at the price, it turned out to be a strong approach, securing an excellent cost of funds, but still leaving enough on the table for secondary market performance.

**Peru**

N$1.84bn ($545m) re-opening of 5.4% 2034s at 104.5143 to yield 4.95%.

N$8.26bn ($2.445bn) 5.35% 21 year

Bank of America, Citi, HSBC, JP Morgan

November’s local currency bond from Peru came just six weeks after one of the worst constitutional crises in the country’s history. The deal’s success — achieving record yields for the issuer on both tranches — was in part testament to investor faith in the country’s economic outlook amid political volatility. Indeed, international accounts took some 70% of the trade, even as major social unrest was taking hold across Latin America — including in fellow investment grade countries Chile and Colombia.

The liability management deal also highlighted the progress made by the debt management office in recent years in increasing liquidity in its domestic curve. Peru is now a seasoned local currency issuer, and the outstanding stock of sol government bonds has more than doubled since 2015. Average daily trading in the local government bonds has increased sevenfold. While global local currency issuance from corporates has been nearly non-existent in other countries, Peruvian companies, including Telefónica, Alicorp and Interbank, have taken advantage of liquid government benchmarks to issue abroad in soles this year.

**Sharjah Islamic Bank**

$500m 5% perpetual non-call six year sukuk additional tier one capital

Citi, HSBC, Standard Chartered (global coordinators)

Sharjah Islamic Bank’s first AT1 met with overwhelming demand at its launch in June. Some $5bn of orders piled into a deal capped at $500m.

The dearth of supply from the region in the wake of Eid and the US Federal Reserve’s dovish meeting had combined to leave investors scrabbling to pick up risk assets with positive yields. Investors were attracted to the deal by the 5% handle, but in truth, it was hardly over-generous for Middle Eastern bank capital, particularly in a week when Commerzbank’s debut AT1 hit the market with a 7% yield. In fact, Sharjah’s 5% coupon equals UBS for the lowest coupon ever for a dollar AT1.

The slim yield reflects investors’ confidence that Sharjah Islamic Bank enjoys strong support from the United Arab Emirates’ government.

**Ukraine Railways**

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Russian borrowers march on as fear of sanctions fades

Five years after the US and EU slapped sanctions on Russia following its invasion of the Crimean peninsula, the country’s capital markets are doing far better than many expected. Mariam Meskin reports

Russian issuers and investors proved sceptics wrong in 2019, in what many have called a phenomenal year for the country’s debt capital markets given the difficult circumstances.

“We were positively surprised by the high volumes of Russian bond issuance in international markets this year,” says Olga Gorohovskaya, co-head of DCM at Sberbank in Moscow. “In the second half, we saw a flurry of issuance from borrowers, including some companies that we did not expect to come to the market this year that took advantage of the low rate environment to print debt.”

In 2013, the year before US and European Union sanctions were placed on Russia, the country’s borrowers issued 94 bonds internationally. That number dropped to seven in 2015, as sanctions were extended and more countries got behind the US and EU.

However, by mid-November 2019, Russian issuers had issued 35 bonds internationally, according to Dealogic, accompanied by a tightening of spreads across the board, which some observers say shows some normalcy returning to Russian markets.

This is more impressive considering the sanctions that the US Treasury slapped on Russian sovereign debt in response to the attempted assassination of former Russian spy Sergei Skripal in 2018. Those sanctions prevent US financial institutions from purchasing new non-rouble denominated Russian sovereign bonds in the primary market, though US investors are still buying that debt in the secondary market.

While in the past, sanctions of this scale would have meant a complete shutdown of the Russian debt markets, they appear to have had little effect this time. Indeed, Russian issuers have not been deterred, with 11 of them raising bonds between August 2019, when the Skripal-related sanctions were imposed, and mid-November.

Borrowers include steelmaker Severstal that raised $800m just a month after the latest sanctions and achieved the lowest ever coupon for a Russian non-government corporate issuer of 3.15%.

While those tight spreads and higher levels of issuance are in part due to declining interest rates and quantitative easing being re-introduced by the ECB, investors say they are also a sign that sanctions do not inspire fear as much as they once did.

“Investors do not care as much about sanctions anymore — it’s in their peripheral vision but more important is the nature of the issuer,” says Richard Segal, senior investment analyst at Manulife Investment Management in London.

Banks involved in Russian debt capital markets agree that in the investor community sanctions have begun to lose some of their bite.

“We saw high participation from international investors this year, despite the geopolitical restrictions in place,” says Andrey Solovyev, global head of DCM at VTB Capital in Moscow. “International investors are less sensitive to politics — they will buy debt if they are comfortable with the fundamentals and credit ratings of an issuer. From a macroeconomic perspective, Russia is very strong. Putting aside the sanctions risk, the sovereign and most corporates are A-rated equivalent.”

Norilsk Nickel, one of Russia’s most frequent and well-known issuers, raised a $750m Eurobond in October, with its lowest ever coupon. “We have seen easing on the risk premium associated with sanctions,” says Igor Burlakov, head of capital markets at Sova Capital in Moscow.

Some participants are confident that Russian markets are on their way back to normality, believing the investor community no longer sees the country’s debt as “too risky”.

“The pricing that Russian issuers have achieved in the second half of this year have been some of the lowest values I have seen in two decades — the established corporates are achieving the lowest possible values,” says Gorohovskaya at Sberbank.

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This strong performance is expected to carry into 2020 as global interest rates will remain low and the Russian economy continues to improve — the IMF forecasts GDP growth of 1.9% in 2020, up from a projected 1.2% in 2019. “We could see substantial issuance in the first quarter — some people thought because it has been a busy year that it will slow down in 2020, but that is not the case. We have a busy pipeline, especially in the first half of the year,” says Segal at Manulife.

Destination: diversification

The pipeline may get more exciting if Russian issuers continue to access a widening range of foreign markets, which some say is a “de-dollarisation” tactic to reduce the fallout from potential additional US sanctions.

While sanctions may have left investors mostly unscathed, they have had a structural impact on Russian capital markets. Since 2014, Russian banks and borrowers alike have been the

Russia

Source: Dealogic

working overtime to develop a buffer to a potential increase in sanctions.

In October 2019, Russia’s deputy finance minister Alexei Moiseev confirmed Russia would issue renminbi government bonds by early 2020 as more Russian corporates begin eyeing Chinese markets. But it is the euro that offers the deepest alternative to dollars. Indeed, in September at the Loan Market Association’s syndicated loans conference in London, Penelope Smith, head of developing markets corporate loan origination at Commerzbank, said that the newest trend lenders were seeing in Russia was the rise of euro-denominated lending.

“In 2018, 15.79% of loans raised in Russia had a euro-denominated tranche. By mid-November this year, the euro’s share had risen to 35.71%.”

“Euro funding is attractive for borrowers for two reasons: firstly, it is less subject to sanction consequences, although it is not completely insular from it, and secondly, it is the natural funding base of European banks, a number of which are part of the lender landscape in Russia,” says Zvi Wohlgemuth, head of project, asset financing and emerging markets syndicate EMEA at Société Générale. "It is difficult to predict volumes for 2020, but we think it will be a similar story to 2018 and 2019. We are primarily seeing depressed volumes because of low issuance rather than lack of demand, which may in part be due to local liquidity, which can be competitive.”

While in the past international banks dominated the dollar-denominated loan market, Russian corporates are finding it increasingly easy to raise non-rouble funds at competitive rates from Russian banks that are frequent users of FX swap markets.

“Russian banks are making bigger efforts to lend in foreign currencies and are offering competitive rates by swapping rouble funding into dollars in the swap market,” says a European banker who chose to remain unnamed.

International banks’ lending teams have not been aided by an increasingly attractive bond market.

“In Russia, banks are primarily working with large corporates that have access to both markets,” says Vladislav Chiriac, head of CEEMEA loan syndicate at UniCredit in London. "This increases the competition for loan products. Volumes in Russia may pick up slightly in 2020, but we expect them to remain flat."
Ukraine moves past political troubles to enjoy record run

Ukraine’s political establishment was shaken up and, in large part, replaced by newcomers early in 2019. The lead up to the election was fraught, as investors’ fear of the unknown drove up Ukrainian rates. But President Zelensky swiftly won over the international community, setting up a superb run of borrowing. Lewis McLellan reports

Ukraine’s corporate borrowers have taken full advantage of their time in the sun, turning in the highest number of international deals since 2017, according to Dealogic.

Investors’ confidence in the nation’s economy is strong. Paul Greer, senior emerging markets portfolio manager at Fidelity, still considers Ukraine to be a candidate for ratings upgrades, even after both Standard & Poor’s and Fitch upgraded the sovereign in September. Fidelity is overweight Ukrainian assets, both local currency and external.

That seemed impossible in the first quarter of the year. Rarely has the opinion of the international community on an emerging market political leader shifted so quickly and so profoundly. In March, investors in Kiev were bemoaning the fact that the broader rally in emerging market debt had barely touched Ukraine because of concerns around the wildcard presidential candidate comedian-turned-politician Volodymyr Zelensky.

By the middle of 2019, Zelensky’s Western-friendly approach had won him plenty of fans and restored Ukraine’s market access.

The restoration of confidence in the Ukrainian economy has brought down borrowing costs substantially. Eurobond yields are at their low for the year — around 6%-7%, three to five percentage points down since the start of the year,” says Alexander Martynenko, head of corporate research at ICU in Kiev.

But while the borrowing costs have come down a long way, Martynenko believes that there is still value at present levels. “Ukraine assets are still quite attractive compared to Europe.”

Alexander Martynenko, ICU

In 2019, Clearstream added Ukrainian hryvnia T-bills to its network, allowing easier international settlement. “Clearstream has made it easier for us, and others, to invest in Ukraine’s local currency sovereign assets,” says Greer. “It’s another step in the right direction, opening up to foreign portfolio inflows.”

The equivalent of around $5bn of foreign currency has flowed into hryvnia T-bills in 2019, around half of which came via Clearstream. But Martynenko believes there is more to come. As of November, the government auctions have not been large enough for some big funds to take positions. However, Ukraine is doing its best to tap foreign investors’ appetites.

It auctioned a four year note in early November, moving longer in the curve to access foreign accounts. “International demand exceeded supply by five times,” says Martynenko.

Corruption still a concern
“Tackling corruption is always a challenge in Ukraine, but we’re encouraged to see Zelensky attacking it with more vigour than Poroshenko,” says Greer. But while Zelensky is making the right noises, he will need to back it up with action if he is to retain his international credibility with investors and with the IMF.

In November, the IMF gave Ukraine a 10 point action plan for a new extended fund facility. One of the points will require Ukraine to put in place legislation to ensure that the liquidation of bankrupt banks cannot be challenged by court decisions, nor to return to the market.

This is in response to the court cases challenging the IMF-mandated decision to nationalise Privatbank, Ukraine’s largest bank. The former owners are suing the Ukrainian central bank to obtain compensation or control of the bank.

One of the former owners, an oligarch called Ihor Kolomoisky, met President Zelensky late in 2019, fuelling speculation that the president would aid Kolomoisky in his efforts.

Zelensky must do what he can to allay these rumours and co-operate fully with the IMF if Ukraine is to fulfil its economic potential. “Privatbank remains the main concern for the IMF,” says Martynenko. “Obtaining the support of the IMF will be important, particularly if the external financial market environment deteriorates. Support from the IMF will open up opportunities to get financial aid from other IFIs like the World Bank and European Commission.”

As long as Zelensky is able to give the IMF and investors the impression that he is serious about tackling corruption, then Ukrainian borrowers and their investors are surely in for another excellent year. GC
Turkey on a knife edge

Turkey’s position economically, and from a capital markets standpoint, is better at the end of 2019 than it was a year ago. However, that is not to say all is well with the country – far from it. Prospects for 2020 are, at best, mixed with growing concerns over central bank independence and high debt levels. Lewis McLellan and Mariam Meskin reports

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or a country recently removed from a currency crisis and still belaboured by the threat of US sanctions, Turkey has enjoyed a sensational year of borrowing. Indeed, the first quarter of the year was Turkey’s busiest ever in the bond market. Turkish borrowers printed around $10.6bn of international issuance — equal to the whole amount raised in 2018 and the lion’s share of the $16bn raised this year.

The loan market has been active too, although the focus has been on price, rather than size. Refinancing has continued to be important, with banks having to refinance $8bn in 2019 year on year at yields of 10bp over Libor. Nevertheless, the combined total borrowing is remarkably healthy given Turkey’s geopolitical and economic woes.

But the good times may not last. “Turkey has a high external financing requirement, which it has been able to finance this year,” says Paul Greer, senior EM portfolio manager at Fidelity in London. “But then, it was a very benign year for EM.”

The US Federal Reserve’s dovish switch early in the year sparked a rush into riskier assets. Turkey cannot count on the same thing happening again this year.

In some respects, Turkey’s position has undeniably improved. The Turkish central bank heeded investors’ cries and delivered a series of brutally austere rate hikes, driving the Turkish economy into recession. Despite Turkish president Recep Tayyip Erdogan’s protests, the high rates had the desired effect. Inflation has collapsed from 25% to 8.5% and the current account deficit has gone from 7% of GDP to almost flat — something Turkey has rarely been able to boast about over the years.

Fiscal fears

But more worrying than Turkey’s monetary policy future is its fiscal picture. “Turkey is looking at a 3%-3.5% fiscal deficit next year,” says Greer.

James Athey, a senior investment manager at Aberdeen Standard Investments, is equally concerned. “The sheer volume of corporate debt is a serious problem.”

The private sector is doing its part. Turkish private banks have done a good job reducing their borrowing needs, and drastically cutting the costs of their annual loan refinancings. In the second refinancing season this year, which began in September, most banks secured pricing of 225bp over Libor and 210bp over Euribor for one year debt. That marks a sharp tightening since last September, which saw banks forced to accept margins of 275bp over Libor and 265bp over Euribor in the aftermath of the currency crisis. Loans signed only a few months before the currency crisis offered pricing for one year debt of around 135bp over Libor and 125bp over Euribor.

Despite 18 of Turkey’s top tier banks, alongside the sovereign, being downgraded earlier this year by Moody’s, lenders have continued to plough money into their relationship banks, justifying the tighter margins by pointing to the resilience and balance sheet strength of Turkey’s banks.

But while the private banks are doing their part, the state banks have not got the memo and are continuing to extend credit. “That’s contributing to the loosening of fiscal discipline,” says Greer.

As a result, “most funds are underweight in Turkish debt and are expecting the trajectory in Turkey to worsen,” says Jan Dehn, global head of research at Ashmore in London.

CB independence hit

Politically, as well as economically, the situation in Turkey remains fraught. Turkish central bank independence suffered an undeniable blow in July, when Erdogan fired the well-respected governor Murat Cetinkaya. Although the central bank delivered the much needed rate rise, it has since made aggressive and divisive cuts and has yet to regain the trust of some investors. Athey is worried by the lack of central bank independence and believes the cuts were the result of political pressure and the good work done earlier could be undone. “I think they cut too much too quickly, and that the direction of inflation is going to reverse as a result,” he says.

But not everyone is so sceptical. Greer believes Turkey still has room to cut its policy rate further. “Although I expect inflation to go higher and finish the year around 12%, the rate is at 14%, so there’s still a buffer of 200bp real policy rate. It would be a mistake to cut the rate to single digits, but a 100bp or 200bp rate cut is justified. Looking at the performance of Turkish assets, the market seems to agree.”

International, Turkey has faced sanctions over its purchase of S400 missiles from Russia, and over its military involvement in Syria. It appears that US president Donald Trump is prepared to defend Turkey from further sanctions, but as Greer says: “The diplomatic picture appears to have cooled off, but we’re one tweet away from a vol spike.”

“The diplomatic picture appears to have cooled off, but we’re one tweet away from a vol spike”

Paul Greer, Fidelity

“Although I expect inflation to go higher and finish the year around 12%, the rate is at 14%, so there’s still a buffer of 200bp real policy rate. It would be a mistake to cut the rate to single digits, but a 100bp or 200bp rate cut is justified. Looking at the performance of Turkish assets, the market seems to agree.”

With global interest rates set to remain low, Turkey should still have access to international markets in 2020. 2019 has shown that the Turkish debt management office is canny at snatching openings when they are available, but Athey fears that the hunt for yield in core markets has “dulled” investors’ fears and made them too forgiving. If Turkey cannot rescue its fiscal trajectory, investors will get their fingers burned.
Bonds take the lead in Middle East financing

The loan market has had a great couple of years in the Middle East but in 2019 the bond market stole its thunder. However, as the region tries to wean itself off hydrocarbons, the sheer scale of financing needed means both markets will have plenty to do over the next 10 years. Mariam Meskin reports.

The Middle East’s rise from an occasional but lumpy user of international capital markets to a regular and important region for loans, bonds and equities has been impressively rapid. Indeed, the Middle East has undergone a period of rapid maturity in the past decade, with the region offering international lenders and investors a broadening range of financing opportunities.

It is a blossoming that is set to continue. With Russian markets sullied by sanctions and Turkey teetering on the brink of implosion, the Middle East — the bulk of which comprises issuance from the Gulf Cooperation Council, in many years constituting more than 90% of volumes across the region — has become one of the most lucrative regions for those involved in international financing markets. Low yields in developed markets have helped to ensure a steady stream of investors in the search for better returns. EM fixed income funds have enjoyed a flood of money throughout 2019, mostly at the expense of developed equity markets.

“Issuance for 2019 will very likely close at record levels, which is an indication that MENA is now an integral part of emerging markets,” says Khalil Belhimeur, executive director, EMEA bond syndicate at Standard Chartered in London. “The GCC has had a stellar performance in line with broader emerging markets, despite geopolitical volatility and commodity-related concerns, which shows the strength of the region.”

We should expect more of the same in the coming years. Vision 2030, Crown Prince Mohammad bin Salman’s ambitious programme to diversify Saudi Arabia’s economy through infrastructure investment and public-sector restructuring in an effort to lower its dependence on oil exports, is expected to require billions of dollars of equity and debt from the international capital markets. The process has already begun, with Saudi Aramco — the world’s most profitable company — likely to list in December, in what is expected to be one of the largest ever initial public offerings.

The Middle Eastern international debt market is already large in the world of EM: the combined size of the region’s bonds and loans market in 2018 was equivalent to $217.1bn, according to Dealogic, growing from $181.6bn in 2017. The region has been rapidly catching up with other emerging markets that have been a more familiar first choice for most Western investors. The size of the combined central and eastern European market in 2018 was $237.3bn, only 8% larger than the Middle East.

But for lenders, 2019 has not been a great year. Year to date volumes of signed deals have dropped 50% from 2018. The problem for them is the bond market. Issuers in Saudi — including the sovereign and its largest companies — and the five other GCC countries have successfully tapped fixed income investors in 2019, in the process raking in billions of dollars of debt at attractive levels, at the expense of traditional lender banks. As of mid-November, bond issuance compared with 2018 was up 12% in the Middle East and up 18% in the GCC. CDS spreads across all the countries have tightened sharply since the beginning of 2019. Saudi Arabia and Qatar have tightened by 40bp to 65bp and 45bp respectively, with the more fiscally-troubled Bahrain managing to come in from 320bp to 210bp.

“There has been a migration from syndicated loans to fixed income, evidenced by debut trades from Saudi Aramco and Almarai.”

Andy Cairns, First Abu Dhabi Bank

Though investors were spooked by the drone attacks on Saudi Aramco’s facilities at Abqaiq and Khurais in the eastern part of the country in September, with Saudi and GCC credit spreads immediately widening, just days after the attacks Abu Dhabi was able to issue a $10bn bond with a minimal new issue premium and a heavily oversubscribed order book. Meanwhile, CDS levels across the region returned to normal within 10 days.

“The region’s geopolitical risks are well flagged and long-standing,” says Andy Cairns, head of global corporate finance at First Abu Dhabi Bank in Abu Dhabi. “And importantly, investors are well compensated for them. The GCC offers very attractive relative value in rating equivalency terms. The perception of geopolitical risk increases the further you travel, so GCC accounts demonstrate greater price elasticity for regional credit than international investors.”

Lenders dismayed

At the end of 2018, bankers at the largest global lenders were singing the Middle East’s praises in anticipation of the business they expected to work on in coming years, following a jumbo year of issuance that saw more than $122.47bn of loans raised by the six Gulf states alone. But those expectations fell flat in 2019, with the number of deals signed across the region down by 53%. The Middle Eastern loan market tracked...
by Dealogic contracted sharply, from $126.8bn of borrowing signed in 2018 to $62.8bn by mid-November, leaving a giant Gulf-shaped hole in many lenders’ budgets. Looking just at deals run by bookrunners, borrowing fell from $76bn to $33bn.

“It has not been a great year for Middle Eastern loan volumes. It has been difficult for both international and regional banks,” says Zvi Wohlgemuth, managing director, head of project, asset financing and CEEMEA loan syndicate at Société Générale in London. “We are headed for similar volumes as 2017, but it is always difficult to match the bumper years like 2018, which had a couple of jumbo deals.” The value of the deals signed in Saudi Arabia by November was nearly half of that seen in 2018. In March, Saudi Aramco finally announced it would be purchasing compatriot petrochemicals firm Sabic from Saudi’s sovereign wealth fund, Public Investment Fund (PIF), for $69.1bn in a bid to inject capital into the Saudi state in preparation for the reforms. Lenders were excited that a chunk of that financing would be done in the loan market, with some pointing to the $16bn and $11bn jumbo loans raised by the sovereign and sovereign wealth fund in 2018 as a sign of the country’s affinity with loan markets.

But the deal did not materialise — instead, lenders were tapped by PIF to raise a moderate (in relative terms) $10bn bridge loan, in a largely self-arranged transaction.

“The highly anticipated wave of financing activity driven by Vision 2030 out of Saudi Arabia has not yet materialised,” says Rizwan Shaikh, co-head of loan syndication EMEA at Citi in London. “It is a question of time.”

**Bonds gain where loans lose**

Despite outbursts of geopolitical volatility and the persistently low oil price leaving funding markets on edge, Middle Eastern borrowers are being hunted down by lenders who are still very much committed to the region. Société Générale’s Wohlgemuth says: “Sentiment has been rather good across the GCC — while country risk of course exists, there is not as much mention of it as previously.”

Borrowers were driven to the bond market where regional issuance flourished in 2019 and issuers locked in tight pricing as credit spreads tightened across the GCC in line with a reduction of US dollar yields. “There has been a migration of [corporate] borrowers from syndicated loans to fixed income markets, evidenced by debut trades from Saudi Aramco and Almarai,” says Cairns at FAB.

As he points out, while in 2018 syndicated loans dominated (volumes were 29% higher than bond issuance), in 2019 bonds have come out on top, with $100.01bn issued in the Middle East, compared with $62.8bn of loans.

Global loan volumes are on the decline, with the number of EMEA loans signed down 39% on 2018, and the Middle East is no different. But for issuers, that does not matter as the bond market has proved a reliable and deep funding pool this year.

“Some borrowers have rotated from the loan market into debt capital markets to lock in better pricing and tenor, given how favourable the environment is,” says Shaikh at Citi.

Should global monetary policy remain dovish and should US Treasury yields continue declining, yields will remain low across EM, stimulating bond issuance and potentially stealing more business from the loan market.

“It has been a record year for MENA issuance; it is only the second year on record where DCM volumes have exceeded syndicated loans,” says Cairns. “We expect something similar in 2020, with bonds and sukuk remaining the region’s preferred fundraising format and total issuance around $100bn.”

Some lenders are more optimistic, though, that volumes may pick up in 2020, with a number of large loans coming to maturity and therefore refinancing. “We expect a bounce-back in volumes next year across corporate and project financing in GCC,” says Citi’s Shaikh.

But others are less certain, pointing to more attractive conditions in the bond markets, which have been aided by the GCC’s inclusion into key EM indices. “The loans pipeline does not point to a strong pick-up in 2020 volumes in the Middle East,” says a banker at a European lender. “The big question is whether we will see more sovereign activity. Saudi tapped lenders heavily in 2018 and the other GCC countries do not seem likely to come just yet. Qatar has a jumbo deal maturing soon, though they may take advantage of the bond market conditions and refinance it there.

“However, we still expect part of the Aramco-Sabic financing to come from the loan market. The PIF will receive another $60bn from Aramco at some point, but until that happens I would not exclude the PIF coming back to the market.”

**Index-crazy investors**

Bond issuance across the GCC has been boosted in 2019 by the phased inclusion of five of its states in the JP Morgan emerging market index (EMBI), a move that put the total value of GCC bonds in the index at about $165bn (Oman was already part of the index). Belhimeur at Standard Chartered says: “As a result of the index inclusion, the amount of investors following the GCC has improved dramatically. We have seen a tightening of spreads on the back of increased demand, and in general, we have seen improved market access for most issuers from the GCC.”

The Kingdom of Saudi Arabia tapped international investors three times in 2019: for $7.5bn in January through a conventional 10 year and 31 year bond; for €10bn in July via its euro bond debut with maturities between eight and 20 years; and for $2.5bn in October through a 10 year sukuk.
The inclusion has led to an increase in passive investor flows into the GCC, which now comprises almost 12% of the index. “Institutional investors are index-crazy,” says Jan Dehn, head of global research at Ashmore in London. “They will buy whatever goes into the index as long as markets are performing well.”

After a stellar year, issuers look set to enjoy even better bond market conditions. “Though many issuers have pre-funded or will pre-fund their liabilities, we do not expect volumes to decline from levels we saw in 2018 and 2019,” says Standard Chartered’s Belhimeur. “If the market is constructive, some issuers that did not come to the market in 2019 will look to 2020 for potential opportunistic trades.”

The characteristically low-key Kuwait is one of those trades that issuers are patiently on standby for, with its CDS spread having tightened by 20bp to 44bp in 2019. “There will still be substantial issuance in Saudi Arabia, despite the government cutting spending in 2020,” says Jason Tuvey, senior emerging markets economist at Capital Economics in London. “But if the Aramco IPO proceeds are used to finance the deficit, that could remove some of the impetus for sovereign debt raising.

**Corporates called to the frontline**

But in the face of a slowdown in China and the creeping fear of a US recession, global markets are at a critical point. To sustain the pace of issuance within an increasingly challenging macro-economic environment, more companies need to enter the market, say bankers. Some corporate trades this year set the market alight: Saudi Aramco made a landmark debut in April when it issued for the first time in international markets, a $12bn bond with maturities between three and 30 years that amassed a final order book of $100bn — unprecendented for a debut EM deal.

“Demand for corporates in the Middle East is outstripping supply, it is the sovereigns and banks dominating the market,” says Dehn at Ashmore. “The fundamental picture in the Middle East is getting worse — slower global growth will impact all currencies pegged to the dollar, but because of the supply-demand imbalance the market remains strong in the Middle East. There is strong excess demand for corporate debt — while sovereign issuance expanded this year to $49bn, the corporates have been lagging behind.”

**GCC goes green**

Corporate issuance could be boosted by green financing, a trend that has been slowly but steadily gaining traction among GCC issuers, as they look to diversify their investor bases. Although the amount of green debt raised in the GCC is a tiny proportion of total volumes, it is the topic dominating conversations and conferences across the region.

In May, Dubai-headquartered shopping mall operator Majid Al Futtaim (MAF) issued a $600m 10 year green sukuk — the first of its kind by an issuer from the region — and sparked discussions across EM capital markets about the new product after it achieved a zero new issue premium. The success of that deal led the issuer to tap the market again in October with an identical green sukuk issuance.

“Green bonds are gaining more traction, but it will take some time for GCC corporates to fully come to terms with the prerequisites, such as the continuous ESG reporting, the publication of comprehensive financial reports and the increased transparency,” says John Arentz, head of treasury at MAF.

Lenders remain hopeful that a sustainability push across the GCC will result in swathes of sovereigns, government-related entities and corporates tapping debt markets. Following the 2016 Paris Climate Agreement, all six GCC states announced plans and programmes to wean themselves off their oil dependency and increase their generation and use of renewable energy. That shift, expected to occur over the next 20 years, coupled with international investors threatening to dump bonds issued by borrowers whose carbon footprints are too high, (in November, for example, Sweden’s Riksbank ditched its investments in Australia’s Queensland State and Canada’s Alberta Province), may be the impetus required to bring green financing into mainstream markets.

“We are seeing an increasingly disciplined approach to issuance: wider adoption of MTN programmes, separation of investor marketing and transaction execution and greater disclosure. This improved transparency will be key as we see more regional ESG fundraising,” says Cairns at FAB.

So far, only a handful of green bonds have been issued in the region: a $587m green bond issued by National Bank of Abu Dhabi (now First Abu Dhabi Bank) in 2017, the double green sukuk issuance by MAF in April and then October. At the time of writing, Jeddah-headquartered Islamic Development Bank had mandated banks to do the region’s third green sukuk. A little further afield, Egypt is working on a green bond, as are Tunisia and Morocco, the latter having issued a small green bond in November 2016 in local currency via its sustainable energy agency, Masen. Casablanca Finance City followed in September 2018 with its own Moroccan dirham green bond.

But the appeal is growing as issuers become aware of the untapped international investor base committed to ESG investing. “The more people you can appeal to on an issuance the better, and doing a green sukuk enabled us to access a wider investor base than a vanilla sukuk or bond,” says MAF’s Arentz.

Ali Ahmad, head of capital markets FIG, Africa and Middle East at Standard Chartered in Dubai, believes that companies are likely to drive issuance in 2020, though many banks are developing ESG frameworks and could also be candidates to issue sustainability-linked and green debt. “There is greater appetite from international investors now for green debt,” he says. “Increasingly funds when presented with identical vanilla and green bonds will select the latter, while the issuer gets the benefit of investor diversification and publicity points.” GC
LatAm looks for growth amid easy borrowing conditions

US rate cuts were, admittedly, the driver behind the Latin American international bond market’s return to form in 2019. Although regional growth remains disappointing, there are encouraging technical and fundamental signs to be found. Oliver West reports.

At first glance, Latin American bond markets enjoyed a healthy recovery in 2019. Despite minimal supply from Argentina (see box) and Venezuela being out of bounds, new issue bond volumes were up, and investors enjoyed far improved returns. Yet Latin America itself can hardly take the credit.

“We did not expect such a good year for LatAm bonds in terms of volumes, but this is mostly a result of the US Federal Reserve cutting rates,” says Cristina Schulman, head of Latin America DCM at Santander in New York.

In January, few bond market participants anticipated the 75bp of US rate cuts that materialised between July and October, allowing borrowers to take advantage of lower financing costs.

Jennifer Gorgoll, co-lead portfolio manager, EM corporate debt at Neuberger Berman in Atlanta, says these rate cuts have supported “inflows and decent appetite for risk.”

LatAm bond markets cannot therefore take their eyes off the Fed, especially as economies struggle; the Institute for International Finance (IIF) expects the region’s GDP to shrink by 0.1% in 2020. Ironically, however, this sluggish performance is improving funding conditions as companies redeem more bonds than they issue.

“On the technical side, the market capitalisation of Latin American cross-border corporate bonds is shrinking year-on-year due to limited capex spending, low economic growth, and steady growth in domestic financing markets,” says Lisandro Miguens, head of Latin America DCM at JP Morgan in New York. “This means higher prices and lower spreads in international markets.”


Amid this liability management focus, several Latin American borrowers have repaired balance sheets, lowered reliance on international markets and funded more locally.

This would appear to be bad news for New York DCM desks — though JP Morgan says its LatAm DCM business had a record year by diversifying beyond on-the-run public bond issues. Yet for the region’s companies and economies it is very positive, says Miguens.

In Brazil, domestic debenture issuance hit a record R$122bn ($29.3bn) in the first three quarters of 2019, according to capital markets association Anbima. Volumes were on course to beat the previous full year record of R$153.716bn, registered in 2018. As recently as 2016, there was just R$60.69bn issued in Brazil’s debenture market.

“Domestic market growth is a trend that I expect to continue,” says Schulman at Santander, which operates in several of the region’s local bond markets. “In Brazil, growth has been huge, with local investors offering lower costs of funding than international markets.

“The domestic market is here to stay, with the hedge fund, infrastructure fund, and asset management sectors all growing. This is great for Brazil.”

Fundamental improvements

If the relative lack of first-time issuers and new money transactions is representative of the region’s disappointing growth rates in recent years, Latin America is far from the only part of the world where low growth is a concern.

Gorgoll says that the slowdown is “not as marked in EM as in developed markets” meaning the developed market to EM differential is narrowing.

“In Latin America there are hot spots of potential disruption, but overall growth is stable to picking up,” she says. “Inflation is under control, current account balances are stable and this is providing a fertile ground for corporates to prosper.”

Indeed, the IIF’s regional growth forecast for 2020 might be a modest 1.1%, but it does at least represent a recovery. In fact, it would be the second best year since 2013, behind 2017, when the region grew 1.2%. Moreover, the 2020 fore-
Argentina’s restructuring still a guessing game

The sell-off in Argentine assets after Peronist candidate Alberto Fernández won the presidential primaries by 15 points — leaving one-time market darling Mauricio Macri with virtually no chance of re-election — made a sovereign debt restructuring inevitable. Macri himself announced the restructuring and Fernández agrees something must be done. Yet six weeks after Fernández eased to a first round victory in October, bondholders are none the wiser on the restructuring. All options from a disorderly default to a friendly maturity extension are still on the table.

“Fernández and his people make comments but only succeed in generating greater uncertainty,” says Alejo Costa, head strategist at BTG Pactual in Buenos Aires. “There are some people in the next administration with some good individual ideas, but for now we see no consistent, collective plan.”

Lisandro Miguens at JP Morgan says that the best case would be a “quick, market-friendly” restructuring, saying “a swift NPV-negative re-profiling could bring back confidence”.

Indeed, Fernández said during the campaign that he was keen on a “Uruguay-style” restructuring mostly involving maturity extensions. Yet, Costa says, this would require “a real fiscal sacrifice, sustainable savings, and a primary surplus of 1%-2%”. There are few signs that this is on Fernández’s agenda. While all types of restructuring are theoretically feasible, “the difficulty is making them consistent and compatible with economic reality”, says Costa.

Such a light restructuring would also require the co-operation of the IMF, which in September postponed a $5.4bn loan disbursement to the government until further notice. Finally, on November 19, Fernández had a phone call with IMF managing director Kristalina Georgieva, during which he reiterated plans to increase spending.

But contact between the Fund and government had been a long time coming. Fernández’s message suggests they are not seeing eye to eye, and — as of that date — Fernández had not even named his economic team. Sovereign bond prices have drifted below 40 cents, suggesting the market has little faith a Uruguay-style restructuring would follow. “No news has been bad news; the perception is that the new government has not realised the urgency of the matter,” says Costa.

For Shamaila Khan at AllianceBernstein, a haircut is not warranted, as it is not a “debt sustainability issue”. But the more important factor to consider, she says, is the discount rate. “This will depend on the economic policies of the new government and the level of credibility it can regain.”

Beyond the sovereign, there is a world of Argentine corporate issuers who could find themselves plunged into the harsh — if familiar — reality of operating under a sovereign default.

As Jennifer Gorgoll at Neuberger Berman points out, several companies survived the 15 years of the last sovereign default; some even started up during that period. But bondholders must now work out which credits can deal with the pressure.

“Argentine corporates may need to get creative with their funding, but we feel several companies have enough liquidity to withstand the volatility,” says Gorgoll.

Though she acknowledges bondholders of some companies may suffer restructurings that offer very low recovery values, Gorgoll says others will “just need a haircut to right-size their bonds”, while others will survive without restructuring.

Companies with government contracts are considered most vulnerable, with concern over some utilities, in particular. “The questions at the moment are whether there will be a delay in payments from [electricity sector administrator] Cammesa, whether this will trigger liquidity issues for any credits, and whether the PPAs are going to be modified,” says Gorgoll.

With absolute interest rates at all-time lows, it makes sense to tap markets early

Lisandro Miguens, JP Morgan

“The question mark for the Mexican sovereign — especially if US growth slows — is whether this fiscal conservatism is down to the inefficiencies and delays of a new administration, or whether it is genuinely disciplined policy,” she says.

Indeed, it is Mexico and Brazil that move the needle in terms of LatAm volumes, and refinancing transactions made Mexico the largest source of deals this year, with just under 30%. But excitement is mostly reserved for Brazil, where the government pushed through a landmark pension reform in October.

If there has already been a strong rally in many Brazilian names, both Gorgoll and Khan say that they like companies that could benefit from domestic growth in Brazil, among other selected names, with Khan saying that “the positive macro outlook in not fully priced in” in some cases.

“Investors still have a lot of space for Brazil, in particular, and there is a lot of expectation that this sleeping giant will wake up,” says Schulman.

So as some observers seek to link social unrest across Latin America, despite very distinct reasons behind each protest, it is important to understand the nuances in the region.

“We must work out where tail risks exist and which credits have the biggest buffers to a shock or downturn,” says Khan. “Chile has had major protests, for example, but it is a country with more than enough room to accommodate any spending demands from social pressures.”

Argentina’s restructuring still a guessing game

The sell-off in Argentine assets after Peronist candidate Alberto Fernández won the presidential primaries by 15 points — leaving one-time market darling Mauricio Macri with virtually no chance of re-election — made a sovereign debt restructuring inevitable. Macri himself announced the restructuring and Fernández agrees something must be done. Yet six weeks after Fernández eased to a first round victory in October, bondholders are none the wiser on the restructuring. All options from a disorderly default to a friendly maturity extension are still on the table.

“Fernández and his people make comments but only succeed in generating greater uncertainty,” says Alejo Costa, head strategist at BTG Pactual in Buenos Aires. “There are some people in the next administration with some good individual ideas, but for now we see no consistent, collective plan.”

Lisandro Miguens at JP Morgan says that the best case would be a “quick, market-friendly” restructuring, saying “a swift NPV-negative re-profiling could bring back confidence”.

Indeed, Fernández said during the campaign that he was keen on a “Uruguay-style” restructuring mostly involving maturity extensions. Yet, Costa says, this would require “a real fiscal sacrifice, sustainable savings, and a primary surplus of 1%-2%”. There are few signs that this is on Fernández’s agenda. While all types of restructuring are theoretically feasible, “the difficulty is making them consistent and compatible with economic reality”, says Costa.

Such a light restructuring would also require the co-operation of the IMF, which in September postponed a $5.4bn loan disbursement to the government until further notice. Finally, on November 19, Fernández had a phone call with IMF managing director Kristalina Georgieva, during which he reiterated plans to increase spending.

But contact between the Fund and government had been a long time coming. Fernández’s message suggests they are not seeing eye to eye, and — as of that date — Fernández had not even named his economic team. Sovereign bond prices have drifted below 40 cents, suggesting the market has little faith a Uruguay-style restructuring would follow. “No news has been bad news; the perception is that the new government has not realised the urgency of the matter,” says Costa.

For Shamaila Khan at AllianceBernstein, a haircut is not warranted, as it is not a “debt sustainability issue”. But the more important factor to consider, she says, is the discount rate. “This will depend on the economic policies of the new government and the level of credibility it can regain.”

Beyond the sovereign, there is a world of Argentine corporate issuers who could find themselves plunged into the harsh — if familiar — reality of operating under a sovereign default.

As Jennifer Gorgoll at Neuberger Berman points out, several companies survived the 15 years of the last sovereign default; some even started up during that period. But bondholders must now work out which credits can deal with the pressure.

“Argentine corporates may need to get creative with their funding, but we feel several companies have enough liquidity to withstand the volatility,” says Gorgoll.

Though she acknowledges bondholders of some companies may suffer restructurings that offer very low recovery values, Gorgoll says others will “just need a haircut to right-size their bonds”, while others will survive without restructuring.

Companies with government contracts are considered most vulnerable, with concern over some utilities, in particular. “The questions at the moment are whether there will be a delay in payments from [electricity sector administrator] Cammesa, whether this will trigger liquidity issues for any credits, and whether the PPAs are going to be modified,” says Gorgoll.
Green loans are coming to EM — eventually

Emerging markets borrowers have been much slower to join the caravan of green and sustainability-linked financing that has swept up so many companies in western Europe. This is not because firms in CEEMEA are indifferent. As Mariam Meskin reports, interest is spreading, but companies must overcome practical obstacles, which will take time.

In 2019, a handful of sustainability-linked loans were signed in EM, notably a $300m facility for Ghana’s Cocobod, a $2bn revolver for the United Arab Emirates’ Noor Energy, both in March, and a $1.1bn loan for Russia’s Rusal in October. But these and the other deals are a mere sprinkling, compared with the 87 green and sustainability-linked loans signed in Europe by mid-November.

Though these specialist loans are for general corporate purposes, but the interest margin can be varied, depending on how the borrower performs on certain ESG metrics.

Sustainalytics, the provider of ESG ratings and corporate governance research, rates 11,000 firms, of which 460 are in CEEMEA. Companies can apply to it to license their rating, enabling them to use it for marketing securities or structuring sustainability-linked financings. If Sustainalytics does not already rate the firm, it will make a new rating. In 2019, up to mid-November, 12 companies in CEEMEA asked Sustainalytics for this licence.

“More EM borrowers are requesting to be rated by ESG agencies, which shows a desire to monitor their capabilities,” says Sandrine Enguehard, head of positive impact structuring at Société Générale in Paris. “But borrowers aren’t defining their CSR strategies and getting rated just to do green loans, but because there is a growing pressure to be sustainable and environmentally responsible.”

The trend for green and sustainability-linked financing that has captured western Europe is filtering into emerging markets.

Borrowers in central and eastern Europe, the Middle East and Africa are attracted by benefits including racking up brownie points with lenders, priding themselves on helping to fight climate change and sometimes even lowering their cost of funding.

In the past two years, international trade associations have codified green and sustainability-linked loans to boost and regulate issuance. Green borrowers must use the loan for a specific green purpose and report on this. Sustainability-linked loans are for general corporate purposes, but the interest margin can be varied, depending on how the borrower performs on certain ESG metrics.

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Though these specialist loans are still a fraction of EM debt, lenders are confident that green and sustainability-linked loans will multiply in CEEMEA in future. But there are many parts of the ESG puzzle that EM borrowers must fit together first.

Rocky road
The difficulties are numerous. “The delayed upick in the number of borrowers raising ESG-linked loans is down to awareness and education,” says Anna-Marie Slot, global sustainability partner at law firm Ashurst, in London and Hong Kong. “A key challenge for many borrowers is actually understanding fundamental structural features of the product, such as what it means to enter into an ESG-linked facility, how they can track key performance indicators internally and how much more work is created for treasury teams.”

Arranging a green or sustainability-linked loan is not just a case of asking relationship banks for a cut in margins. With a green loan, the borrower must have specific green assets and set up a process for selecting them. Sustainability-linked loans can be simpler, as there is no asset tracking. But lenders are wary of deals put together too hastily.

Usually, a loan’s margin is linked to company performance, either on an ESG rating from an external provider, or on key performance indicators (KPIs) that the firm defines itself. If it is an external rating, the company needs to obtain or license this, and both it and lenders must be comfortable with what the firm can do to improve its rating, and what could cause a deterioration.

Internally defined KPIs should ideally grow out of a sustainability strategy that the board is pursuing. That will mean the company is working on sustainability initiatives, to which the indicators can be tied.

“This is a long term strategy — implementing corporate social responsibility policies is not something a corporate can do in a few months. It is a long term process they may be engaged in for years,” says Enguehard.

To make the deal signify a real commitment to sustainability, KPIs ought to be both stretching and relevant to the company’s core business.

Such deals are fairly easy for companies whose senior management has been engaged with sustainability for years, and which already have programmes for implementing improvements. But many in CEEMEA have not done this yet.

Nevertheless, there are bright spots. Companies in the Middle East have shown a particular interest in green capital markets. In the UAE, property company Majid Al Futtaim issued a $600m green sukuk in May, and ports group DP World set up a Sustainable Development Financing Framework to prepare for issuance.
After the 2015 Paris Agreement, Gulf states announced programmes to decrease oil dependency and boost renewable energy production, which lenders predict will create big opportunities for ESG-linked financing.

"The conditions are favourable for ESG-linked issuance [in the Gulf], especially in the UAE, where there are a large amount of renewable energy projects under way and a number of large borrowers with clear sustainability objectives. This is definitely a market where we will see more growth," says William Sharpe, managing director, corporate loan syndicate at Natixis in Paris.

In March, a $2.5bn green loan was raised to support Noor Energy 1 in Dubai, set to be the world’s largest concentrated solar power plant.

In 2018, DP World obtained a $2bn sustainability-linked revolving credit facility and Masdar a $75m green revolver for clean technology and sustainable real estate.

"In the Middle East, until recently, only entities focused on renewable energy were considering green financing, but now more corporates have developed broader ESG policies and are able to pursue sustainability-linked financing," says Rizwan Shaikh, co-head of loan syndication EMEA at Citi in London.

But developing a framework is only part of the jigsaw. Once the loan is signed, borrowers will have to become transparent, providing reports on green assets and processes.

"There are many constraints borrowers face, such as extra cost and specific reporting requirements," says Sharpe. "Plus doing a green loan invites significant scrutiny that would not have been the case otherwise."

EM companies, many unlisted, tend to do less public reporting. "Most emerging market companies are not familiar with ESG," says Ian Howard, director of sustainable finance solutions at Sustainalytics in Toronto.

"There is a large education process that borrowers go through, and that is especially longer for first movers in their regions."

But making the first move may not be so hard. "The assumption is that it is too much work or too difficult but we’ve found that is not the case," says Slot at Ashurst. "Companies already track a lot of data on financial and performance metrics — they need to assess what KPIs are workable and what they are able to accurately assess on an ongoing basis."

**It’s not about the money**

Despite the difficulties, more EM borrowers are attracted to ESG-related financing. And the main draw is not cost, as one might think.

The price discount borrowers can obtain is minimal. Cocobod’s $300m three year sustainability-linked loan in March had an initial margin of 295bp over Libor. That will tighten by 15bp if Cocobod meets ESG metrics. For some EM borrowers, that tightening may appeal; but for most, there are wider benefits.

"The pricing discount under sustainability-linked loans is moderate," says Sharpe. "Many borrowers do sustainability-linked loans to project a positive image internationally in terms of their ESG credentials."

With green bonds, a company can attract investors that would not otherwise buy its debt. But this is harder to be sure of in the loan market, where loans are usually given on a relationship basis.

But, Slot says: "A common complaint is that the pricing differential is not beneficial enough, but doing an ESG-linked loan buys a company a whole new set of investors."

Some borrowers have a particular reason to want the extra green sheen a sustainable loan can give them. When Rusal, the Russian aluminium company, came to the market in October for a $750m sustainability-linked pre-export financing (PXF), it was its first entry into international debt markets since the US had lifted sanctions against it in January.

The deal was a great success, and was increased to $1.085bn. "It was not just the green format that was driving the demand, but rather Rusal’s long track record in the application of green technologies, production of low carbon aluminium and focus on sustainability in general," says Oleg Mukhamedshin, head of strategy and financial markets at Rusal in Moscow. "The demand was high because the market sees and supports Rusal’s commitment to low carbon aluminium technologies and green aluminium production."

Perhaps surprisingly, Western banks have been busy arranging sustainability-linked loans in Russia. ING signed bilateral sustainability-linked credit lines with firms such as Polymetal and Metalloinvest in the past two years.

"Sustainable finance seems to be a quickly developing trend," says Mukhamedshin. "We want to ensure that we are in the forefront of the current trends, and with sustainability-linked PXF setting the bar, we might consider other types of sustainable financing instruments."

Several Russian firms are obtaining ESG ratings. "The pick-up in activity in ESG-related loans has been driven by investors, as large Russian corporates are facing more questions about what they’re doing in the sustainability space," says Vladislav Chiriac, head of CEEMEA loan syndicate at UniCredit in London. "We will definitely see more green or ESG-linked loans in Russia in the next two years."

But the onus is not only on borrowers. If banks want the market to grow, they too must encourage green financing, even if it costs them. "To stimulate issuance, banks can continue to steer their internal lending policies towards more environmentally friendly borrowers," says Sharpe.

Natixis introduced a green weighting factor to its internal capital model in 2019. Others are set to emulate it.

If EM borrowers overcome hurdles to green financing, a much bigger share of their debt can involve sustainability criteria.

Slot at Ashurst says: "We will see a definite growth in green and sustainability-linked loans in EM, as banks become more cognisant about the scope of the global crisis."
Private credit builds EM momentum

New sources of capital and new financing models are appearing for emerging markets borrowers as investors broaden the search for yield. Traditional EM bank lenders and bond buyers now find themselves battling direct lenders and private capital markets, reports Mariam Meskin

Europe’s private debt markets are seeing heightened levels of emerging markets activity. India’s Reliance Industries raised a €405m Schuldschein earlier this year, while CEE borrowers have also entered the market in recent years — particularly from the Czech Republic and Hungary. In addition, Etihad Airways became the sector’s first Middle Eastern borrower.

But a broader push is also under way. EM-focused private credit vehicles raised $9.4bn in 2018, according to the Emerging Markets Private Equity Association (EMPEA), the highest level it has recorded since the inception of its data programme in 2006.

More than 50 EM funds closed last year, EMPEA reports, up from 14 in 2008.

Battling the banks

“A typical source of financing for most borrowers is the local banks, though we are making inroads and showing corporates why we are a better solution than banks in some cases, primarily because of our flexibility in structuring deals that may be more suited for direct lending instead of bank financing,” says Jaime Prieto, founding partner at Kartesia, a specialist direct lender with a particular interest in central and Eastern Europe and based in London.

“For example, with us, borrowers may pay less amortisation every year,” he says. “They may have a more flexible cash coupon so they could get equity upside, as opposed to having everything as a contractual return.”

The funds aim for a 12%-13% return. This is far higher than they would expect in western Europe. In addition, terms may also be an incentive. Fierce competition in western Europe has weakened financial covenants and tightened pricing. There is little sign of either trend in EM yet.

Traditional lenders claim to be unconcerned about the prospect of competition from private credit. “We see increased activity by non-bank investors across EM in various sectors, but it’s still a fraction of overall loan volumes,” notes Ben Connable, director, head of loan syndication distribution, Europe, Africa and Americas at Standard Chartered in London.

“For most IG credits that gather strong traditional bank appetite, there is simply no space for anyone else to enter,” adds Rizwan Sheikh, co-head of loan syndication EMEA at Citi in London. “Funds will operate in less crowded spaces, in structured finance or leveraged situations.”

New financing models

The appearance of private equity players in some EM sectors has led some to anticipate new financing models. For example, Abu Dhabi National Oil Company (Adnoc) signed a $4bn pipeline partnership with BlackRock and KKR that provided the firms a stake in Adnoc Oil Pipelines that Adnoc will repay via tariff over 23 years. Some $3.275bn of the total was funded via a syndicated loan.

This combination of private equity and bank financing could lead to similar infrastructure-based partnerships, some argue.

“This could be a very good business model for similar entities in the Middle East, allowing them to attract infrastructure equity investors to stable businesses in order to raise cash. It could also lead to non-bank debt investors expressing more interest for these sorts of loans in due course,” says Zvi Wohlgenuth, head of project, asset financing and emerging markets syndicate EMEA at Société Générale in London. “We could see a lot more deals like this, but it will take time.”

‘Specific structure’

 Nonetheless, the link between PE and private credit may not be direct. Adnoc, one of the stronger credits in the Middle East, is sceptical about private debt despite the success of its PE deal.

“When it comes to borrowing, we would not use private equity or private debt funds. Private credit providers are typically more expensive than bank credit, so it only makes sense to use private equity or institutional money for equity financing in the type of structure we have with BlackRock and KKR,” says Michele Fiorentino, chief investment officer at Adnoc in Abu Dhabi.

“It is difficult to see how private debt can be more attractive or pricing more competitive than bank lending or capital markets,”

Michele Fiorentino, Adnoc

“It is difficult to see how private debt can be more attractive or pricing more competitive than bank lending or capital markets.”

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The modernisation of the Talimarjan Power Plant
New Uzbekistan under the leadership of His Excellency President Shavkat Mirziyoyev is transforming in many ways. Economic reforms, including state-owned enterprise (SOE) reforms and liberalisation, are among the key pillars of current structural transformations in Uzbekistan.

To ensure our economic reforms benefit from the best international practice, the president created the Economic Council in January 2019. It comprises senior Uzbek government officials as well as international scholars and practitioners, including those at Growth Dialogue, a think-tank under George Washington University, chaired by Michael Spence and Danny Leipziger.

In its inaugural meeting on July 18, 2019, the Economic Council agreed to implement reforms in nine priority areas, of which the energy sector stands out. With expected GDP growth of over 5% per annum in the medium term, the country simply needs much more energy to fuel its growth. With the current mismatch of energy supply vis-à-vis growing demand, reforms in the energy sector are viewed as a real driver both in terms of energy-growth nexus and exports, especially to Uzbekistan’s southern neighbours.

Therefore, the government has embarked on a wide-ranging reform agenda in the energy sector. Unbundling state monopolies — Uzbekenergo into generation, transmission and distribution and Uzbekneftegaz into exploration, transportation and distribution companies — has created opportunities for the private sector, including foreign investors. While Uzbekistan is a late reformer as unbundling took place long ago in other developing countries, we can learn from these earlier reforms to make the right decisions.

At the same time, we have to work on administered tariffs to make this sector more attractive. Working together with our trusted advisors at the World Bank, ADB and EBRD, the government is decisively pursuing gradual liberalisation of energy prices in the country.

Last August we raised electricity prices by 18% (retail) and 36% (corporate). Natural gas prices rose by 19% (retail) and 23% (corporate) while gasoline and diesel went up by 13%. This followed a 10% increase in energy tariffs in November 2018.

With expected tariff increases in the future (eventually leading to free market prices in the medium term), we believe the power sector should be even more attractive to investors. This is very important as we want to nearly triple Uzbekistan’s power generation capacity to over 30,000MW by 2030.

Substantial investments in the power sector are expected through the Public Private Partnership (PPP) mechanism. For example, with the advisory support of the International Finance Corporation (IFC), a pilot project (as part of the scaling solar programme) is being implemented to build a 100MW solar photovoltaic (PV) station in the Navoiy region. The international competitive tender recently followed with five bidders, namely Total Eren (France), TBEA Solar (China), Masdual (UAE), Acwa Power (Saudi Arabia) and Jinko Solar (China), reaching the final stage. Masdual won the tender with the offer of $0.267 US cents per kWh. Given the success of this tender, we are soon to launch two more tenders for 900MW solar PV stations.

Moreover, transaction advisory mandates have been signed for a further 1,300MW combined cycle gas turbine (CCGT) greenfield project in the Sirdarya region with the IFC and for a 1,000 MW solar PV project in the Surkhan-darya region with the ADB. These projects will pave the way for more PPP-based conventional and renewable energy projects. By 2030, we plan to increase the installed capacity of solar power plants to 5,000MW. Furthermore, through the PPP mechanism, wind (2,000MW) and gas-fired CCGT (3,400MW) power stations are also planned by 2030.

In the oil and gas sector, the investment programme for the next decade is estimated at $34bn, consisting of 40 projects including exploration, development, transportation and storage of natural gas and petrochemical processing.

A substantial proportion of these investments will be covered through FDI. Therefore, the government is keen to open up further investment blocks for foreign investors. This, together with investments in Uzbekneftegaz, would increase the domestic production of natural gas to 74.8bn cubic metres (plus 23% versus 2018) and liquid hydrocarbons to 7.1m tonnes (plus 13% versus 2018) by 2025.

In chemicals, together with Boston Consulting Group, we have developed our Strategy 2030 based on three priority areas: fertilisers, gasochemical and other chemical products. This strategy mostly relies on FDI through privatisation and greenfield investments which has already started working with Indorama Corporation firmly on the ground. At the moment, several SOEs producing fertilisers are up for sale.

CORPORATE GOVERNANCE AND INSTITUTIONAL DEVELOPMENT

The government is keen to improve corporate governance in SOEs. Together with international organisations such as the World Bank, ADB, EBRD as well as local and international consulting firms, we have identified key areas of concern. Based on that, there is a firm commitment and political will to address these concerns.

As a result, more transparency, independent directors, IFRS implementation, credit ratings and access to capital markets (including IPOs) are reflected in all the roadmaps to reform the SOEs. To illustrate, Uzbekneftegaz and Uztransgaz will have IFRS reporting in 2020 while Thermal Power Plants, UzHydro and National Electric Systems will move to IFRS by 2021. The World Bank, ADB and EBRD have confirmed their commitment to assist newly formed power companies in corporate governance implementation, including selection of independent directors with international experience.

It is important to mention that a focus on corporate governance is happening within the framework of a broader strategy to strengthen institutions in Uzbekistan. Development Strategy 2017-2021 is based on five pillars, including development of the institutional framework of the state administration and rule of law and legal reforms.

To measure our progress in structural reforms, the government is following 24 global rankings and indices, including Worldwide Governance Indicators (World Bank) and the Corruption Perception Index (Transparency International). Line ministries and agencies have developed roadmaps with clear milestones to improve each indicator. While the progress may take time, we believe we are on the right path with the right partners.

VISION

Our leader, His Excellency President Shavkat Mirziyoyev, has set ambitious objectives for the government. When we succeed, Uzbekistan will be a different country with a modern economy and well-functioning energy market benefitting from strong private sector participation.

This vision requires well-sequenced and irreversible reforms to attract substantial investments. Therefore, under the President’s leadership, the government of Uzbekistan is strongly determined to continue with the reforms, embrace new challenges ahead and build trusted relationships with investors. Uzbekistan is open for business!
Uzbekistan’s energy sector at the threshold of major reforms

Uzbekistan’s turbulent past has left its mark on every aspect of the country’s economic and social life, but we are now looking to the future. The new government, headed by President Shavkat Mirziyoyev, is searching for ways to reform outdated managerial and technological practices and bring the country into the 21st century.

Several government decrees have been adopted recently aimed at radically increasing the efficiency of fuel and energy complex management as well as switching to modern methods of organizing the production, transportation, distribution and marketing of electricity both within Uzbekistan and beyond its borders.

The energy sector rightly deserves special consideration. Uzbekistan is one of the most energy-intensive economies in the world and its industrial sector, which utilises inefficient and obsolete technology in its production processes, accounts for around 40% of total energy consumption. For years this sector was run using non-economic methods, a practice which is no longer sustainable.

In the power generation industry, the most critical problems are the growing shortfall of electricity supply and significant wear and tear on equipment, including the distribution networks. According to analysts, one of the main causes is the insufficiently effective management of the electricity industry and historical underinvestment into new technologies throughout the sector.

To help find solutions to the growing problems within the sector, a new Ministry of Energy was established, tasked by the state to deal with all issues related to the fuel and energy sector of the country.

The Ministry of Energy now directly includes the Uzatom Agency, Uzneftegaz-inspection, Uzenergo-inspection, and the Implementation Group, which co-ordinates projects under production sharing agreements.

The Ministry also co-ordinates the activities of the Uzbekneftegaz, Uztransgaz and Regionalgaz joint stock companies, as well as the entities created from Uzbekenergo JSC: Thermal Power Stations, National Electric Grids of Uzbekistan and Regional Electric Grids.

It is also important to address the expected shortage of natural gas, which is today the main raw material for electricity generation, along with the inadequate energy-saving measures by modern standards and the significant untapped potential for the use of renewable energy sources.

A significant role in ensuring the country’s energy efficiency is given to diversification of energy sources. To this end Uzbekistan has made a historic decision to begin the development of nuclear energy generation.

The Agency for the Development of Atomic Energy of Uzbekistan was founded in July 2018; and in October 2019, a project was launched to build the country’s first nuclear power plant using Russian technology.

In May 2019, two new laws were adopted in Uzbekistan: ‘On the use of renewable energy sources’ and ‘On public-private partnership’. This created a legislative basis for attracting investment in the energy industry, as well as a system of incentives for users and manufacturers of renewable energy equipment.

By 2025, the share of electricity production using renewable and alternative energy sources is planned to increase to at least 20% of total generation.

The fundamental reform of the fuel and energy complex also applies to the oil and gas industry. For decades, the industry has been driven by non-economic methods, which has led to lags in the growth of hydrocarbon reserves and an increasing deficit in natural gas, especially in the private enterprise sector.

In July 2019, a resolution of the president was adopted, aimed at large-scale reform of the industry. During the restructuring, excessive intermediate management links have been reduced through the merger of sub-holding companies of Uzbekneftegaz and the withdrawal of Uztransgaz from this system.

Uzbekneftegaz’s stake in the authorised capital of Uztransgaz has been transferred to the state through the State Assets Management Agency.

Efficiency Drive

Measures to improve the efficiency of processing, transportation and sale of natural gas, and analysis and optimisation of investment projects were identified. Uzbekneftegaz has begun the process of improving mechanisms for the sale of finished products, strengthening financial discipline and optimising pricing at enterprises in the oil and gas industry.

The process of reforming the fuel and energy sector is based on accumulated experience, analysis and support of the best international models. World experts in this area have been engaged and substantial assistance is being provided by international financial institutions (IFIs).

For example, the World Bank is supporting projects to increase the energy efficiency of district heating, develop the energy market and modernise the mechanism of electric power transmission. Energy efficiency will help minimise operating and maintenance costs, improve productivity and generate real cashflows. It will also contribute to mitigation of the effects of climate change.

The Asian Development Bank is promoting regional co-operation projects to expand cross-border energy trade and integrate renewable energy sources into the grid, develop sustainable hydropower projects and increase the efficiency of electricity production.

The European Bank for Reconstruction and Development is participating in the implementation of the Talimarzhan energy project and modernisation of the Tashkent Power Station and Muruntau transmitting stations.

Uzbekistan’s economy has been developing rapidly in recent years, leading to a significant increase in energy consumption. Over the next 10 years we expect consumption to more than double. It is therefore crucial to ensure the country’s energy security, taking into account the constant growth of needs, reforming of managerial styles, attracting foreign investment and creating new jobs.

This complex and demanding work is being done today with the assistance of IFIs and consultants as well as dedicated efforts by the Uzbekistan government, its new Ministry of Energy and thousands of people in the sector who are building for future generations.
**Reforms set to revitalise Uzbekistan’s energy industry**

Unveiled in July, a new roadmap for Uzbekistan’s energy sector lays out plans for the restructuring and modernisation of state-owned firms and a major expansion of the industry with foreign investment.

By Lucy Fitzgeorge-Parker

Even by the standards of Central Asia, Uzbekistan is rich in natural resources. The country boasts more than 270 hydrocarbon deposits and is second in the region for natural gas production — and in the top 20 globally. A recent independent audit put Uzbekistan’s reserves of natural gas at more than 1tr cubic metres, while liquid hydrocarbon reserves are estimated at around 150m tonnes. Income from the oil and gas sector accounts for 10% of GDP and 15% of budgetary revenues.

Unfortunately, the potential of the industry has not previously been fully realised due to inefficient management and lack of investment in exploration, infrastructure and technology. As a result, despite an 8% increase in natural gas production in Uzbekistan over the past 20 years, the proportion produced by Uzbek firms has fallen to 29%. Moreover, for the past five years, the rate of natural gas reserves replacement has averaged barely 70%.

The sector is clearly ripe for reform — and, under new president Shavkat Mirziyoyev, policymakers have taken up the challenge. In 2018, a comprehensive study of the oil and gas industry was commissioned by the government, with the backing of the Asian Development Bank.

“We were given the goal of working out how to bring the sector up to international standards,” says Ulugbek Ashurov, deputy chairman of Uzbekneftegaz. “We spent a year studying the practices of international oil companies, as well as taking an inventory of the situation in Uzbekistan.”

The results of this investigation were revealed in July, when Mirziyoyev laid out plans for a radical overhaul of Uzbekistan’s energy industry.

At the heart of the government’s programme is a major restructuring of state-owned oil and gas giant Uzbekneftegaz (UNG).

This included the merger of four subsidiaries of UNG — drilling company Uzburneftgaz, oil and gas producer Uznftegazdobycha, petroleum refining firm Uznftepelnprodukt, and machinery and equipment manufacturer Uznteftgazmass — with the parent company.

Six oil and gas producing and gas processing entities were also brought under the direct management of UNG, while all the company’s service companies and nearly 300 non-core assets were marked for disposal.

UNG is now responsible for upstream and downstream operations in the state sector, comprising exploration, production, recycling and reproduction.

Midstream operations have been handed to Uztransgaz, which has been unbundled from UNG and transferred to the ownership of the Agency for Management of State Assets.

As well as sole responsibility for Uzbekistan’s high-pressure pipelines, Uztransgaz’s remit includes purchasing natural gas from extraction and processing organisations, and selling it to end users and new regional gas distribution entity Hududgaztaminot.

The latter was established to manage the local distribution of gas to consumers within Uzbekistan, with responsibilities including the operation and maintenance of distribution networks, and the purchase, storage and sale of liquified gas to consumers.

Hududgaztaminot’s corporate structure includes 14 local distributors, which have been earmarked as potential candidates for foreign investment through public private partnerships.

**REFORM IMPLEMENTATION**

A working committee, chaired by prime minister Abdulla Aripov has been established to oversee the implementation of the government’s programme for the energy industry.

The committee has been tasked with monitoring the progress of reforms, ensuring continued technical and financial support from international development institutions, government bodies and consultants, and approving roadmaps for the achievement of the key goals of the project.

These include modernising Uzbekistan’s gas transmission system — more than half of the country’s 13,000km of main gas pipelines are more than 30 years old and 58% of its gas compressor units need replacing — and, above all, increasing hydrocarbon production volumes.

This will be achieved both through exploration and the enhanced exploitation of existing fields in conjunction with leading international oil and gas companies.

On the exploration side, UNG is already working with long-standing global partners including Russia’s Lukoil and Gazprom, China National Petroleum Corporation and Korea National Oil Corporation, as well as new market entrants from countries including the UK, France, India and Azerbaijan.

The Uzbek government has announced plans to offer more than 50 investment blocks to foreign investors, with a focus on hard-to-recover hydrocarbon fields. Indeed, the decree mandates the transfer of the latter to companies with relevant experience.

The expansion of geological exploration of poorly studied areas and blocks with complex geological structure is already under way with the help of foreign firms including Total, BP, Mubadala Petroleum, SOCAR, Thyssenkrupp, Tatneft, ONGC Videsh and Epsilon Development.

Tatneft and Mubadala Petroleum, along with other companies from Russia and the United Arab Emirates, are already working with UNG on increasing hydrocarbon production in depleted, stripped and suspended oil and gas fields, as well as those with hard-to-recover reserves.

Ashurov notes that the increase in production will help to meet a rise in demand for hydrocarbons driven by the rapid growth of the Uzbek economy. GDP is expected to expand by at least 5% over the coming years as the government’s reform agenda bears fruit.

The increase in domestic demand may be mutated, however, by a parallel programme to improve energy efficiency in Uzbekistan, both in industry and in the household sector.

That will increase the potential for a substantial rise in natural gas exports. Already more than 15% of Uzbekistan’s natural gas production is sold outside the country. Some goes to Russia but most goes east, to Tajikistan, Kyrgyzstan, the south of Kazakhstan and China.

Ashurov sees great opportunities for UNG to serve rising demand from China for natural gas. “China is a huge market and we can see that they are now implementing a policy of moving away from coal towards cleaner energy sources,” he says. “Natural gas is a much safer and more ecological product.”

UNG is also looking to develop new export markets for both natural gas and other hydrocarbon products. “We know there is huge demand for natural gas in India and Pakistan, and we are ready to enter discussions with those countries,” says Ashurov.

“We also see opportunities for exporting products such as LPG gasoline to Tajikistan and we are exploring the options for working in Afghanistan, which could be a major export market for us.”

**PETRO INDUSTRY DEVELOPMENT**

Another key objective of the government’s reforms is the development of Uzbekistan’s petrochemical industry, particularly in the
sphere of high value-added products. Responsibility for this part of the programme has been assigned to UNG, along with state-owned chemicals producer UzbekKimyonanoat.

“We are currently solving a large-scale task of extracting valuable components from available raw material resources by means of their deep processing,” says Ashurov.

Progress is already being made in this area. Over the past two years, a number of key projects have been implemented, including the development of a complex of fields at Kandyim.

In April 2018, a new gas processing facility with an annual production capacity of 8.1bn cubic metres of hydrogen sulphide-containing gas was commissioned at the site. The complex is jointly owned by Lukoil and UNG, and was funded by international banks including ING, UniCredit and Deutsche Bank.

Kandyim is located in the Bukhara region, which is also home to one of Uzbekistan’s largest refineries. A second major refinery, in the Fergana region, is one of the facilities where policymakers are hoping to bring in foreign investment.

“We are already in negotiations on this project and expect to have reached agreement by the end of the year,” says Ashurov.

A year earlier, the government of Uzbekistan signed a production-sharing agreement with Swiss and Cypriot investors and Uzbekneftegazdobycha for the Uzbekistan Independence gas field in the southern Surkhandarya region, the value of which is estimated at more than $5bn.

The first phase of the project, due to be completed by 2023, will see the construction of a gas processing plant with a capacity of 5bn cubic meters of natural gas per year. That will be followed within three years by the construction of a gas chemical complex with a production capacity of 500,000 tonnes of polymer products.

Uzbekistan’s other major hydrocarbon production facilities include the Mubarek gas processing complex and gas chemical complexes at Shurtan and Ustyurt.

As part of the government’s programme, the Shurtan gas chemical complex — which was completed in 2000 — is being expanded with the construction of a plant for the production of synthetic liquid fuel (gas-to-liquids) based on purified methane.

Work is also underway at the Bukhara refinery, where the modernisation and reconstruction of existing facilities is proceeding in parallel with the construction of a new gas chemical complex based on methanol-to-olefins (MTO) technology.

UNG has partnered with US chemicals giant Air Products, Mubadala and firms from South Korea and Singapore on the Bukhara projects.

FUNDING TARGETS
Along with substantial increases in production and the introduction of new products, the July decree also calls for dramatic improvements in corporate governance and management across the Uzbek oil and gas industry.

“Our president has set us the goal of making all operations in the sector transparent and efficient,” says Ashurov.

UNG and Uzbektransgaz have introduced supervisory boards and are in the process of recruiting independent directors. Both companies have also been mandated to appoint external auditors and move to IFRS accounting standards in 2020, as well as to obtain an international credit rating.

That in turn will pave the way for the issuance of debut Eurobonds in 2020 and initial public offerings over the following three years. The companies will remain under state control, however, with the government retaining a 51% stake in each.

Key to attracting investment in both companies, as well as the sector as a whole, will be the liberalisation of tariffs. Prices of natural gas and gasoline in Uzbekistan have traditionally been well below those in other Central Asian states due to generous government subsidies.

These are now being phased out. An increase in tariffs was implemented on August 15 and further rises to bring the price of gasoline in line with market rates are promised for 2020.

For natural gas, policymakers have moved from a single fixed price to a variable tariff range. Under the new regime, tariffs are higher for large consumers and non-energy efficient companies.

“Our goal is to implement step-by-step increases across the board to bring internal prices up to international levels,” says Ashurov. “It is important to note, however, that at the current level UNG is already profitable.”

The final key plank of the government’s energy strategy calls for the introduction of modern information and communication technologies in all operations of UNG and Uzbektransgaz, including automated systems for controlling and recording the production, transportation and sale of oil and gas products.

“It is safe to say that the Uzbek oil and gas industry is rapidly gaining momentum,” says Ashurov. “The industry is currently implementing both large-scale investment projects and structural transformations.

“This will enable UNG to significantly increase the production of highly liquid products necessary to meet the needs of the population, industry, transport and agriculture, and remain a crucial contributor to the economy going forward.”

Investment highlights: oil and gas

OIL
The construction of a plant for the production of synthetic liquid fuel (GTL) based on purified methane from the Shurtan Gas Chemical Complex
The plant will produce high-quality diesel and aviation fuels that meet stringent environmental standards, unparalleled in quality and without harmful impurities. The total cost of the project: $2bn, financed by Korea Eximbank, along with 15 commercial banks.
Creation of a gas-chemical cluster based on methanol-to-olefins (MTO) technology.
This will enable the manufacture of new types of products, such as polyethylene terephthalate, polystyrene, polyvinyl chloride, propylene oxide polyl, gasoline and diesel fuel, in accordance with the requirements of Euro 5.
This project is in collaboration with Air Products and Mubadala, as well as engineering and construction companies from South Korea and Singapore.

GAS
A joint venture with Forus JSC, a Russian company, to reconstruct the storage facility at Gazli.
This will more than triple the gas storage capacity to 10bn cubic metres. Work is already underway on the first phase of the project, which will double the storage capacity to 6bn cubic metres by the end of 2021.
The second phase is due to be completed in 2024.
Infrastructure at the facility will be modernised in parallel with the reconstruction work.
The total cost of the project: $850m
A new gas processing facility with intended annual production capacity: 8.1bn cubic metres of hydrogen sulphide-containing gas.
The complex is jointly owned by Lukoil and UNG, and is funded by international banks including ING, UniCredit and Deutsche Bank.
‘Uzbekistan Independence’ gas field in the southern Surkhandarya region.
In 2017 the government of Uzbekistan signed a production-sharing agreement with Swiss and Cypriot investors and Uzbekneftegazdobycha.
The total cost of the project: $5bn.
The first phase of the project, due to be completed by 2023, will see the construction of a gas processing plant with a capacity of 5bn cubic meters of natural gas per year. That will be followed within three years by the construction of a gas chemical complex with a production capacity of 500,000 tonnes of polymer products.
ENERGY COMPANY UNG LOOKS TO GIVE WARM WELCOME TO FOREIGN INVESTORS

**GlobalMarkets**: How has the government’s strategy for the energy sector affected Uzbekneftegaz (UNG)?

**Ulugbek Ashurov**: Our primary task is to create a new vertically integrated company that corresponds to international standards of efficiency, transparency and corporate governance.

We have already started our work on the transformation of the company. We began by realising nearly 300 non-core assets, a process which is due to finish by the end of this year.

We have also started work on the sale of our service companies, which will take place next year, in order to increase competition in the market and lower the price. This will be done under open tender and we expect the majority of buyers to come from the private sector.

The next step is to make the company more attractive for public market investors. Our financial statements have been audited by EY for the past three years and we are currently preparing to move to IFRS standards at the start of next year.

We are also working on improving our corporate governance. We have created a supervisory board and are planning to appoint independent directors with good experience of the international oil and gas industry. The process is already underway and we expect it to be completed by the end of 2019.

In addition, we are looking to appoint executives from outside Uzbekistan to our management board. We are currently recruiting internationally for a first deputy chairman, who will be responsible for the implementation of our investment programme, and for our deep processing and downstream projects.

Once we have completed our organisational restructuring, we want to achieve an international credit rating and then issue a Eurobond.

**GM**: Why is capital markets access important for UNG?

**UA**: We want to change the way we fund ourselves. Until now, all our financing has come directly from the state or with a sovereign guarantee. We want to issue a Eurobond in order to diversify our funding sources and reduce our reliance on government support.

We have had discussions with large investment banks and financial institutions, and the feedback we have received is that there is strong appetite for our bonds among global investors.

Some banks have encouraged us to come to market this year, but we believe it is important to finish our corporate transformation first. What we are hearing from investors is that their top priority is having access to high-quality and transparent financial statements.

Once we are confident that we are up to international standards, and have seen an increase in our production levels, then we will be ready to issue a Eurobond.

After that, the government’s strategy calls for the privatisation of UNG via an IPO before the end of 2024. We will remain state-controlled but investors will have an opportunity to buy up to 49% of the company.

Before that, however, we will need to make substantial improvements to our profitability and our production capacity.

**GM**: What level of investment does UNG require?

**UA**: We have around 40 projects lined up for the next 10 years with a total cost of around $34bn. We expect half of this to come from foreign direct investment and loans.

**GM**: Where do you see the greatest opportunities for development?

**UA**: The investment policy of UNG is aimed firstly at replenishing reserves and increasing hydrocarbon production with the use of advanced technologies, carrying out geological exploration on poorly explored and complex subsoil areas, and intensifying production at fields with hard-to-recover reserves.

We want to modernise and improve the efficiency of our existing oil refineries, as well as introducing advanced information and communication technologies across the industry. We want to digitalise all our processes, starting with our wells and finishing with the distribution of our final products.

It is also important to remember that the energy sector in Uzbekistan not only covers the extraction of resources from the earth but also the system of complexes for processing raw materials and manufacturing products.

We want to deepen the processing of hydrocarbons and introduce new high-added-value petrochemical products to serve the domestic market and for export.

**GM**: What are the key development projects in this area?

**UA**: One of our biggest projects is the construction of a plant for the production of synthetic liquid fuel (GTL) based on purified methane from the Shurtan Gas Chemical Complex, which is one of the world’s largest gas processing and polymer production plants.

The plant will produce high-quality diesel and aviation fuels that meet stringent environmental standards, unparalleled in quality and the absence of harmful impurities. The project will cost $3.7bn and is being financed by our own resources at UNG and international loans.

We are also implementing a series of large projects, one of which is modernising the Bukhara refinery, that allows the release of high-quality fuel — gasoline and diesel fuel — in accordance with the requirements of the Euro 5 Directive.

Furthermore, work is underway to establish a gas chemical cluster based on methanol-to-olefins (MTO) technology. We are collaborating on this project with Air Products, as well as with the engineering and construction companies from South Korea and Singapore.

The implementation of the gas chemical cluster project will allow the production of new types of products, such as polyethylene terephthalate, polystyrene, polyvinyl chloride, propylene oxide polyol.
UZTRANSGAZ TRANSFORMATION AIMS TO FUEL UZBEKISTAN’S ECONOMIC GROWTH

There is a lot of work to be done but we understand the challenges. I am confident that in three years Uztransgaz will be a very different company, based on the direction of travel set by our president.

GM: When do you expect Uztransgaz to be profitable?
SU: If prices were based solely on market mechanisms we would be profitable. However, at the moment, some sectors are still receiving gas at below-market prices.

The government is working hard to close this gap. Tariffs were increased on August 15 and, as a result, we expect to show a full-year profit in 2020.

The purpose of unbundling Uztransgaz from Uzbeneftegaz was to make the company profitable and reduce its dependence on government support.

GM: How much investment does Uztransgaz need?
SU: Our key focus areas at present are the modernisation of our gas transportation system, and the expansion of export and transit opportunities.

More than half of our main gas pipelines are more than 30 years old. We also urgently need to upgrade our network of gas compressor units. We have 250 units in total, of which 145 are outdated and need renovating or replacing.

We want to work with a single international partner on the gas compressor network project and will put it out to public tender.

We estimate the total cost of modernising our gas transport system at around $1.5bn. We have secured funding from the ADB for part of the project, and we also plan to work with the European Bank for Reconstruction and Development, World Bank and Japanese public sector funds.

GM: What are the biggest challenges you face?
SU: One of the hardest tasks is to change our corporate culture and the mindset of our employees. We have brought in external consultants to help with this and they are currently conducting training to bring our staff up to international standards.

Another major project is the digitalisation of our operations. We need to integrate all our processes, from pipelines to compressor stations, in one platform. This will hugely improve the efficiency of our operations. We are working closely with our strategic partner, Gazprom, in this area.

Our other main challenge is to improve our gas storage facilities. In our region, levels of gas consumption are very different in winter and summer. We need to be able to store gas produced during the summer period so that we can meet customers’ requirements and increase exports in winter.

We have a large underground gas storage facility at Gazli, one of Uzbekistan’s largest gas fields. We have set up a joint venture with Forus JSC, a Russian company, to reconstruct the storage facility. This will more than triple the gas storage capacity to 10bn cubic metres.

Work is already underway on the first phase of the project, which will double the storage capacity to 6bn cubic metres by the end of 2021. The second phase is due to be completed in 2024. Infrastructure at the facility will be modernised in parallel with the reconstruction work.

The total cost of the project, which also includes additional exploration and development of the gas and oil fields at Gazli, is $850m.

GM: Is Uztransgaz ready for projected increases in gas production?
SU: We are working closely with Uzneftegaz and are confident that we will be able to cope with the expected increase in production. Part of this will obviously be supplied to the internal market, where we are expecting a steady rise in demand in line with the growth of the Uzbek economy.

We are also ready to support the planned increase in exports. Uzbekistan is located on two main gas transit corridors. One runs from Turkmenistan via Kazakhstan to Russia, while the other connects Turkmenistan to China.

We currently supply around 8bn cubic metres of gas to China but have the capacity to increase that by a further 25%. In future, we want to utilise to the maximum all our export capacity.
A radical restructuring and upgrading of Uzbekistan’s power sector is creating opportunities for foreign investors and adding new generation sources, from renewables to nuclear.

By Lucy Fitzgeorge-Parker

The restructuring of Uzbekistan’s energy industry has been mirrored in its power sector, where policymakers have embarked on a radical programme of reforms to increase capacity and attract foreign investment.

The country’s power complex has traditionally struggled to meet the demands of a rapidly growing population and developing economy due to outdated infrastructure and inefficient management.

With consumption forecast to surge over the coming years, as economic reforms spur a jump in industrial production, the need for change has become urgent.

“We are seeing new industries coming on line in processing, textiles, agriculture, manufacturing and metallurgy, as well as a huge expansion in tourism and other services,” says Jurbek Mirzamahmudov, first deputy minister of energy. “All of these will need access to a stable and reliable electricity supply.”

Meeting this demand will not come cheap. Over the next five years, officials estimate that more than $2.8bn will be required to upgrade existing infrastructure, while adding new power generation could cost as much as $14.4bn.

“The aim is to create a modern, highly efficient electric power complex based on the use of advanced world experience to create an optimal, economically sound structure of generating capacities and electric grid facilities,” says Fayzulla Shaimatov, deputy chairman of Thermal Power Plants.

To reduce the drain on the state budget, as well as enhance the flow of technology and know-how into the country, the government is looking to attract foreign investors to a sector that until recently was largely off-limits to outsiders.

“We have never had private sector investment in our power generation or distribution network, so this is a huge opportunity,” says Mirzamahmudov. “And on the first come, first served principle, those who get in earliest will benefit the most.”

The key step in the opening up of the sector was taken in March, when a decree by president Shavkat Mirziyoyev ordered the break-up of Uzbekenergo, Uzbekistan’s notoriously inefficient state-owned electricity giant.

Previously, the firm was responsible for the production, transmission, trade and distribution of nearly all Uzbekistan’s electricity.

The new structure, devised in collaboration with international financial institutions (IFIs) including the World Bank and Asian Development Bank (ADB), splits these roles between three new joint stock companies.

Responsibility for electricity generation has been assigned to Thermal Power Plants (TPP). National Electric Networks of Uzbekistan now oversees transmission and trade, including imports and exports, while Regional Electric Networks distributes and markets electricity to end users.

“We want to introduce modern corporate governance into all three companies,” says Mirzamahmudov. “We are in discussions with IFIs to bring in foreign experts, not only as consultants but also potentially as senior managers.

“We also plan to move all the companies to IFRS reporting standards to improve transparency.”

At TPP, these changes will apply not only to the company itself but also to its subsidiaries. The firm, which last year generated 90% of Uzbekistan’s electricity, controls 10 power plants across the country. Most are gas-powered, although two in the Tashkent region use coal.

Under the new system, these plants have also been restructured as joint stock companies with their own supervisory boards and independent directors, with TPP effectively acting as a holding company, as part of the preparation for a planned programme of privatizations.

A pilot deal is already in the works. In March, during a visit by Mirziyoyev to the United Arab Emirates, Abu Dhabi-based investment company Mubadala agreed to start negotiations to take a stake of at least 50% in the Talimarjan thermal power plant in Kashkadarya province.

The plant has already been expanded in recent years with the addition of two combined-cycle plants with a total capacity of 900MW constructed by Daewoo and Hyundai. A second project is underway to build another two combined cycle gas turbines (CCGTs) with a capacity of at least 900MW, with $790m of financing backing from the ADB and European Bank for Reconstruction and Development.

Further privatizations of existing power plants are scheduled to follow. In the meantime, investors keen to gain access to the sector also have the option of getting involved in greenfield projects.

Work is already underway on the construction of two combined cycle gas turbine plants by Turkish companies in the Sirdaryo and Tashkent regions, and in September Saudi Arabia’s ACWA Power signed an agreement with the Ministry of Energy to build two power plants with a total capacity of 2,250MW.

RENEWABLE ENERGY TO THE FORE

One of the plants will be gas-fired but the other will utilise wind power, as part of an ambitious plan by the Uzbek government to build renewable energy capacity.

“We have large reserves of natural gas but like any resource that will deplete over time,” says Mirzamahmudov. “That’s why we are actively working to introduce new power generation sources, as well as increasing the efficiency of existing plants, in order to reduce gas consumption.”

At present, Uzbekistan has a total installed capacity of 11.26GW. Policymakers are aiming to triple that by 2030, with nearly half of new capacity coming from renewable sources.

Part of this increase will come from hydroelectric power. Currently Uzbekistan’s only renewable energy source, the government is aiming to double its share in the country’s energy mix over the next 10 years to around 13%.

The remainder of the renewable energy quota — and a fifth of total electricity generated in Uzbekistan — will be provided by new solar and wind power installations.

A survey by the Uzbek government, in conjunction with the ADB, shows high potential for solar power in the south of the country, especially in the Surxondaryo region, as well as in the Fergana Valley. For wind power, the most promising regions are Navoiy, Bukhara and Karakalpakstan.

The majority of new capacity will come from solar power, which is expected to provide 5GW of installed capacity by 2030. Wind power will account for a further 3GW. All of these new facilities are scheduled to be built by foreign investors through public-private partnerships.

Initial indications suggest that interest in the sector will be intense. A pilot 100MW solar power plant project in the Navoiy region, de-
Investment highlights: electricity

The modernisation and upgrade of 22 main power substations in Uzbekistan
- **Starting date:** 2022
- **Finish date:** 2023
- **Finances:** World Bank’s loan: $150m
- **Total cost of the project:** $292m

The construction of the Takhiaatash-Sarimoy transmission line in the Khorezm region
- **A 340 km stretch of line**
- **Total cost of the project:** $258m
- **$150m by the Asian Development Bank**
- **Finishing date:** 2019

An overhead transmission line from Navoiy TPP to Besanop
- **Total cost of the project:** $80m, partly funded by the European Bank for Reconstruction and Development
- **Electricity for the newly established mining and metallurgical production facilities in the Navoiy region and to develop the power grid in the northwest**

A high-quality power supply to the Tashkent Metallurgical Plant Construction of Puli Khumri (Hoja-Alvon) power line
- **Total length of the line:** 245.6km, of which 45km runs through the Surkhandarya region and 200.6km through Afghanistan

For nuclear power, meanwhile, policymakers looked closer to home for help. Uzbekistan signed an intergovernmental agreement with Russia in September 2018 for the development of the country’s first nuclear power plant.

The facility, which will be constructed by Russian state-owned giant Rosatom, will have two blocks with a combined capacity of 2.4GW. The first is due to come on line in 2020 and the second in 2022.

“We want to add nuclear power as well as renewables to ensure the sustainability of our energy mix,” says Mirzamahmudov. “With nuclear, you can plan your energy strategy for the next 60 years — and we are one of the top countries in the world for uranium production, so we have the raw material.”

**TARIFF REDUCTIONS**

For all current and potential investors in Uzbekistan’s electricity generation sector, one of the key issues will clearly be the future direction of tariffs.

Traditionally, electricity prices have been heavily subsidised by the state but Mirziyoyev’s government has undertaken to introduce market mechanisms. A rise in tariffs was implemented in August and further increases are promised.

“This will be a sensitive issue, because tariffs are not only a mechanism to attract investors but also have a high social impact,” says Ergashevic. “To protect the population, the government has therefore decided to implement gradual increases in tariffs.

“Nevertheless, we have a strong understanding that tariffs should be cost-covering.”

Following the unbundling of Uzbekenergo, each power plant in Uzbekistan will now negotiate tariffs separately with the monopoly purchaser, National Electric Networks.

The company, which is scheduled to remain in state ownership, is also responsible for co-ordinating and overseeing the development of energy-efficient technologies.

“This unit has the responsibility of ensuring that new CCGTs are built to maximise efficiency and reduce the consumption of gas,” says Mirzamahmudov.

Regional co-operation in this area in order to meet increasing demand.”

At the same time, Uzbekistan is also looking to step up exports of electricity to Afghanistan. The country has been selling electricity to its southern neighbour since 2002 and in 2018 delivered 2.6bn kWh.

National Electric Networks is now working on a new 154km transmission line to Afghanistan. The Uzbek government has agreed to provide a discount for the construction of the line in return for a 10 year contract from the Afghan purchaser, a condition set by the ADB for the provision of project finance.

**REGIONAL DISTRIBUTION**

The final pillar of Uzbekistan’s new power complex is Regional Electric Networks, which is responsible for delivering electricity to end users.

The company comprises 14 regional electric power networks, which supply around 300,000 Uzbek businesses and seven million households. Individual and communal domestic consumption accounts for 35% of the total, with industry and agriculture taking a further 41% and 20% respectively.

As with the other parts of Uzbekistan’s power network, the lines and facilities operated by Regional Electric Networks are severely outdated. The company estimates that around 50% of all overhead power transmission lines require modernisation and one-third of all substations.

“The deterioration of power lines and transformer units means there will be a problem with the supply of electricity in the near future,” says a company spokesperson.

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“The more than 55% of the elements of distribution power networks are operated with a period of more than 30 years and have practically exhausted their resources,” says a company spokesperson.

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The company comprises 14 regional electric power networks, which supply around 300,000 Uzbek businesses and seven million households. Individual and communal domestic consumption accounts for 35% of the total, with industry and agriculture taking a further 41% and 20% respectively.

As with the other parts of Uzbekistan’s power network, the lines and facilities operated by Regional Electric Networks are severely outdated. The company estimates that around 50% of all overhead power transmission lines require modernisation and one-third of all substations.

“The more than 55% of the elements of distribution power networks are operated with a period of more than 30 years and have practically exhausted their resources,” says a company spokesperson.

“The deterioration of power lines and transformer units means there will be a problem with the supply of electricity in the near future,” says Ergashevic.

“Protect the population, the government has therefore decided to implement gradual increases in tariffs.

“Nevertheless, we have a strong understanding that tariffs should be cost-covering.”

Following the unbundling of Uzbekenergo, each power plant in Uzbekistan will now negotiate tariffs separately with the monopoly purchaser, National Electric Networks.

The company, which is scheduled to remain in state ownership, is also responsible for co-ordinating and overseeing the development of energy-efficient technologies.

“This unit has the responsibility of ensuring that new CCGTs are built to maximise efficiency and reduce the consumption of gas,” says Mirzamahmudov.
POWERING UZBEKISTAN’S NEW ENERGY STRATEGY

GlobalMarkets: What has the government’s new energy strategy meant for Thermal Power Plants?
Fayzulla Shaismatov: The biggest change in our company has been the attitude to efficiency. Uzbekenergo was a large and cumbersome vertically integrated company.

It was very difficult to identify bottlenecks because financing was centralised. The inefficient parts of the business were covered by the more efficient, mainly through income generated from the sale and export of electricity.

After unbundling, we know what our weak spots are and where we need to focus our efforts to minimise the costs of production and to improve the management efficiency of our power plants.

We are working to implement modern management principles in all our entities, and we are very focused on corporate governance and transparency. We are introducing supervisory boards with independent members in our power plants.

We want to do this and we have to do it, because we currently rely heavily on international financial institutions (IFIs) for financing, and their requirements on transparency and efficiency are very stringent. They also set high standards for us in terms of environmental impact.

GM: What has changed for the power plants?
FS: Every plant now has a power purchase agreement with National Electric Grid. The cashflow goes directly to the plant and the management can decide how to use the money.

This was done to create a sense of asset ownership and economic incentives. Previously nobody cared about efficiency because they received funding from the parent company on demand.

Now each power plant has started to make a more accurate assessment of their costs, look for bottlenecks and weak spots, and work on improving them.

There is still long way to go but we have already achieved a shift in attitudes. The managers of the power plants now know their income is dependent on how efficiently they work. They are the masters of their own businesses.

GM: How much investment do you need over the next 10 years?
FS: According to forecasts for demand growth, we need to at least double our existing capacity, which will require a considerable amount of investment.

Unfortunately around 80% of our generating units are outdated and obsolete, with an average age of more than 30 years, so we also have to decommission most of the existing units.

This means the pace of renovation has to be very rapid, which is why the government wants to open the door to private investment. Attraction of private investment is set to be the primary goal because the government has realised that it is too heavy a burden for them to bear alone.

GM: What are the main challenges you face today?
FS: Our biggest challenge is to increase efficiency. Once private investors start building independent power producers (IPPs) it will become an existential matter for us, because we will have to compete in the open market against firms with the most advanced technology and management systems.

It will take two to three years for new investors to construct and commission their power plants, so that’s how long we have to structure our operation to become competitive enough to survive.

Another major challenge is changing the attitude of our staff. After many years working under the old management system it’s difficult to break the inertia in their minds and switch them to a “business oriented” mode.

Fortunately, we have very strong support from IFIs including the World Bank, European Bank for Reconstruction and Development (EBRD) and Asian Development Bank (ADB). They are helping a lot by running seminars and providing access to consultants in this sector.

We are trying to ensure that we meet the highest standards in corporate governance, and in parallel to educate our employees.

We are running courses on topics including corporate governance and project finance and in order to build capacity in our workforce.

We also want to bring more international managers into the company. With the help of the IFIs, we are currently looking outside Uzbekistan for a new deputy chairman, who will be responsible for adopting international standards of expertise, governance and management.

GM: How important is knowledge transfer?
FS: It is the number one priority for us at the moment. Most of our fleet of generation units are obsolete, and new units need experienced people who are educated to work on these units efficiently. It’s not enough to buy new equipment — you need people who can operate it.

We are also aware that green technologies are very much in focus at the moment and that we need to keep up with this trend. We are paying a lot of attention to energy-saving technologies.

GM: Would you consider raising funds through the capital markets?
FS: To develop further and expand our company we will need access to capital markets, but first we need to complete the process of becoming self-sustainable.

Cost-covering tariffs were only introduced in August. It will take a couple of years at least to get on a solid footing after that, because to access the capital markets you have to be strong enough to persuade your counterparts to lend you money.

At the moment we rely heavily on state support, but the government has made it clear that in future this will be reduced and we will have to take care of ourselves.

So first we need to achieve self-sufficiency, then in two or three years we will be ready to get an international credit rating and enter the capital markets.
NATIONAL POWER NETWORKS: MANAGING THE TRANSMISSION TRANSITION

GlobalMarkets: What is the remit of Uzbekistan National Power Networks?

Elmurodov Kholik: The main activities of the company are the operation and development of the main electric networks of Uzbekistan, the supply of electricity through the main power grid of the country, and the implementation of interstate transit co-operation with the power systems of neighbouring states.

Currently, our organisation consists of 14 regional power transmission lines and 77 substations. Overall, 4,713 specialists work in the company.

GM: What are the main challenges you face?

EK: The total length of Uzbekistan’s power grid is around 255,000km, more than six times the length of the Equator. Of that, 9,700km is 220-500 kV main overhead power transmission lines which are serviced by our organisation. It is clear that such a long network needs constant construction and repair, modernisation and innovative technologies.

Unfortunately, nearly 62% of our electric network is more than 30-35 years old. The distribution networks are extremely worn out, which leads to a large loss of electricity, now accounting for more than 2.8% of the total energy supplied by thermal power plants to the grid.

GM: What are your main investment projects?

EK: The largest project we are working on at the moment is the modernisation and upgrade of our 22 main power substations in order to increase the reliability of electricity supply. This involves the renewal of old machinery and power lines with modern equipment corresponding to international standards.

The renovation project was started in 2017 and will finish in 2022. It is being partly financed by the World Bank, which has provided a loan of $150m. The total cost of the project is $292m.

Also ongoing is the construction of the Takhiatash-Sarimoy transmission line in the Khorezm region. A 340km stretch of line is being built at a cost of $258m, of which $130m has been provided by the Asian Development Bank (ADB). The project is due to be completed this year.

Work also began this year on the construction of an overhead transmission line from Navoiiy TPP to Besopan. The new line, which will cost $80m and is partly funded by the European Bank for Reconstruction and Development, will provide electricity for the newly established mining and metallurgical production facilities in the Navoiiy region and to develop the power grid in the northwest.

Our next major project, which will start this year, will be in the Tashkent region. We have undertaken to provide a high-quality power supply to the Tashkent Metallurgical Plant, as well as to meet the needs of the population and industrial facilities in Tashkent and the border areas of Tashkent region.

GM: Do you have any projects outside the country?

EK: Yes, we are currently working on the construction of the 500kV Surkhon-Puli-Khorezm power transmission line to Afghanistan.

This will improve our relations with Afghanistan and enhance our ability to export electricity to neighbouring regions, thereby increasing the inflow of foreign currency into Uzbekistan and our standing in the international arena.

The total length of the line is 246km, of which 45km pass through the Surkhandarya region of Uzbekistan and 200km through Afghanistan.

GM: What effect have improvements in regional co-operation had on your work?

EK: In the last three years, we have seen dramatic change. Previously, working on our transmission lines outside Uzbekistan was very challenging due to the difficulty of moving equipment and personnel across borders.

Today, thanks to the efforts of our president, this has become much easier. We have been able to monitor and make repairs to our lines in Tajikistan, Kazakhstan and Turkmenistan, and our regional partners have been able to come and work in Uzbekistan. This has been mutually beneficial.

GM: Are you ready to support the expansion of renewable energy in Uzbekistan?

EK: It is very important for us to be prepared for the transmission of generated electricity by renewable energy sources. As a company, we are very supportive of initiatives to produce cleaner energy and improve efficiency. We are working on bringing the issues of energy efficiency and energy conservation to the general public and introducing proposals to start education on the topic at pre-school age.

We also closely work with citizens, raising awareness about what steps must be taken to produce electricity, how it can be delivered, and the continuous and quality distribution of energy to consumers. Energy efficiency and efficient use of natural resources are inseparably linked with the development of society. I think this is our duty to the future generation and our debt to nature.

GM: What other changes are you making at National Power Networks?

EK: We are making gradual changes to our company management, partly as a result of changes to our company management, partly as a result of improvements in the energy sector, and hope we can work with foreign partners with experience in the energy sector, and hope we can.

We are making gradual changes to our company management, partly as a result of improvements in the energy sector, and hope we can work with foreign partners with experience in the energy sector, and hope we can provide a platform for mutually beneficial co-operation.
Uzbek chemicals sector unveils formula for growth

Policymakers have unveiled an ambitious plan to revitalise and expand Uzbekistan's chemicals industry with the help of foreign investors to serve booming domestic demand and boost exports.

By Lucy Fitzgeorge-Parker

For a country rich in hydrocarbons and boasting a large domestic market, Uzbekistan has traditionally underperformed when it comes to the production of chemicals.

The industry currently accounts for just 2% of the country's total production volume and 1% of GDP. "These are very small numbers," says Odilbek Temirov, chairman of local chemicals company Uzkimyosanoat. "For developed countries this figure is more than 10%.

Uzbekistan's reformers are aiming to close that gap. The process began two years ago when president Shavkat Mirziyoyev ended the practice of price-setting by the government for chemical products, allowing the sector to move to market principles.

The next step was a year-long analysis of the Uzbek chemical industry, undertaken in conjunction with Boston Consulting Group, to assess market demand and identify key areas for investment.

The results of this study were released in April, when the government unveiled an ambitious $12bn strategy to modernise and restructure the sector with the help of foreign investors.

The primary objective of the programme, which comprises more than 30 projects to be completed by 2030, is to reduce Uzbekistan's dependence on imported chemicals and service rapidly growing domestic demand.

"We are a developing country with a population of 33 million and economic growth of around 5% per annum," says Temirov. "We can expect a big increase in demand for all basic chemical products."

A core plank of the strategy — which aims to increase chemicals production to 5% of GDP — is the expansion of Uzbekistan's organic chemicals industry.

Despite its ample reserves of natural gas, the organic chemicals segment currently accounts for just 11% of the country's chemical output. By 2030, this is scheduled to increase to at least 50%.

Much of this growth is due to come from the manufacture of new value-added polymer products, including polyethylene terephthalate (PET), polyvinyl chloride (PVC), synthetic rubber, polystyrene, butyl acrylate and others.

This in turn will support some of Uzbekistan's largest and fastest-growing industries. The country's textile sector in 2018 imported around 70,000 tonnes of PET fibre, while more than 85,000 tonnes of PVC was purchased from foreign suppliers by Uzbek textile and processing companies.

Household chemicals are also largely sourced from outside the country. Around 30,000 tonnes of linear alkylbenzene (LAB) and linear alkylbenzene sulfonic acid (LABSA) are imported annually for detergents and other household products.

Part of this domestic demand will in future be met directly by Uzkimyosanoat, Uzbekistan's largest state-owned chemical producer. The firm has announced plans to start production of PVC at its flagship Navoiyazot complex. Initially, a new facility will produce 100,000 tonnes a year of the PVC polymer.

"According to our forecasts that will not be enough to keep up with increasing in-country demand, so we will subsequently add a second complex with a capacity of 130,000 tonnes," says Temirov.

Uzkimyosanoat also plans to begin production of LAB and LABSA using feedstock from the Shurtan gas chemical complex and a new gas-to-liquid (GTL) complex due to be created by state oil and gas giant Uzbekneftegaz.

"We will produce enough LAB and LABSA to cover full in-country consumption," says Temirov. "We also expect to be able to export around 20,000 tonnes a year of household chemicals to nearby countries."

Overall, policymakers expect domestic demand to account for around two-thirds of Uzbekistan's output of organic chemicals by 2030, with the rest being sold outside the country.

The sector development programme also calls for a step-up in output of other chemicals currently produced by Uzkimyosanoat.

These include drilling and water system chemicals for the Uzbek oil, gas and petrochemicals industry, as well as adhesives and melamine for the wood processing and furniture sectors.

FERTILISING GROWTH

Uzkimyosanoat also manufactures a range of chemicals including cyanic salts and urea for major mining and metallurgical combines based in Almalyk and Navoiy, respectively Uzbekistan's leading producers of non-ferrous metals — copper and gold — and uranium.

Production of mineral fertilisers, which currently account for around 75% of Uzkimyosanoat's total chemical output, will also remain a key component of the government's strategy for the sector.

"Indeed, policymakers see the segment as offering excellent opportunities for export growth. "There is strong demand for mineral fertilisers in other central Asian countries, Turkmenistan, southern Kazakhstan and Russia. The government is also backing the development of a rail link to China."

Along with the large and growing domestic market, this export potential is expected to be one of the main attractions of the Uzbek chemical industry for foreign investors, who will have the chance to gain exposure to some of the country's key assets over the next four to five years.

April's presidential decree mandated the privatisation of a clutch of production facilities and non-core assets under the control of Uzkimyosanoat. The company, which employs 33,000 staff, currently comprises 14 industrial enterprises and six service organisations.

Topping the list of assets for sale are three fertilisers and chemical plants: the Dekhkonobod potassium plant; Ferganaazot, which produces nitrogen fertiliser; and the Kungrad soda plant.

The Uzbek government is offering to sell a 51% share in each of the three, in return for investor commitments to modernise facilities, increase capacity — by more than 100%, in the
case of the Kungrad soda plant — and establish new production lines.

All three are profitable, although a fall in global potassium prices has recently affected revenues at Dekhkonobod. The most profitable of the three is Ferganaazot, which boasts an Ebitda margin of around 40%.

The privatisation process is already underway, with EY acting as investment consultant to Uzkimyosanoat. More than 150 investors have been invited to view the privatisation process and more than 20 have expressed an interest in Dekhkonobod, while the other facilities have each attracted half a dozen potential buyers.

“We expect to receive binding offers for the Kungrad soda plant and Ferganaazot by the end of this year, and sign the share and purchase agreement in the first quarter of 2020,” says Temirov.

For foreign firms, however, the most attractive deals may be those that involve greenfield projects. In May, US chemicals firm Air Products signed a joint agreement with Uzkimyosanoat and Uzbekneftegaz for the construction of the planned gas-chemical complex using methanol-to-olefins (MTO) technology.

Temirov says the involvement of the Uzbek government and state-owned enterprises in both individual projects and the wider sector development programme helps to inspire confidence in potential investors.

“With big projects, naturally the risks are also big,” he says. “Investors are therefore keen to partner with local entities that own the mineral resources, feedstock and infrastructure.”

**ECONOMIC ZONES**

Policy-makers have also provided assurances to foreign direct investors regarding the provision of utilities, while further benefits will come from a new drive by the Ministry of Economy and Production to promote co-operation between sectors within Uzbekistan.

To encourage the creation of industry clusters, the government has created a series of economic zones across the country, including one comprising the whole of the Navoiy region. Other greenfield opportunities up for grabs include Samarkandkimyo, where the government is offering to sell 100% of the company in return for a commitment by the buyer to build a new production facility for phosphoric and NPK fertilisers.

The proceeds from these privatisations will be put into an investment fund, which will be used to finance Uzkimyosanoat’s part of the development programme.

Part of this funding will be spent on knowledge transfer. “For each new project, we will sign licensing agreements to bring in technology and know-how,” says Temirov. “We are also planning to send our specialists abroad for training, as well as bringing experts here to provide in-country training.”

This will be backed by a drive to improve technical education in Uzbekistan’s universities. This year will see the opening in Tashkent of a branch of Russia’s Mendeleev University of Chemical Technology, the result of a collaboration between Uzkimyosanoat and the Ministry of Higher and Secondary Education.

The company is also working on a project to create a research and development centre in Uzbekistan for the chemicals industry. A feasibility study funded by Korea Eximbank is already underway and officials say the centre could open as early as 2023.

“This will be an invaluable resource to ensure we have the expertise in Uzbekistan to drive our industry forward,” says Temirov.

Meanwhile, Uzkimyosanoat is also undergoing a major internal restructuring to improve corporate governance and transparency.

The resolution passed in April mandated the appointment of independent directors to the firm’s supervisory board and the establishment of an audit committee, as well as the preparation of financial statements according to IFRS accounting standards.

Significant progress has already been made. IFRS standards have been introduced at the entities earmarked for privatisation, while the parent company is due to follow suit shortly.

This in turn will pave the way for Uzkimyosanoat to obtain an international credit rating and, in the near future, access the Eurobond market.

Temirov notes, however, that bond buyers will have to wait to gain exposure to the company. “First we have to sell our shares in the main entities listed for privatisation, which will have to wait to gain exposure to the company,” he says.

In the meantime, the firm is looking to attract finance from international public and private sector banks for individual projects.

“One of the reasons for creating joint ventures with the direct involvement of foreign investors is to bring in project financing from the likes of Export-Import Bank of China and Japan Bank for International Cooperation, and from other [export credit agencies],” says Temirov.

There are no plans at present to sell equity stakes in Uzkimyosanoat, although Temirov says that will come further down the line. “Naturally in future the government will look to reduce its participation in the company,” he says.

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**Investment highlights: chemicals**

Uzkimyosanoat investment projects total more than 30 and the total investment is more than $12bn.

**Production of paints and varnishes for a growing domestic market**

- Domestic market size: 80 KTA ($120m)
- Market expected to double by 2030
- Currently, the production of paints and varnishes is based on imported acrylic resins

**Production of household chemicals**

- Laundry detergents current market size: 40 KTA
- Expected market size: up to 200 KTA by 2030
- Growing household disposable incomes
- The share of local detergents: 59%
- Raw materials: soda ash, baking soda, sodium sulfate: produced in UZ

**Production of cosmetics**

- Indicative Capex: $15m
- Construction area: 12,000 m2
- Production of polyester fibres
- Domestic market size: $45m with expectations to grow to $450m by 2030
- Polyester fibres are most relevant PET segment for Uzbekistan
- Used for fabrics production, which are further used for the production of apparel, home furnishings, and other finished textile goods

**Production of pesticides**

- Indicative Capex: $30m-$40m
- Market attractiveness:
  - Domestic market size: $30m
  - Market expected to grow up to $60m-$80m by 2030
- Carbon black production
- Capex: $100m
- Implementation period: 2020-2023
- Project’s main consumer: ‘BRZ’ tyre producer
- EVA film production
- Capex: $2.5m
- Implementation period: 2020-2021

**Production of LAB and LABSA**

- Using feedstock from the Shurtan Gas Chemical Complex and a new GTL complex due to be created by state oil and gas giant Uzbekneftegaz that will use gas-to-liquid (GTL) technology
- of the planned gas-chemical complex using methanol-to-olefins (MTO) technology.
- Temirov says the involvement of the Uzbek government and state-owned enterprises in both individual projects and the wider sector development programme helps to inspire confidence in potential investors.
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**Uzbekistan’s universities**

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There are no plans at present to sell equity stakes in Uzkimyosanoat, although Temirov says that will come further down the line. “Naturally in future the government will look to reduce its participation in the company,” he says.
PPP BRINGS KNOW-HOW AND EXPERTISE INTO THE COUNTRY

In an interview with GlobalMarkets, Golib Kholjigitov, head of Uzbekistan’s PPP Development Agency, lays out the advantages that working with the private sector can bring in terms of lower costs and more efficient delivery of much-needed infrastructure projects.

GlobalMarkets: How has Uzbekistan’s PPP framework developed?
Golib Kholjigitov: The PPP Development Agency was established in October 2018 and the law on public-private partnerships (PPP) was adopted in May this year. We have co-operated very closely with international financial institutions (IFIs) throughout the process. The first draft of the PPP legislation was prepared by the European Bank for Reconstruction and Development (EBRD).

We subsequently customised it to local requirements with parliament and the relevant ministries, and then confirmed again with IFIs including the World Bank and Asian Development Bank that it meets international standards. We are currently working actively with IFIs, along with our government ministries, to develop a strong, diversified pipeline of projects.

For us, the involvement of the IFIs in the initial stages of our PPP development is key. As a country that is just opening up, and where the institutions are new and haven’t been tested over time, having the support of institutions such as the World Bank, IFC and EBRD is vital in giving confidence to investors.

For the first few years, we will use IFI support actively. After that, once we have the expertise, the documentations and the relationships with investors, we will start preparing transactions on our own.

GlobalMarkets: Which sectors are you focusing on?
Golib Kholjigitov: We have several priority areas, including energy, transportation, water, healthcare, agriculture and education.

The energy sector is particularly important for us. It provides the foundation for any economic growth and the current technology is quite outdated, with low efficiency and instability in some areas. We are therefore very focused on encouraging investment in electricity generation and distribution.

We want to support the government’s strategic plan for the development of the energy sector. This includes the diversification of our generation capacity with a focus on renewables and the modernisation of outdated infrastructure.

The government also wants to improve the financial sustainability of the sector. Over the past decade, high levels of energy subsidies meant that our energy companies were loss-making and incurred debts. Demand for electricity in Uzbekistan is forecast to grow by 40%-70% over the next 10 years, so it is clear that considerable investment is needed in the power sector. We estimate the figure at around $15bn.

GlobalMarkets: What are the advantages of the PPP format?
Golib Kholjigitov: Given the level of investment required, the government is keen to leverage private sector funding to solve public sector issues such as the contingent-liability structure. With PPP, most of the risks are taken by the private sector, from market risk to operational risk.

We also know from experience in other jurisdictions that the cost overrun on PPPs is nearly three times lower than on projects using traditional procurement.

Similarly, PPP projects tend to be delivered in a more timely manner and to a higher standard, because deadlines and key performance indicators are built into the contracts and power purchasing agreements. These are powerful motivating factors for private companies.

The other big advantage of PPP is that it brings know-how and expertise into the country. Foreign companies will not just be responsible for building assets but also for operating them, maintaining them and managing them to international standards — which is exactly what our country needs.

GlobalMarkets: How many projects are you currently working on?
Golib Kholjigitov: We have close to 30 projects in the pipeline, of which 17 are at an advanced stage and two are in the final bidding round. For others we are about to sign transaction advisory consultancy agreements with IFIs and for some pre-feasibility studies are already underway.

Most of these projects are in the energy, power, transportation and healthcare sectors. Those in the final bidding stage are a 100MW solar plant in the Navoiy region and the creation of dialysis centres in three regions. Both of these are pilot projects. We want to start small in order to gain expertise and build capacity.

We are not just working on projects on an individual basis. In power generation, our approach is programmatic. We want to build new solar plants with total capacity of 5GW over the next 10 years.

We have seen strong interest from investors. For the Navoiy solar project, we had initial expressions of interest from 42 companies from countries including France, Saudi Arabia, the UAE and China. That was a good signal for us that we are on the right track.

GlobalMarkets: What concerns are investors raising?
Golib Kholjigitov: The level of engagement of investors at present depends on their risk appetite. Some are actively involved and some are waiting to see how the first pilot projects turn out.

From investors who come to the agency, the reaction has been positive. They can see that we have a strong pipeline and that we are committed, and they appreciate our professionalism. They can see that our staff have a high level of international experience and expertise.

It is one thing to make policy. You also have to implement it, which is much more difficult. When investors see that we speak their language and understand their concerns, they are very keen to get involved.

If anything, at the moment we have too much interest from investors! PPP is a complex structure, so we have to be careful about taking on too many projects at once.

The IFIs are being very helpful in the project preparation process. They are doing market-sounding activities to gauge the level of interest for projects and signing consulting agreements.

One of the key concerns is our tariff policy. Foreign investors obviously want to be sure that they will be able to recover their costs and make a profit. This is a sensitive issue from the social perspective, but one we are working on. We are committed to ensuring that tariffs are reasonable and sustainable for both our population and investors.
ALWAYS DEAL RESPONSIBLY

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For any questions please contact: mark.goodes@globalcapital.com
Libor’s long kiss goodbye

For corporate treasurers, the rates markets’ transition away from Libor and other Ibor benchmarks has created a messy future for their derivatives portfolios that many would prefer not to think about. Uncertain liquidity in new products and having to understand volatility in the new benchmarks are complicating the migration but there are signs of progress amid the confusion, writes Ross Lancaster.

Coming at the end of a decade of relentless financial market reform, interest rate derivatives markets’ transition away from Ibor benchmarks has suffered from fatigue.

A lack of enthusiasm for benchmark reform is easy to find in all corners of the rates market. But corporate treasurers have more cause than most to feel dread. As the Financial Conduct Authority’s end of 2021 exit from Libor mediation draws nearer, this section of the market faces sustained upheaval.

Onerous overhauls of accounting systems, understanding the complexities of new reference rates and grappling with the teething problems of new derivatives markets. These are all challenges and costs that are coming down the road fast at corporate treasurers. Many wish that they could just stay put with an Ibor.

“Corporates understand that Libor is flawed, but it is widely recognised and the majority of the time it works for them,” says Sarah Boyce, associate policy and technical director at the Association of Corporate Treasurers in London. “Relatively unsophisticated corporates in particular have struggled to understand why it needed to change at all.”

Libor permeates every corner of a corporate treasurer’s life. Debt instruments and derivatives but also accounting systems, corporate contracts and capital, tax and risk valuation methods.

The scale of rearrangement that corporates will have to undergo to migrate all of these systems and liabilities away from Ibor, which for many has little obvious benefit, has created iner-tia in the community. But December 2021 is not far away and in derivatives markets especially a lot needs to be done to smooth the unavoidable path to transition.

Interest rate derivatives give firms cashflow certainty when managing their liabilities. So unless their debt stacks reference an Ibor alternative, entering into any Sofr (Secured Overnight Financing Rate — the US’s favoured replacement rate) or Sonia (Sterling Overnight Index Average — the UK’s) derivative contract will create a mismatch.

“A lot corporates will not transition until they have all their products available”

Shaun Kennedy, ABP

Europe remains behind the pack, having decided on its replacement rate much later than the US and UK. Glacial pace

While floating rate bond markets have been absorbing issuance of debt that references the risk-free replacements, loan markets have been moving at a glacial pace. That inertia has carried across to derivatives markets too.

“A lot corporates will not transition until they have all their products available,” says Shaun Kennedy, group treasurer at Associated British Ports (ABP) in London. “Most will get a loan and then hedge it in the swaps market so unless the loan is on a risk-free rate they won’t put on the equivalent swap trade.

“That has held a lot of treasurers back because they want to see those new markets there before they enter into them.”

ABP is an outlier among corporates. It has taken a bold stance on the transition and begun rearranging its debt and derivatives to reference Sonia.

Kennedy’s team has partly managed the derivatives piece by using swaps to manage the basis between Sonia and Libor. Market participants see this mechanism as one of the best ways for corporates to start gaining exposure to new reference rates.

But across the regions introducing risk-free rates, the markets for these products are still often under-developed and expensive to enter into. At this stage in the transition most such trades would be test runs, which make them a hard cost to justify.

“Corporates are happy to try using the benchmark but will ultimately have to hedge that basis between Sofr and Libor because internal reconciliation between the two has to be made,” says Subhadra Rajappa, head of US rates strategy at Société Générale in New York.

“So they have to engage in a basis swap to realign their cashflows but there is not much liquidity in the basis swaps that they would use to hedge out the internal risks. So their reticence to use Sofr is understandable.”

Even those treasurers who see value in getting ahead of the curve face a challenge in arguing the case for such derivatives trades to other senior figures in their company. Banks and other financial institutions that operate at the coalface of capital markets may face their own challenges in transitioning away from Libor. But the significance of the migration can be easily drilled into desks across the firm.
In a company that brews beer, makes cars or produces pharmaceuticals, the cost of putting on a basis swap trade can be hard to argue for. “Taking out basis swaps that will cost money doesn’t necessarily get you brownie points in the board room,” says Boyce. “Another challenge is the need to explain the impact of these changes clearly and simply to board members who may not be finance specialists.

“Some corporates do transact basis swaps and are very active but there are probably only about 12 of them. So yes, some companies are trading basis. That is great. But it is such a small corner of the market, and not indicative of the wider corporate world.”

Meet the new reference rate
The problem of understanding can go even deeper. Ibors benchmarks work for many corporate treasurers. They have used it for many decades and understand how it reacts to moves in market conditions. Sofr and Sonia behave in their own ways, which will take time to understand. Their billing as risk-free rates can also seem misleading. On September 16, Sofr showed that it can be volatile too.

Many corporates were alarmed when volatility hit the US repo markets. Transactions there are data points used to calculate Sofr. The wild price swings were poorly understood, and not just by corporate treasurers. That and the US Federal Reserve’s emergency intervention to backstop the market, cast doubt on Sofr.

“There had been an assumption that the benchmark would transition to a more robust and less volatile rate, however September’s volatility in the US repo market and the resultant Fed actions has shown that may not be the case,” says Boyce.

“There is also a degree of nervousness among the older generation that something which works fine when rates are at 1%-2% might show a very different profile when they are at 7%-8%.”

There is still time to build under-

Open interest in CME Sofr futures

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Source: CME Group

standing of the new rates and what triggers volatility in them though. While events such as September’s are concerning for the unfamiliar, there are still attractions to referencing a risk-free rate.

“There have been a lot of conversations about what happened in the US,” says François Jarrosson, director, hedging and derivatives, global advisory at Rothschild & Co in London. “But it is important to remember that although you have bouts of volatility in the repo market, on a three month rolling period Sofr is still less volatile than Libor is. So as a treasurer you are still having a more stable cost of funding using Sofr rather than Libor.”

The repo volatility may even prove a positive in the long run. September’s unexpected market movements suddenly created a real need to hedge. Since then, liquidity has rapidly built in Sofr derivatives. Open interest in CME Group’s Sofr futures grew by 51% in the month following the repo volatility. CME’s CCP cleared a record $6.3bn of Sofr swaps in September.

‘Build liquidity and they will come’
Companies may still be shy of putting on actual trades, especially in the wake of such volatility. But if momentum keeps building in those derivatives, the repo panic may have delivered a boost in building well-traded markets.

The general principle of creating new markets is ‘build liquidity and they will come.’ For corporate treasurers, making the jump from Ibors will be made much easier with the certainty that mature alternative-rate markets could give.

“Volatility in the overnight repo rate led to volatility in the Sofr rate and a need from participants to hedge that rate volatility,” says Sean Tully, senior managing director, global head of financial and OTC products at CME Group in Chicago.

“We saw enormous growth in September, with more than 8.5m Sofr futures contracts traded to date. Some 300 participants have traded the futures since launch, and on September 17, a record 153,000 contracts were traded in a single day. Through the month of October, there are nearly 140 large open interest holders, with $1.9tr of open interest.

“That has very significantly grown and the open interest shows these are real end users, not just prop trading firms (which close their positions at the end of the day).”

In the UK, ABP’s Kennedy has also noticed an improvement in the swaps markets that he has used to manage his company’s move away from Libor. Liquidity has built and pricing improved, an encouraging sign for the next round of corporate treasurers entering such trades.

“When we began transitioning our swaps we used one hedging bank for our Libor/Sonia basis swap, which was useful,” says Kennedy. “But some banks were not seeing a lot of liquidity in the Sonia market mainly because it was not something they traded. It was expensive for them to price that basis. By using banks that were more active in the market we could remove a lot of pain from that basis.”

“In June we went to do more and the market was very different. Most of the banks were pricing Sonia swaps and Sonia/Libor basis swaps consistently and a lot tighter.”

GC
Renewables hedging evolves swiftly as banks crowd in

A fuse has been lit on renewables hedging. In offshore wind alone, a wall of investment is set to hit the industry over the next two decades, one that will take many project sponsors into cross-border investments. Those prospects are already deepening hedging markets, writes Ross Lancaster.

Developers in the offshore wind sector are looking forward to rich growth. The sector represents only 0.3% of global power supply but is predicted to grow by 13% a year and have increased 15 times over by 2040, according to the International Energy Agency.

The IEA says that this growth, forecast using existing investment plans and policies, will require $840bn of investment. Adjust the model to account for global climate and sustainability goals and faster growth, and the number will surpass $1.2tr.

That surge of investment will demand hedges. In countries with more advanced offshore wind markets, such as the UK, sophisticated and competitive hedging is already established for rates and inflation risk. UK project developers no longer have to rely solely on commercial banks for their loans and hedges.

Investment banks are also now involved. Firms that won hedging business on the back of providing loans now compete with houses that offer only swaps. That has driven the price of hedging down.

"At present the banking market is extremely strong and if you are doing swaps or cross-currency swaps you can win spreads that are relatively low, not as low as 2006/07 but not at all bad," says François Jarrosson, director, hedging and derivatives, global advisory at Rothschild & Co in London.

"The iTraxx crossover index illustrates the same trend. Risk is demanding a lot less remuneration than it used to."

Increasing competition for hedging mandates is set to push into FX as well. More jurisdictions, such as Vietnam, are devising roadmaps for their offshore wind industries. The potential for offshore wind capacity is high in Asia and Latin America.

Those factors are in play against a backdrop of US, European and Japanese central banks renewing loose monetary policy. That is set to keep the wheel spinning on the global search for yield, and banks reaching to achieve their returns with hedges.

"We are in a QE environment where infrastructure projects benefit, especially those with government support," says Marios Paparistodemou, head of rates and risk solutions structuring at Nomura in London. "So despite the pricing pressure that we have seen, given the wider economic environment we expect a continued healthy hedging market in renewables."

Markets such as the UK’s benefit from a secure regulatory environment and eager competition from banks. But those conditions are setting in throughout the world, including in many emerging market regions. Vietnam is a notable example, having introduced wind-friendly policies in recent years and attracted foreign banks keen to provide financing for its projects. Taiwan has already built a robust hedging market for its offshore wind sector.

Cross-border ambitions fuel FX demand

That has created a need for more FX hedging. As sponsors eye cross-border opportunities they have to assess how to manage the mismatch between the denominated currency of their fund and that of the revenues flowing from the project they invest in.

"Some 18-24 months ago, FX risk was lower down the list of our sponsor clients," says Rishin Patel, director at JCRA (now part of Chatham Financial), an advisory firm in London. "But we are now bringing our FX team on to every transaction. It has been a noticeable trend.

"More clients are looking at cross-border activity, and into EM. FX risk management has been a key focus area for a lot of these clients and we can only see that trend continuing with a series of funds announcing new EM mandates."

Hedging in these circumstances involves trade-offs, though. Sponsors have to decide which part of their investment they

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Assessing investment opportunities

Source: Ernst & Young

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DERIVATIVES
Renewables hedging

want to hedge. Investing in an EM project will often mean having to weigh up whether to hedge FX risk on the value of the asset being invested in or the cashflows — usually biannual or quarterly dividends — that flow out of that asset. Sponsors can’t hedge both.

“Funds can either hedge value, and then spot trade dividends as transactions when they come, and keep on rolling the value hedge,” says Chris Townner, director at JCRA. “Or they can just look at forecast dividends as the cashflows coming out of the asset and hedge the total of those. But if you hedge value and cashflow it can give rise to over-hedging where you are basically transacting too much. So funds need to be careful.”

**Competition heats up**
With FX hedging relatively new in offshore wind, the pace of innovation lags rates. But more sophisticated products are being used. While deal-contingent hedging has long been used by private equity funds, it has also increasingly been employed by infrastructure funds and sponsors. This form of pre-hedging is mainly used to manage the — usually — FX risk of a cross-border acquisition. It allows an acquirer to lock in the price of a deal for a premium and walk away with no unwinding cost if the transaction fails.

“As renewable energy became more accepted by banks, deal-contingent hedging began to seep into their toolkit. “Five to six years ago, deal-contingent hedging in renewable space was embryonic, but over the last two to three years we have had more data points, seen more projects delivered on time and brought to the market as expected, so we see them used more regularly” says Jean-Philippe Castellani, head of structured finance hedging at Société Générale in London.

“We have done a number of such trades in Europe, Asia and the US. It has become a regular feature of the market that is interesting for both sponsors and banks. Sponsors got to offload the risk and have also benefited because the cost, which is a function of the underlying implied volatility of rates and FX, especially in euro/dollar volatility, has been low versus historical standards. So the contingent hedge has not been very costly for the sponsors.”

In the more established rates market, innovation has been running at an even faster pace, says JCRA’s Patel. The developed offshore wind markets are not always the engine room of this creativity either. Structurers in more nascent jurisdictions are often just as innovative and 2020 should bring new hedging solutions in offshore wind financing.

“You would expect the European and US markets to be setting the tone on risk management innovation,” says Patel. “But we are actually finding some of the foreign branches of US/European banks coming up with near risk management solutions.

“The level of innovation going into these deals from the banks is phenomenal, as they try and create the next neat solution to take out the risk. In Taiwan, the market can usually absorb most project hedging. But offshore wind deals are often €2bn-€3bn equivalent, a multiple of the daily trading volume in the market. That is quite a lot of risk being taken down on the rates side, so you need to find new ways to do that.”

**Regulation can still surprise**
While momentum firmly favours offshore wind and other renewable sectors, investors still have to consider the risk of disrupted regulatory frameworks or hostile politics. While the arc of development is generally moving towards green policies, there are notable exceptions, such as the world’s largest economy.

US president Donald Trump’s stance on renewable energy has had a marked effect on those markets, says Bryant Lee, director of commodity risk management from Chatham Financial in Pennsylvania.

Developers’ ability to guarantee the price they sell energy for, in power purchase agreements, has become significantly more difficult. The market for PPAs beyond 10 years has dried up, with mainly short-term agreements being available — introducing uncertainty into the market.

“There will always be uncertainty about climate regulation,” says Lee. “And it can impact the level of development. In 2016, a large number of projects that had been in development came on line ahead of the potential expiration of the Investment Tax Credit. The credits had been renewed in late 2015, but were re-examined as part of President Trump’s Tax Reform plan in 2017, so the development pipeline took some time to ramp back up.”

But the political and regulatory trend is mostly supportive to renewable development. That will continue to give banks the security and desire to compete on hedges for the sector — maybe to the extent that even a withdrawal of government support would matter less in the future.

“In the western and, increasingly, in the emerging world, a positive for renewables is that they have government support,” says Paparistodemou. “That makes them very attractive to investors and has been a key part of these transactions’ success.

“As the market evolves, we may see that support weaken. That is something we as banks will be watching out for. “But it is important to note that when we started doing renewable transactions there were a lot more questions from hedgers about the technologies being used, technical and engineering expertise and wider project risk. As the market becomes more mature, the sensitivities to these risks goes down and maybe that could compensate to some extent for a reduction in government support.” GC
GlobalCapital is pleased to announce its second annual European Securitization Awards. The publication will honor the players and institutions that were most skilled at navigating the market in a time of significant change for European structured finance.

The awards will recognize firms for outstanding achievements across sectors and innovation in the market in the past year.

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