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Capital Optimisation for SSAs — the Role of Capital Markets

Making the most of development capital

FEBRUARY 2025

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MOODY'S RATINGS

Development banks embrace array of innovations

Supranationals and agencies, including the multilateral development banks and national and regional development banks, are going through a period of profound change.

There is enormous demand for their services, to keep global goals of fighting poverty and climate change within reach. But developed countries are reluctant to provide all the capital required.

Since 2022 the sector has been plunged into a process of self-examination about how public sector banks can lend more with the capital they already have.

This has led to a wave of reforms and financial innovations, ranging from changes in leverage ratios through rating agencies rethinking their methodologies to hybrid capital issuance, securitization and portfolio insurance.

In February *GlobalCapital* held a GC Live briefing in London for specialists in this area, sponsored by Moody's, bringing together MDB funding and risk experts, investors and insurance professionals.

The first two half hour panel discussions were on the record and you can read them here. The first covers issues including the value of callable capital, the nascent public market for MDB hybrid debt, the growth in development banks' firepower and how to evaluate the cost-effectiveness of different forms of capital relief.

***GlobalCapital*: What are the most promising innovations in capital markets for public sector banks to leverage your capital?**

Andrew Cross, Asian Infrastructure Investment Bank: AIIB is in a very different position from all the other MDBs in that we still have a colossal amount of rare treasure — capital that the shareholders have given us.

After nine years of existence, we're still very much in an accelerated growth phase — we're accumulating assets. Broadly speaking, we can double the balance sheet with our existing capital. That doesn't mean, though, that we're not acutely sensitive to capital discipline.

So the things on my mind are probably not the glamorous things everybody is thinking about: I'm

Discussion participants

Omar Sefiani, treasurer, African Development Bank

William Perraudin, managing director, Risk Control Ltd

Kathrin Muehlbronner, senior vice-president and global MDB lead, Moody's Ratings

Maria Kartcheva, head of ALM and financial structuring, European Stability Mechanism

Andrew Cross, chief financial officer, Asian Infrastructure Investment Bank

Moderator: **Toby Fildes**, managing director, *GlobalCapital* thinking about things like funds transfer pricing.

Aspects like securitization for us are less relevant because we're accumulating assets. But we've been working with other MDBs to do guarantees and risk transfers. But when we're accumulating assets, we're looking to put capital to use rather than release capital.

Maria Kartcheva, European Stability Mechanism: ESM is not a multilateral development bank. Our mandate is to safeguard financial stability in the euro area. For this mandate we have €500bn of lending capacity.

How could we manage to have this firepower? We are in the unique position of being the most capitalised international financial institution. We have €80bn of paid-in capital, €627bn of callable capital. This very strong capital position is underpinning our very strong creditworthiness and investors that buy our bonds are very well protected.

In terms of innovation, we are of course looking very closely at what our peers are doing. It is fascinating to see these developments on capital optimisation, because we have a common objective to make the biggest impact possible with the capital that has been entrusted to us.

Our immediate focus right now is on the opportunities we could have using artificial intelligence, for instance. We are looking at various business cases for how we could apply AI in our operations. We are also looking at market evolutions like the growing share of electronic trading. These are areas of focus for our teams.

***GlobalCapital*: Omar, a year ago we were talking about your $750m hybrid capital issue, the first major transaction in the public market by a multilateral development bank. Can we expect you back issuing this product any time soon?**

Omar Sefiani, African Development Bank: We said we'd be a regular issuer and that hasn't changed. The initial transaction was a resounding success but further work needs to be done to develop the asset class.

Actually we're quite happy to see that the momentum is building up and other issuers are also looking into this space.

> *"It is fascinating to see these developments on capital optimisation, because we have a common objective to make the biggest impact possible with the capital that has been entrusted to us"*
>
> ***Maria Kartcheva, European Stability Mechanism***

The experience has been quite good. We continue to look at both the options of placing hybrids with shareholders and with private sector investors. Each one has its own benefits. It's been a year now since we issued and we said we'd be a regular issuer so we are currently assessing timing and would like to do something in 2025.

***GlobalCapital*: Kathrin, what do you think are the most promising innovations?**

Kathrin Muehlbronner, Moody's: Looking at the whole range of MDBs, we think it is the combination of the various initiatives that have been put forward in the G20 Capital Adequacy Framework report. It's not a single one that will enable the MDBs to massively raise their lending.

The G20 published a progress report last year where they looked at what has been already implemented, and we've done our own calculations on the back of that.

If all these innovations are implemented, the 12 largest MDBs would be able to raise their lending by a combined $400bn or $450bn over 10 years. If you compare that to lending levels back in 2023, that would be a 45% increase. So this would enable significant additional lending.

Around $300bn of that number has already been implemented. Some of it is from hybrid capital, portfolio guarantees, securitizations. But if you look deeper, of the $300bn nearly half is due to a moderate increase in risk appetite by the MDBs, which of course leads to more senior bond issuance. That has so far been the one change with the biggest impact, then portfolio guarantees.

With hybrids we have seen a slower start. We think portfolio guarantees and also securitization can be very powerful — I'm sure we'll talk about that more. But it really is the combination of these different innovations and new instruments and approaches that will give the MDBs a lot more firepower.

William Perraudin, Risk Control Ltd: When I explain to commercial bank clients about MDB balance sheet optimisation, I say to them it's like having three Basel frameworks with which you have to operate simultaneously.

Instead of optimising your balance sheet against regulatory capital, you must think about the three rating agencies and their methodologies.

We've recently analysed two big MDBs and looked at nine or 10 different forms of balance sheet optimisation. Each bank achieves radically different gains from a given BSO policy, depending upon which rating agency is the constraining factor.

Unfunded risk transfers make much more sense if you are constrained by Standard and Poor's rather than Moody's.

So what are the more promising things to do is very much an institution-specific question. But I think it's very encouraging that there's so much expectation of different MDBs exploring these different innovative options.

***GlobalCapital*: Omar, you mentioned it was great to see that other institutions had**

issued a couple of hybrid trades — we've had deals from Africa Finance Corp and Banque Ouest-Africaine de Développement. But have you actually been a little bit disappointed that you haven't seen more from your fellow issuers since you broke the ice a year ago?

Sefiani, AfDB: I would have wanted to see more obviously. But I understand. As William said, MDBs have different constraints.

It's just a matter of time. For hybrid capital, we, and now AFC and BOAD, are showing that this is an instrument that is viable for MDBs. The timing is obviously going to vary from MDB to MDB. But we're seeing the momentum pick up. It started at the beginning of this year and I believe that as time passes by, and as MDBs start to compare the cost of some of these different instruments, you will see more MDBs get into this space.

Today you have quite a variety of instruments MDBs can use to optimise their balance sheets. But there hasn't necessarily been a thorough analysis to compare costs. Which is more cost-efficient? Which allows us to deal with X, Y or Z?

There is also the question of building the asset class. Of course it's easier to get into the space when the asset class is built, when you have an investor base that knows very well how these products work.

But again, we're laying the groundwork and seeing more and more MDBs interested in it and as the asset class gets built, it will be easier for other MDBs to join. So it's a progressive process we've started.

***GlobalCapital*: Having done your first deal, how do you expect the investor base for your second deal to differ? The first had quite a lot of hedge funds in it. Do we expect that to change next time you come with a hybrid?**

Sefiani, AfDB: Yes. We expect the investor base to progressively evolve. A lot of the real money accounts require a bit more time to analyse these products. Initially this was a very new product — hedge funds are actually quite nimble and are able to set a price on this.

So it was very good to have them, and actually a lot of the hedge funds were extremely constructive. Some of them are long term holders of our securities. We are quite happy to have some of these hedge funds in the transaction of course.

But I expect the investor base to evolve. We did quite a lot of marketing last year. I've been travelling and trying to meet investors to better educate them on MDBs. A lot of the investors in the hybrid space don't necessarily understand MDBs very well, they don't know how conservative MDBs are. All our ratios are extremely conservative when you compare them to commercial banks.

So all of that work is being done and I believe it will progressively shift the investor base from what we saw in the initial transaction to a bit more real money in the deal.

In fact, this shift is already evident in the secondary market activity of the inaugural transaction over the past few weeks, with a greater participation from real money investors compared to hedge funds.

"We continue to look at both the options of placing hybrids with shareholders and with private sector investors. It's been a year now since we issued and we said we'd be a regular issuer so we are currently assessing timing and would like to do something in 2025"

Omar Sefiani, African Development Bank

But it takes time, so this is not going to happen overnight in the primary market. And as I said, some hedge funds are actually long term holders. They're sophisticated investors that understand the product.

Muehlbronner, Moody's: I agree with Omar: we are certainly seeing quite a bit of interest in hybrids from MDBs, including from their bankers.

You mentioned AFC and BOAD issued. The World Bank's IBRD has made a proposal for a shareholder version, which is in a way very different. I can see why for a number of very highly rated MDBs that might be the more attractive option, because the cost is obviously much lower.

Also, it can serve as a neat bridge to the next capital increase and it allows individual shareholders to support an MDB without diluting voting shares.

What we have seen apart from AfDB so far is lower rated MDBs issuing hybrids. For them I think the commercial version has benefits because they tend to have weaker shareholders who might not be able to provide a general capital increase so easily.

It's a good way to diversify their funding and bring in new shareholders or new sponsors like BOAD has done with BADEA [The Arab Bank for Economic Development in Africa] and Italy's Cassa Depositi e Prestiti.

***GlobalCapital*: William and Omar have touched on how MDBs and their like are starting to compare all these instruments against each other, taking into account cost to see which are more efficient. But Andrew, are we all barking up the wrong tree fundamentally? Should we be worrying about something else?**

Cross, AIIB: I find AIIB in a very privileged position in terms of this conversation. Hybrid capital is a unique product that makes sense for a unique issuer in a unique circumstance. Does it have wholesale applicability for the nine or 12 largest MDBs? Possibly not.

Because fundamentally, capital decisions are a political decision for an MDB. It's not an entirely financial decision. If you're a commercial bank, you can issue shares, you can do buybacks — we can't do either of those things.

Having a triple-A balance sheet means we are intentionally inefficient with our capital. We have a colossal amount of equity, that's the requirement of being triple-A. That means you have to run your equity position very inefficiently. If you were trying to optimise, you would issue debt right up to the point where you think you might get a downgrade, but that's not a choice that we as MDBs have.

I think the value of the hybrid conversation is that it's been one of the catalysts along with the G20 for the MDBs to act much more as a system. So in the last couple of years, you now see the CFOs and chief risk officers getting together regularly, more often than just the spring and October IMF Annual Meetings.

There's a collective sharing of information that wasn't so transparent and accessible in the past. The mutual dialogues we're having with Moody's and the other credit rating agencies are also a real positive.

Isabelle [Laurent, head of funding at EBRD] and I were just exchanging a slight grin because we've both been in this space for a while and probably have shared views on this — another aspect is that capital is not only about a capital increase, it's also about the P&L.

One of the best ways of increasing your capital is through retained earnings and I noticed in the G20 conversation that's been less emphasised. People don't necessarily want to have a conversation about profit because we're not profit-maximising organisations. Our whole point is development and therefore the lowest cost of capital, along with the lowest transaction cost to our borrowers.

But if you have retained earnings, that's a dollar for dollar increase in your capital. There's nothing political about that conversation. So some of the conversation is really around how do we manage our P&L.

I'm seeing conversations now about: do MDBs need an office in every country of our shareholders? Those are extraordinarily expensive. Is it absolutely necessary that every MDB has an office in a country that doesn't borrow from it?

We're starting to see those questions — those are good questions. Resident boards on every MDB are extraordinarily expensive to run. Is that absolutely necessary?

I might be a little bit biased because AIIB has a non-resident board and somehow the governance has still worked brilliantly and we're still the largest co-lender to ADB and IBRD.

So I think the G20 conversation, to your point about barking up the wrong tree, is triggering conversations that haven't occurred before.

It's triggering cooperation at a really in the weeds level. It's leading to new products that make sense for some issuers.

We're a bit unique, so how can we work with other MDBs? We bought $1bn of assets off IBRD — it made sense for them, it made sense for us. But it wouldn't necessarily make sense if we were to do that with another MDB. So it's horses for courses.

And I'll just pick up Kathrin's point about the G20. We have 110 shareholders. The G20 is only a portion of 110. IBRD I think has 189, EBRD 74. So the G20 is important to us, but so equally is every single shareholder that has contributed its capital.

And a last point if I may: think of a developing country that gave capital to an MDB. That's an extraordinarily important decision for them. Think about how rare that treasure is to a double-B rated country. That's extraordinarily important.

So the one thing we always have to be really conscious of is: yes, we're responsive to the G20, yes, we're responsive to the rating agencies, yes, we're responsive to countries that have funded us. But we are also hugely responsive to the countries that put what is an incredibly rare treasure for them for development.

And so being very capital-disciplined, applying sound banking principles, looking to sweat every asset we have including liquidity books, is something we have a professional obligation to do.

Kartcheva, ESM: We have been following the hybrid bond issuance very closely. It's remarkable work by our colleagues at the African Development Bank to bring this transaction last year to the market.

And it is now a very tangible reference to analyse, to see whether it fits to the balance sheet and to the objectives for the ESM. We have currently close to €430bn of available lending capacity fully supported by our existing capital structure.

What I would like to bring here, among the tools that are part of the G20 discussion — even if we are not an MDB ourselves and not directly participating in these discussions — is the reach of callable capital.

I mentioned already that we have very large callable capital, €627bn, and we also have unique provisions on how we could access that. It is very efficient, hassle-free.

Our treaty has three ways in which the callable capital can be deployed. Here I am talking about the third case, the emergency capital call.

If we detect that there is a shortfall of funding to pay cash flows to our investors on our outstanding bonds, our managing director can issue a capital call.

"If all these innovations are implemented, the 12 largest MDBs would be able to raise their lending by a combined $400bn or $450bn over 10 years. If you compare that to lending levels back in 2023, that would be a 45% increase"

Kathrin Muehlbronner, Moody's

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> ***William Perraudin, Risk Control Ltd***

There is no other approval required by the governing bodies of the ESM. And our member countries have committed to make the payment within seven days.

This provision is to the benefit of the investors and provides the highest possible assurance that they will get timely payment and in full on the cash flows they expect from our bonds. And it has contributed to the resilience of our credit rating and to enabling our lending capacity.

Perraudin, Risk Control: On the recent hybrid issues, it is worth mentioning that the Inter-American Development Bank and the African Development Bank have another proposal for hybrids funded with special drawing rights.

The IMF has created two trusts resembling mini-MDBs that the IMF itself controls, in which shareholders can invest their SDRs to finance development.

IDB and AfDB have proposed a form of hybrid that would mimic features of the IMF trusts and permit shareholders to invest their SDRs in MDB hybrid capital.

That is another important part of the developing landscape of MDB capital raising, with commercial investors and shareholders investing in hybrid issues and then with this SDR-backed instrument.

These instruments are important for some of the biggest MDBs, including IBRD, which are basically leverage-constrained, because of the role the Moody’s and Fitch ratings methodologies give to leverage.

***GlobalCapital*: On callable capital, MDBs have collaborated on enhanced callable capital and the World Bank has unveiled its version. Kathrin, do you think this is a breakthrough?**

Muehlbronner, Moody’s: I think it’s interesting. We have always considered ESM’s emergency procedure for calling capital as a strength.

What we saw last year with five of the large MDBs publishing reports on their processes and timelines for calling callable capital — we’ve found those reports very useful.

Similarly, the reverse stress tests on how an MDB would get into a situation of stress, and how many shareholders have already appropriated some of the callable capital, which would take it at least a bit out of lengthy political discussions.

So we’ve found those reports very helpful. In our scorecard we’ve reflected this by giving these five MDBs similar uplift as we do for the ESM.

Now all these MDBs in our view are already very strongly supported by shareholders, so the additional benefit of that in terms of scorecard modelling mechanics was limited, but it does provide additional downside protection.

On IBRD’s enhanced callable capital, that’s a very interesting proposal. We haven’t publicly commented on it because it was a proposal. We understand the board has approved it, shareholders are looking at it, which would allow IBRD to call on some shareholders much, much earlier, for them to provide part of their callable capital, in a situation where the IBRD is at risk of losing its triple-A rating.

That’s way ahead of the typical callable capital, which you can only call when you are at risk of not being able to honour your obligations.

So I think we are moving closer to seeing this as a realistic proposal. We published a discussion paper last year where we asked for feedback from the market and from the MDBs on a number of areas where we see a lot of movement. Callable capital was one of them.

One question was: what terms would callable capital need to have to be considered closer to paid-in equity? It certainly is on our radar screen. But we’d be interested in seeing shareholders subscribe to it.

***GlobalCapital*: Omar, portfolio guarantees by shareholders such as the World Bank and Asian Development Bank have used offer a great variety of flexibility. Is there more room to exploit their potential? And could you describe the deal the AfDB did in 2022?**

Sefiani, AfDB: Sure. The Room 2 Run transaction we did covered a $2bn sovereign [loan] portfolio. It had a junior $400m tranche subscribed by various insurers and a $1.6bn senior tranche guaranteed by the UK Foreign, Commonwealth and Development Office.

This transaction showed there is room for innovation. The approach of the African Development Bank has been to not only rely on shareholders, but also on the private market where it makes sense.

A lot of our transactions are structured that way. This was an excellent case in point where we got both private insurers and a shareholder to participate.

We’re doing the same thing with the deal we’re doing in Tanzania, the Standard Gauge Railway, where we’re getting a combination of public investors — export credit agencies, MDBs and so on — but also private investors at the same time.

We think a combination of private market and public capital is probably the most efficient route when dealing with transactions.

And it’s actually the same approach we adopted even for the hybrid capital. We pushed the private transaction quite strongly but are also considering the shareholder transaction. We think the combination is more optimal.

If you look at MDBs and their funding, capital is still in its infancy compared with what we do when it comes to liquidity. But today liquidity is 100% funded by the wholesale market, private investors. We're not relying on shareholders for that.

So I'm not saying we should adopt the same model but when it comes to capital, a mix between shareholder and private capital is the optimal way of doing things.

This can be applied at a transaction level and at a more general level when looking at the balance sheet.

Perraudin, Risk Control: I would like to make a point about shareholder guarantees. I frequently talk to MDBs about different types of risk transfer and a common comment is 'Oh we can't do that [transaction bringing in private capital] because it's exploiting our preferred creditor treatment.'

But a shareholder guarantee is also exploiting PCT. The shareholders don't enjoy PCT in that if there's a sovereign restructuring and they have a direct exposure [bilaterally, not through an MDB], their claims are written down.

There is clearly much potential for shareholder guarantees. They provide a flexible way for certain shareholders to contribute more without all the bother and complexity of a general capital increase.

But there's a broader issue here. MDBs and indeed the Paris Club should be much clearer about how different types of risk transfer are treated in sovereign restructurings.

PCT has two dimensions: it reduces the probability of default and boosts the recovery rate. The extent that the recovery rate is increased depends on the policies of the Paris Club and these should be made more transparent.

***GlobalCapital*: Thank you. I want to ask one last question. We've heard quite a bit about collaboration, it's obviously necessary in sharing ideas. But I think the CAF report called for an organisation bringing together shareholders and MDB management to coordinate efforts across the sector. What are the prospects for that?**

Cross, AIIB: I think it's already happening. Last year at a meeting coordinated by the CFO of EBRD, the combined CFOs and CROs formed a group with a terms of reference, with a clear sequence of chairing, with clear guidance around how often the meetings should occur. That brings together the CROs and CFOs of essentially the major MDBs and a broader cross-section of international financial institutions.

The G20 can claim some credit for encouraging that. It is the MDBs operating as a system.

And every spring, every October, at the IMF AGM, the community sits down with each of the credit rating agencies and has a mutual shared dialogue of issues that are common or unique to each of the MDBs.

So the reality is it's already occurring. It's not glamorous, it doesn't get lots of headlines. But it's this sort of thing that just gradually, slowly, leads to change over time.

Muehlbronner, Moody's: I agree, and obviously we are having these discussions with the MDBs on a regular basis, also as a group. Where we would like to see a bit more progress is on aligning reporting on capital and the way the capital frameworks are presented a bit more closely.

We all know MDBs aren't regulated, there is no regulator imposing common standards. But the MDBs have very different capital frameworks, very different ways to report their capital and the riskiness of their portfolios.

We currently have a pure leverage metric in our scorecard for looking at MDBs but this is a reflection of the fact that there is no common standard in the industry.

We complement the leverage metric with a risk proxy, trying to assess the riskiness of the portfolios of the MDBs. But our work would be easier if there was a bit more standardisation around capitalisation and the way it's reported.

Perraudin, Risk Control: MDBs have funny governance in the sense that they are run by boards of executive directors who basically are civil servants, not bankers. The CAF panel was transformative in that suddenly there was a report that suggested MDBs could do all sorts of things. One suggestion in which shareholders are interested is having greater transparency, with comparative metrics of the sort you're talking about. So I do think there is progress to be made in that direction.

***GlobalCapital*: Thank you. I have one last question for Omar: when can we expect your next hybrid, can we expect it before Easter?**

Sefiani, AfDB: I can't answer that. We said we'd be a regular issuer. We haven't changed our thought process on that. We think there's a lot of value in maintaining momentum on the market, and we've kept our word in the past. GC

"Some of the conversation is really around how do we manage our P&L. I'm seeing conversations now about: do MDBs need an office in every country of our shareholders? Those are extraordinarily expensive"

Andrew Cross, Asian Infrastructure Investment Bank

From macro to Macron: reassessing the value in the SSA bond market

Record order books have greeted sovereign, supranational and agency bond issuers in the early months of 2025, with the prospect of continued strong demand for the rest of the year. However, volatile swap spreads have been a feature of the market at the same time. While this is positive for investor demand, it only makes accurate pricing more difficult for issuers. Added to that, US regulatory uncertainty, French government woes and electoral upheaval in the EU's biggest economy, Germany, and the only certainty about 2025 is set to be its unpredictability.

To discuss what the rest of the year holds, *GlobalCapital* convened a panel of leading experts, who were eager to discuss topics such as front-loading, MDBs and the impact of President Trump's tariffs.

***GlobalCapital*: The first thing I'd like to discuss today is spreads. Swap spreads in euros tightened quite dramatically in 2024, especially in the fourth quarter of the year, and it has dragged SSA bonds wider as well — I believe we are looking at a 25bp widening for most issuers, if not a little more.**

Jörg, KfW is in the market to fund a 'small' programme of €65bn-€75bn this year, and with no European Central Bank buying, the elevated spreads to swaps and the reduced attractiveness to govvies as a result of the swap spread tightening, what do you see as the main challenges as an issuer, and what is the impact from recent spread developments on you as an issuer and on your investors?

Jörg Graupner, KfW: Let me start with the extension of the title of our panel maybe, From Macro to Macron. Maybe if we were to follow the current polls to [Friedrich] Merz as well, who is potentially the next German chancellor, although let's see after the elections in two weeks' time, at the end of February we will potentially have another macro/Macron/Merz.

Coming back to your question about what the challenge for us as an issuer is at the moment, especially when we look at the very wide spread levels, I have to say looking at Ales to my left, potentially he is very happy with these levels and this is the investor demand perspective. When you look at the huge order books that we have seen since January 2025, the bonds issued have been very well absorbed by the market.

Roundtable participants

Moderator:
Addison Gong, SSA editor, *GlobalCapital*

Conrad Baker, managing director, head of SSA syndicate, Nomura

Jörg Graupner, senior funding manager, treasury, KfW

Ales Koutny, head of international rates – active fixed income, Vanguard Asset Management

Isabelle Laurent, deputy treasurer and head of funding, European Bank for Reconstruction and Development

Of course, for us as an issuer, we are now in a totally different spread environment, because of the swaps environment. But I have to say, this is not only a phenomenon for KfW, but for the whole industry and all the issuers. As long as we have the shift in parallel and there is no change in spreads to each other, KfW can achieve levels more or less in the same context to Bunds as we have seen in 2024, and also in the spread context that we have seen so far versus peers.

So while it is of course a new situation for issuers to accept the new environment, we have to take the market as it is, and at the same time this is more satisfying for investors and that is good for demand.

***GlobalCapital*: We'll come back to the spreads to peers, but before that, Isabelle, is it a similar situation that you are observing in the supra world and as far as the EBRD is concerned, in euros or in dollars or sterling?**

Isabelle Laurent, EBRD: Definitely, spreads have been volatile, and it's not been clear in which direction. I think what's been impressive is, as Jörg was just saying, to see the order book sizes, even when spreads are very tight to US Treasuries. It's not the first time that we've seen some deals with single-digit spreads to Treasuries, but when we last saw them it was when absolute rates were very low. So if you were getting 5bp on top of an absolute rate which was just about 10bp, it actually looked quite encouraging. But when absolute rates are now higher, it's more surprising that we're still seeing good demand at those levels.

We're seeing good global demand, and from many different quarters. The high quality liquid asset players are still definitely a big part of the order books for SSAs, and central banks are still looking for places to put their money. Meanwhile, there are a lot more asset managers and insurance companies globally that seem to be playing. And they all have slightly different focuses: some are looking at absolute rates, some are looking at spreads to govvies, and some are looking at spreads to asset swaps.

This creates an environment where we're still seeing very good and consistent demand, leading to some of the largest order books we've ever seen. Of course, some of those are inflated by accounts that don't think they are going to get a full allocation so one has to treat the numbers with a pinch of salt, but in many instances, the real demand is strong across all the different currencies.

"It's not the first time that we've seen some deals with single-digit spreads to Treasuries, but when we last saw them it was when absolute rates were very low"

Isabelle Laurent, European Bank for Reconstruction and Development

***GlobalCapital*: Ales, you're on the other side so what's bad news for Jörg may be good news for you. But for you, I suppose the key question is, are the levels attractive enough? Do we see more widening on the horizon, or some potential for performance? I believe we've already seen some performance so far this year, but what's to come?**

Ales Koutny, Vanguard: From an investor perspective there are many factors, with everything happening at the same time. For example, we have seen much smaller differentiation between SSAs. We have seen KfW and EBRD remaining on the more conservative side of issuance this year, yet other issuers who have significantly increased their net issuance programmes have not seen much impact in their spreads.

As you said, much of it is due to the significant moves that we saw in asset swaps. I have been in countless roundtables where half of the people there had a tough last year as asset swap spreads kept widening, whereas the other half had a great time because of the tightening between SSAs and govvies. Now this year the tables have turned. ASW buyers are benefiting from the widest levels in many years, where versus government bonds SSA spreads are very tight.

Going forward, I continue to believe that the most important question is where swap spreads go from here. Recent developments suggest that uncertainty will remain in place — just yesterday, for example, we had some announcements regarding potential changes on the regulatory framework for US banks. We also have different views regarding the issuance volume of govvies and that is a competing factor for the other SSAs.

When we look at why SSAs are getting tight versus govvies, my personal take is that governments have been issuing a lot, especially in net terms with quantitative tightening taken into consideration, so the net supply of govvies has increased quite a bit. On the other hand, the net funding for a lot of SSA issuers has been and will continue to be negative this year. Investors are starting to differentiate, with a preference for those more conservative issuers, and that has affected supply/demand.

We have also seen a lot of flows into fixed income. As Isabelle said, the absolute level of rates is quite interesting right now and investors have been shifting their asset allocation more into fixed income. That has meant that the competition for those bonds has increased. And I agree that many of the order books that we are seeing have very different profiles, but it's undeniable that the demand for bonds has increased quite significantly over the past two to three years.

***GlobalCapital*: Conrad, crystal ball time for you now. What's your read on what's happened so far and where do we go from here?**

Conrad Baker, Nomura: I think it's been a very successful start to the year for all the SSA community across euros, dollars and sterling. There have been record order books, and I don't think we're going to see a great change to the demand that we're seeing in the coming months. Yields are still elevated, central banks are predominantly going on a cutting path, and spreads still remain optically wide. Given we have these wide spreads and high yields, we've seen these huge order books and very successful trades getting done in January and I think the demand will continue.

One thing we haven't talked about yet has been the spread difference between the credit products and the SSA products, where SSA has actually looked quite cheap versus covered bonds, for example, coming into January. So we're seeing definitely a shift in the investor composition of some of these books, where traditionally they'd be buying covered bonds, but now they're buying euro SSA because it's cheap.

We just talked about swap spreads and that is a huge factor in our space — it's what we watch all day and every day, from euro swap spreads to dollar swap spreads, and that's really going to drive the relative value of the asset swap spreads on offer. Do we see regulation coming out of the US where swap spreads will widen, and does that mean dollar SSA spreads versus swaps will tighten? Does that mean the demand that we're going to get from the bank treasuries will remain the same?

But there's still a lot of liquidity in the system, as was reflected by these record order books. It's very hard to look into Q2, Q3 and Q4 but in the coming months, I think the demand is going to stay there and that's why issuers are continually issuing after we've seen a record January across sterling, dollars and euros.

Graupner, KfW: We often hear from our dealers that we should come sooner rather than later. Is that something that you are saying for now, or always?

Baker, Nomura: Well, I work as a syndicate, so I'd always say that. But in all fairness, I think you've seen issuers get going across all currencies. Multiple issuers have done sterling, dollars, euros, Swissie and Aussie all in the first one to two weeks of the year. And we've seen in previous years that the second half of the year has been actually challenging in terms of issuance conditions, and in some cases, issuers have waited as they didn't want to pay the spreads at the time, but instead of getting better, things actually got worse.

We've seen with swap spreads and we've seen it with inflation — real inflation — that narrative change at the back end of one year. So I think getting into the market early has proved a good tactic for issuers and a lot of issuers still do it. I know Isabelle hasn't done a [fixed rate] dollar or euro benchmark trade this year, but KfW has been very successful issuing across markets. January is where all the enthusiasm is because everything is back to zero, and issuers have just got on that bandwagon. I think this year we'll see that more and more front-loading will be the case again, and I think the second half of the year will be actually quite quiet.

***GlobalCapital*: I would like to talk a little bit about relative value. Jörg has briefly touched on this, but in the last year, again, we've seen a significant shift in relative value, mostly among eurozone sovereigns, with the French yield soaring and the southern European sovereigns continuing to outperform, but also with players such as the European Union continuing to grow their funding programmes. Those shifts in relative value have more far-reaching implications than on the sovereign themselves but on the other SSA issuers, as well as investors.**

Jörg, back to you. Regarding KfW's current relative value versus Germany, for example, versus other SSAs like the EU or even like the French agencies, who are offering so much more spreads currently, where does KfW fit into all this right now and what do you think that means for your funding going forward?

Graupner, KfW: What does it mean for our funding? I just have to say that we're coming out of a more painful period of time — we just traded around 50bp over Bunds last year in some of the tenors, and that did not really satisfy our internal customers of the refinancing costs. But now we are just coming closer and closer to Bunds, at around 30bp, more or less. This is more the area where we feel more comfortable above Bunds.

Why are we trading so high over Bunds? The answer is always on the liquidity premium. Bunds are, of course, much more liquid, and I would say we are also liquid but not to the same extent of Bunds.

Looking at other SSA issuers, and this is not something that I want to highlight with huge pride, but KfW actually trades in our own environment. There is no one where we think that we should consider [our relative value], for example, the bigger issuers — I don't want to name them but you all know which ones I potentially mean. I think it is a totally different environment at the moment, with the EU as a new issuer with a huge volume as was already mentioned — higher than previous years — and of course this brings a bit of pressure on themselves but also some other names.

As I was saying earlier, KfW is trading, especially in euros, in our own environment and many of

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Ales Koutny, Vanguard Asset Management

the issuers are calibrating the new issuers versus KfW. For us, we only have our own outstanding curve — and it's a very liquid and a very reliable one. And this is, of course, helpful for us for finding, in euros at least, the right approach for our primary activities.

***GlobalCapital*: Isabelle, looking at the current relative value versus major govvies like US treasuries, German Bunds, French OATs as well as others like the EU, where do you think issuers like EBRD and maybe your supra peers fit in? And where do the main attractions lie in investing in supra bonds in this environment where spreads versus govvies, as we just discussed, have compressed considerably?**

Laurent, EBRD: Toby made the introduction with his comment on MDBs and US political issues. I think in general, MDBs are seen as a safe haven. We've had a lot of political uncertainty, including elections, and MDBs in general are somewhat insulated from all that.

The global nature of the investor bases for us and for SSAs generally is certainly helpful. Amid the political fallouts, the MDBs that manage their own balance sheets — especially those with the capital structure that we have — are far more insulated from what is going on. There are some supranationals which are very dependent on the ratings of their largest individual shareholders, but that is not the norm for MDBs.

So when you see tensions between, say, the US and China, or the fallout from issues like trapped monies, the MDBs tend to be insulated.

So if you are looking for a safe haven, some buy gold and if they're not getting gold then they're buying fixed income and MDBs. There's consistent value in that.

And I think, with the US discussion of what's happening with the MDBs, we are not expecting anything [to happen]. Everyone's saying that Trump operates as a good businessman, and given the US paid in 10% of our original €5bn paid-in capital and we've now got over €23bn of capital, and they would only get back what they paid in and not any of their portion of the additional reserves, I can't imagine it'll look like a very good

"This is one of the reasons why a lot of issuers are funding early: because they know there's a lot of volatility to come"

Conrad Baker, Nomura

deal. We'll probably see that MDBs continue to be seen as a safe haven with all the political discussions that are going on. It might be wishful thinking, but I don't think so.

Baker, Nomura: If we look at tight Treasury spreads in dollars for the MDBs, we've had that for a while now but as Isabelle said, there isn't the volatility that we see in the MDB world as we do in government bonds. You can call it weakness in Bunds given that swap spreads have collapsed in euros, and swap spreads in dollars are deeply negative and there's a lot of oversupply. A lot of questions are about where this is going and are on deficits, etc.

I think MDBs, especially in the dollar space, where spreads are very tight versus Treasuries, are indeed seen as a safe haven. And yes, they do track Treasuries but there is still a lot of stability, and there is still good liquidity even at these levels. Given the size of the deals we see across euros and dollars, investors have that perception that they can get out of bonds when they want to — they can take profits; they can be short; and they can be long.

I think liquidity is greatly improved in the SSA world especially in the last three or four years, and it does provide diversification for investors. You could argue that the MDBs should trade through Treasuries from a credit perspective. Of course liquidity then trumps that, but this is why we're seeing still good appetite, even at 7bp-10bp for the MDBs versus Treasuries and for KfW as well.

***Addison Gong*: Ales, I think we need an investor perspective here. Single digits over Treasuries, and some French agencies, for example, are also trading at single digits over OATs. What do you think of these numbers and where do you see interesting investment opportunities now after we had all this shift last year?**

Koutny, Vanguard: I agree regarding liquidity, but what I find most interesting is that, if we take French agencies as an example, some investors that don't want to buy OATs due to the political uncertainty are the same ones rushing to buy French agencies, which are fully and only backed by the French government.

It does beg the question about how the market is squaring the whole geopolitical uncertainties that we are seeing. And if we focus on assets first, I think the main point of SSAs is that everybody understands that, especially in Europe in defence terms, there needs to be more spending. The question is how that spending gets funded. There are some numbers being thrown around for Nato spending increasing to 2.5% or 3%-plus [from 2% currently of the member states' national GDP]. That's a lot of money.

If governments are self-funding these and it feeds into their budget, that weighs more on the govvies' supply side. Another option is for some of the current institutions to finance those amounts or a separate SPV/agency being created — maybe through the EU partnering with the UK and Norway — we could be talking about €50bn or even €100bn of yearly extra issuance. And that would put that vehicle in the top three of issuance in SSA space.

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Jörg Graupner, KfW

So that question has been weighing on the minds of many investors regarding the future for SSA spreads in Europe and where we go from here. Will there be enough demand to absorb it, or will governments prefer to fund that out of their own budgets?

When it comes to the govvie space, it's quite an interesting dynamic, especially for the European periphery as you mentioned before. We have seen countries that we were told before would always be the laggards in growth actually surprise over and over again. Many people don't look at the fact that Spain, as an example, is half the size of the economy of France and a third of Germany, and yet since the pandemic, it has delivered similar amounts of growth in gross terms as each of those two economies. That has led to the tightening of spreads at the periphery versus the core of Europe and I don't think that is unwarranted. I think there is a bigger question if those core, semi-core, periphery classifications do still apply.

Similar to SSAs, we have seen a significant compression across credits and across the periphery so the question is: will the market start to differentiate back again? Or will we just go to an environment where as long as growth is still positive, central banks are cutting rates, money will continue to flow into fixed income and everything continues to perform well?

***GlobalCapital*: The last question is a short one consisting of two words, Donald Trump. He's already made a terrible amount of noise after just a few weeks in office and the latest concerns the MDB sector. There is a lot of policy uncertainty already and more potentially on the horizon. What impact do we think his four-year term is going to have on our market and how do we plan to navigate around that? Not to mention as the panel's subject suggested, there is Macron, there is a German election coming as well, so a lot on everyone's plate.**

Koutny, Vanguard: I can start. For us it's not about politics, it's about policies. What we thought would happen three weeks to a month ago versus now has already completely changed. As I said earlier, just yesterday (February 5) we already had some noise regarding bank regulation. And nobody really knows where issuance for the US is going to end up this year. Europe is also another question, with the tariffs and many other factors.

The only certainty we have is that the uncertainty will linger for a long time. And that does mean that assets will try to price that equation and we will try to react as quickly as we can to new information. But that means the reverse of that is also true: as soon as there is some short-lived agreement between Europe and the US or US and another country regarding tariffs, we have seen a lot of the moves reversing quite quickly as if nothing happened.

We think this is going to keep investors on their toes, thinking what all the different potential scenarios are and the implications on asset valuation could be. Perhaps there is something that could really break things and become more systemic, or we could see continuous wobbles, but, at the end of the day, everything remains broadly similar and the global economy continues to grow.

Laurent, EBRD: I agree about volatility. What we used to think about was that we don't want to price around a data release like a CPI number. Now, maybe we will care less about these numbers. Maybe the administration is bombarding us with a lot of announcements at the start or maybe we'll get used to the noise.

I think we'll continue to see volatility, but I think it will support our [SSA] market actually. But it will make it more interesting than just trying to avoid a data point to price a deal.

Baker, Nomura: I think it goes back to what Jörg asked me, why should we fund early? And this is one of the reasons why a lot of issuers are funding early: because they know there's a lot of volatility to come. From where we sit, volatility has been around for a while now, so you have to be able to ride out the storm and take a longer-term view on investments, which a lot of our investors do. So they're used to that and they're prepared for that. It's a part of life now. Everyone knows that Trump could wake up one day, tweet something, change his mind the next — as we've seen with the tariffs already. So I think fund while the conditions are good, which they are, and that's what a lot of issuers will continue to do.

Graupner, KfW: From my side, as you know, KfW's funding programme is very flexible, we have a lot of possibilities for entering the market, not only in euros but also in dollars, sterling and some other currencies. So that means flexibility is key on the currency side.

And a second huge advantage I would say for KfW, is that our needs are more on the shorter end at the moment, so we have less duration needs. And also when I look to the investor base, in the case that there is some big volatility for the market to handle, it makes more sense for them investing or putting money into the shorter transactions instead of very long ones. GC