RESERVE BANK OF AUSTRALIA

Speech

Australian Securities Markets Through the Pandemic

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Good afternoon. It's a pleasure to be here today with you, albeit virtually, and I want to thank the Australian Securitisation Forum for their invitation.

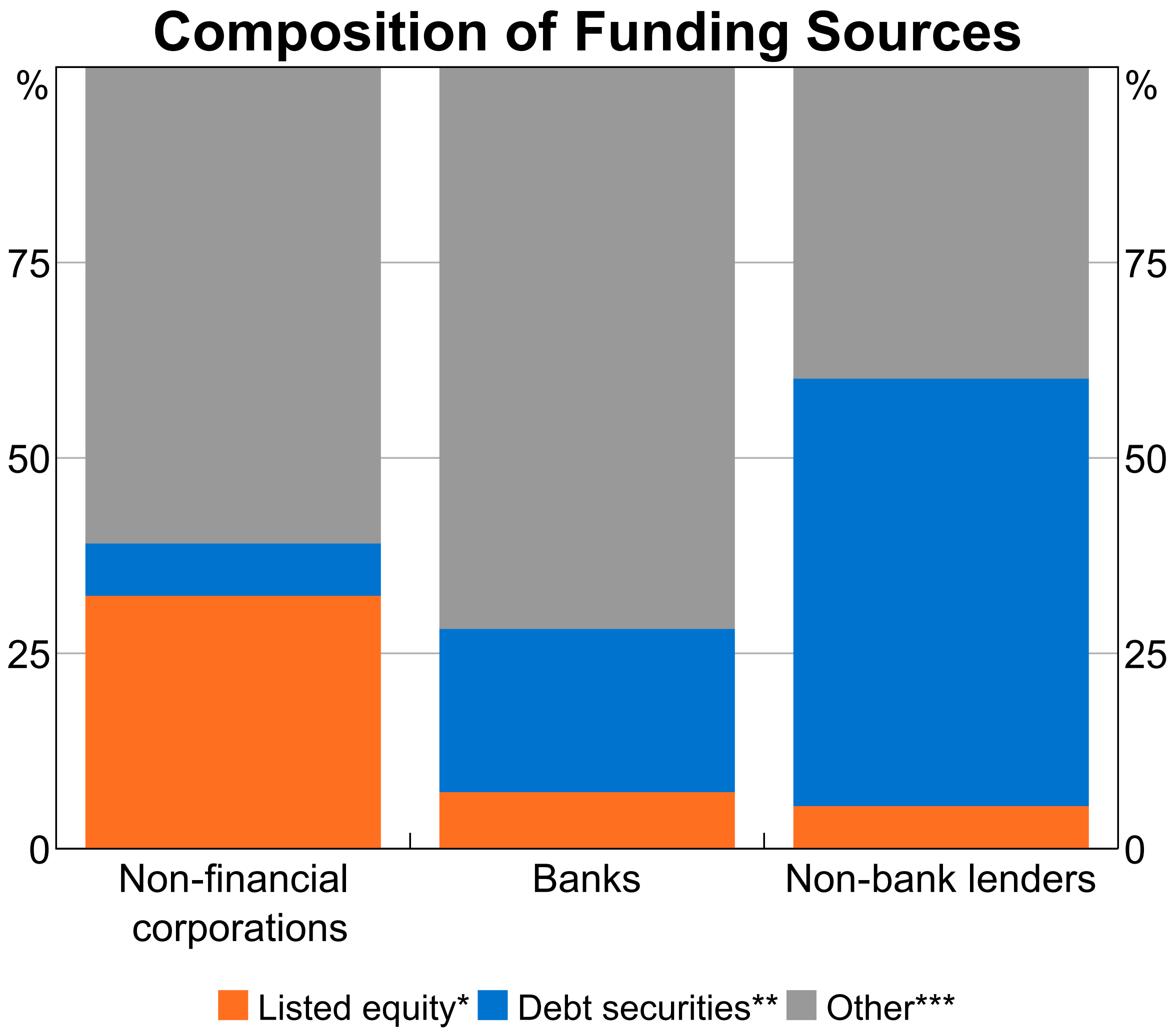
This has been a turbulent two years for everyone, including for financial market participants. Previous downturns have taught us just how important it is that funding continues to flow to households and businesses, through both banks and securities markets. When securities markets aren't working well, this ultimately weighs on employment and economic activity. And securities markets are, of course, key to the transmission of monetary policy. This is also true for the unconventional monetary policy measures that the Reserve Bank of Australia (RBA) has deployed since March 2020.

Today I'll be talking about how markets for non-government securities have weathered the past 20 months, and how this has affected both the availability and the cost of funding for Australian businesses and households. [1] I'll also talk about a few things that we'll be watching in securities markets over the coming months and years.

The role of securities markets

Securities markets play an important role in the Australian economy. Graph 1 shows the composition of funding sources for different types of businesses. Both debt securities and listed equity funding are sourced through securities markets.

Graph 1



* For non-bank lenders, listed equity share is estimated as a percentage of total equity based on whether issuer is listed on the ASX

** Debt securities includes bonds, bank bills, and asset backed securities

*** Other includes deposits (for banks), unlisted equity, bank loans and other debt

Sources: ABS; APRA; Bloomberg; RBA; Refinitiv

You can see in the first column that *non-financial corporations* source one-third of their funding from listed equity markets. Their funding via debt securities is relatively small, at less than 10 per cent. This reflects the large role of the banking system in Australia, as bank loans account for most of corporations' debt. The second column shows *Australian banks* ' funding. Banks source most of their funding from deposits. But around one-fifth of banks' total funding comes from debt securities markets (domestically and offshore). And there are, of course, *non-bank lenders* (in the third column), which rely heavily on debt securities markets to fund the loans they originate.[2]

One function of securities markets that I'd like to highlight is their role in the transmission of monetary policy. The cash rate is an anchor for interest rates in other markets, including in securities markets, and so is a key determinant of the cost of funds for banks and other lenders. This, in turn, influences the interest rates paid by households and businesses on their loans. And for many large businesses, the cost of equity and some debt is determined directly in securities markets.

During periods of volatility, functioning of these markets can become strained, impeding the transmission of monetary policy. In particular, the effect of lower risk-free rates from policy easing on overall financial conditions can be offset if risk premiums increase sharply. Also, banks may reduce new credit if they are uncertain about the availability and cost of their funding. And, if firms are unable to obtain funding from banks or securities markets, they may be forced to reduce employment and investment. This highlights the importance of market functioning during times of stress. The lessons from previous episodes of financial turbulence were at the forefront of our minds when the impact of the COVID-19 pandemic began to play out in financial markets.

Secondary markets

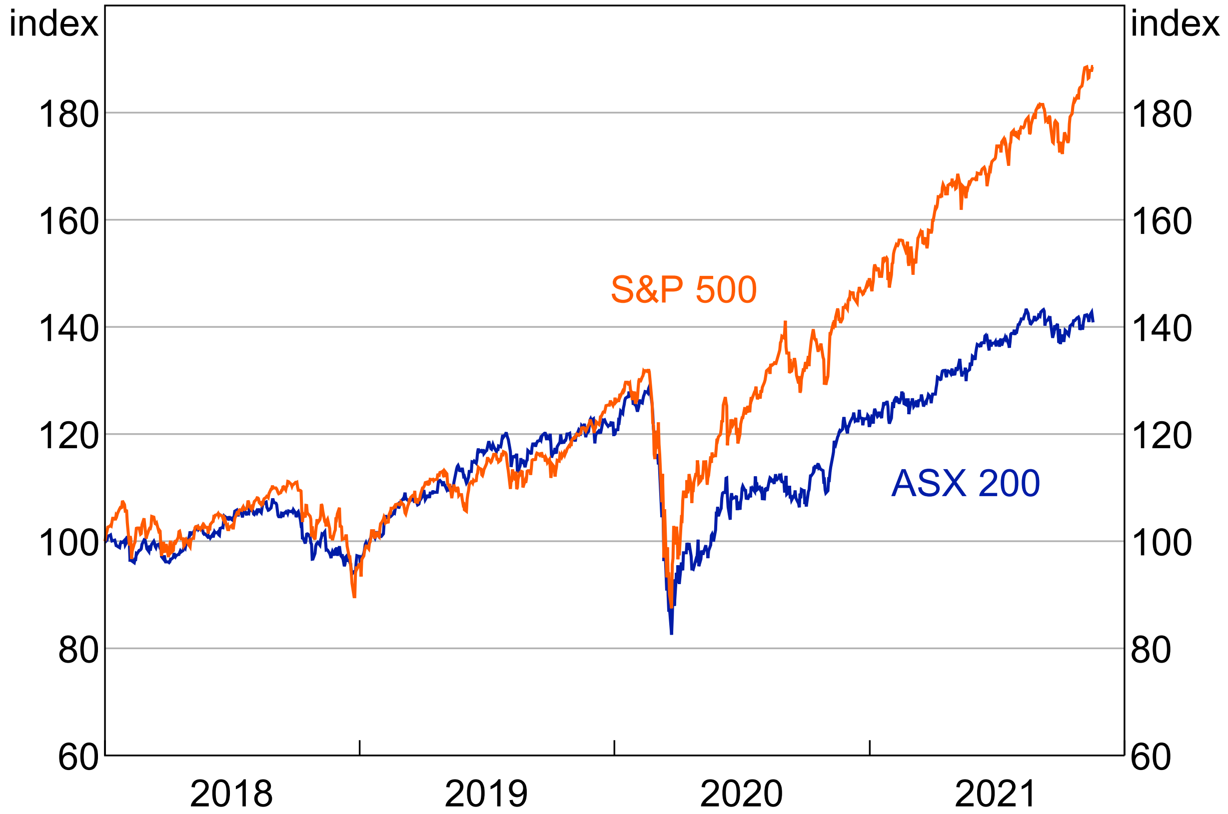
So how did markets react as the pandemic unfolded?

Concerns around the economic impacts quickly became evident in equity markets. On 16 March 2020, five days after the World Health Organization declared a pandemic, the ASX 200 declined by 10 per cent. This was the largest one-day fall in over 30 years. As you can see from Graph 2, this wasn't just an Australian story. The S&P 500 declined by 12 per cent on the same day. During this period, turnover in equity markets was very high.

Graph 2

Total Return Indices

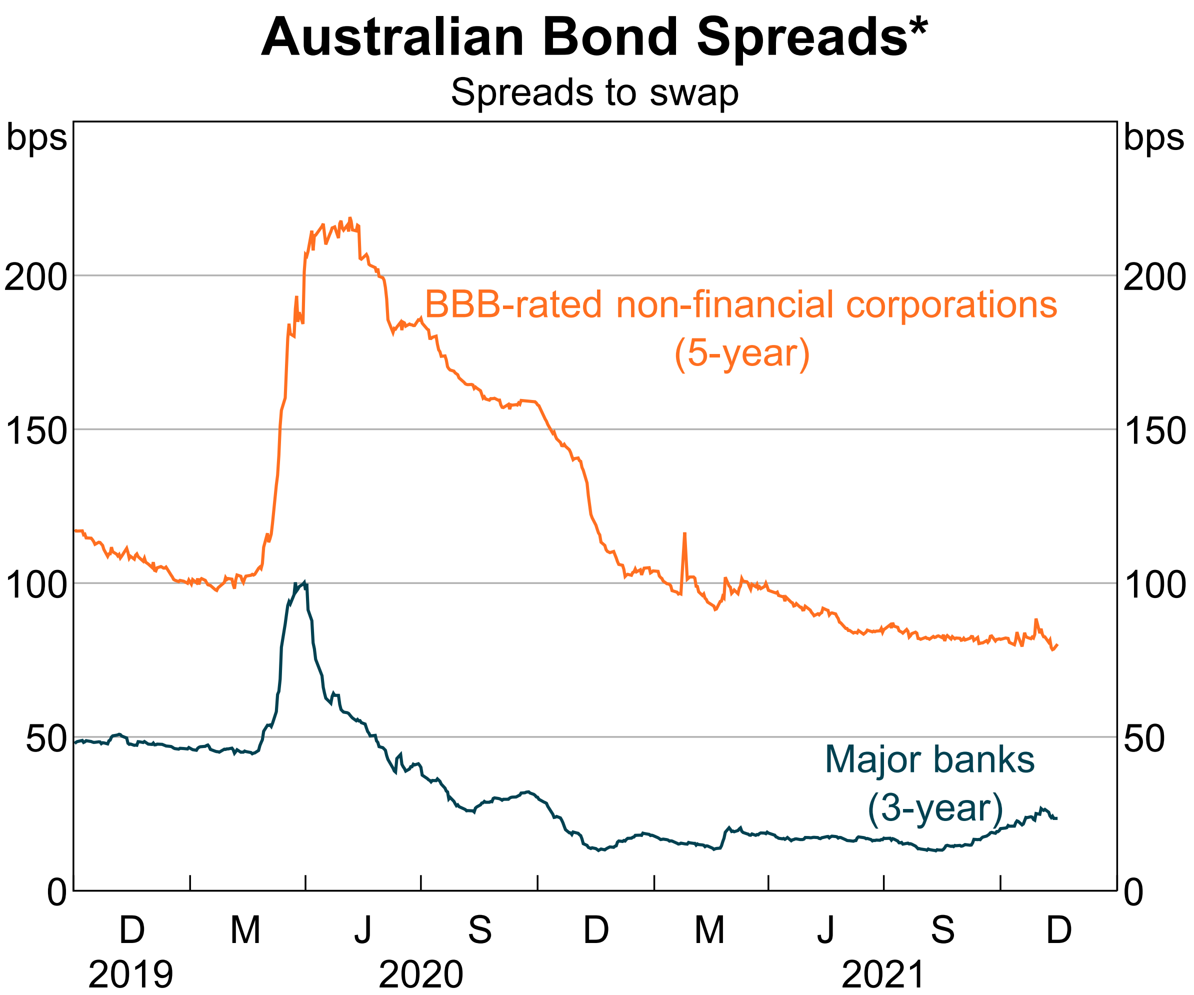
End December 2017 = 100



Source: Bloomberg

Concerns were also evident in corporate bond markets. Bank and non-financial corporate bond spreads began to widen in mid-March, as shown in Graph 3. This reflected a reassessment of credit risks on top of general selling pressures as fund managers faced increasing redemptions. With a much greater number of market participants wishing to sell than buy, market makers ended up holding a lot of inventory and bid-ask spreads increased substantially. Similar issues arose in the market for asset-backed securities, where selling by offshore investors was particularly heavy.

Graph 3



* Bank bond spreads are for domestic major bank bonds; spreads for non-financial corporations are not option adjusted

Sources: Bloomberg; RBA

Around the same time, policymakers in Australia and around the world announced a broad range of actions to support the economy. In Australia, the federal and state governments implemented several stimulatory policies targeted at businesses and households – notably JobKeeper – to cushion the impact of movement restrictions. On 19 March, the Reserve Bank Board announced a package of policy measures to keep funding costs low across the economy and ensure credit remained available. The aim of the measures was also to promote functioning of key financial markets. These measures included a lower cash rate, a target on the three-year government bond yield, bond purchases to address market dysfunction and the Term Funding Facility (TFF). The Australian Office of Financial

Management (AOFM) announced it would provide support to securitisation and warehouse markets; this would assist small banks and non-bank lenders that could not access the TFF.

Conditions in financial markets began to stabilise shortly after, in late March. The ASX 200 reached a nadir on 23 March, around the same time as the S&P 500. Bank bond spreads, along with bid-ask spreads, started to decline in early April, as risk premiums declined. Non-financial corporate bond spreads started to fall in early May. By late 2020, both bank and non-financial corporate bond spreads (and yields) had reached very low levels relative to history.

Overall, the adjustment in pricing as the COVID-19 pandemic spread was sharp, but also brief. During the global financial crisis, volatility in equity prices stayed elevated for several quarters, as did risk premiums for bonds and equities.

Raising funding – the primary market

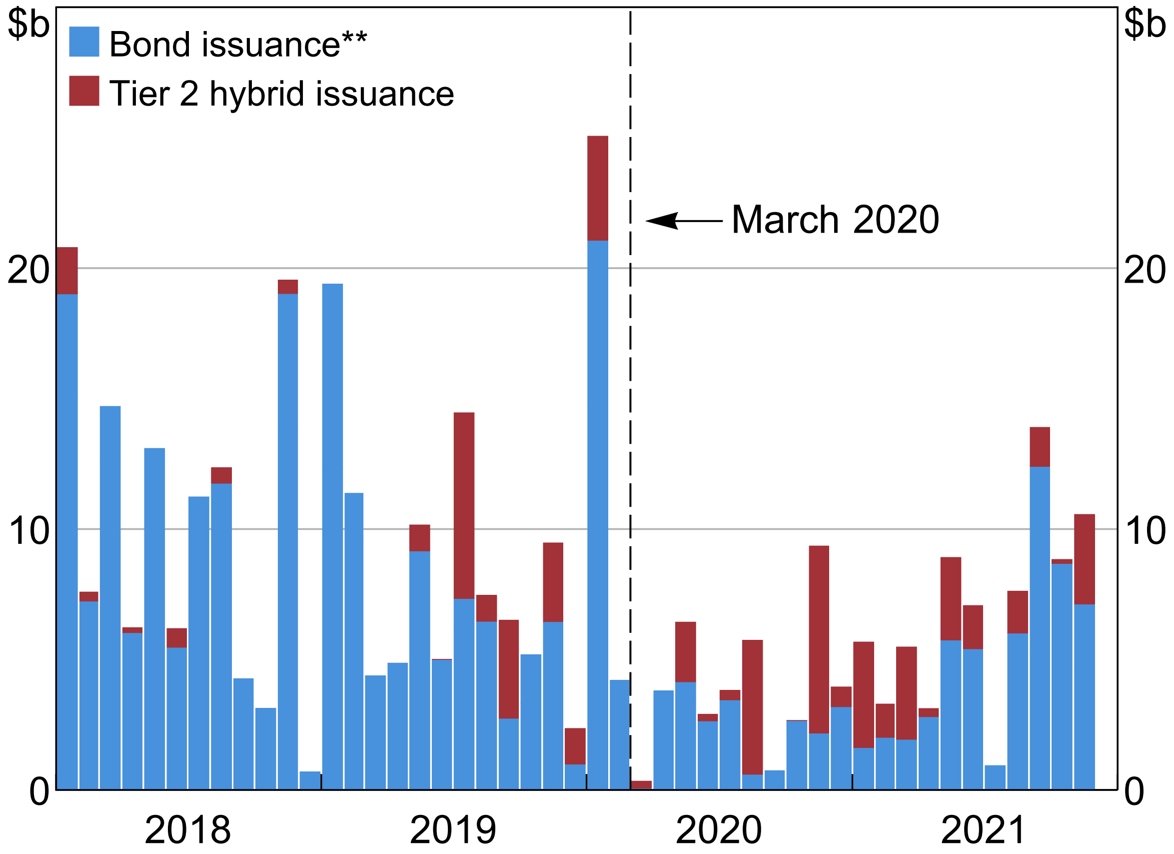
I'll now turn to developments in primary securities markets, focusing first on the banking sector. Banks did not tap securities markets to any significant extent as the pandemic unfolded. In part, this is because the RBA provided repo funding through its daily liquidity operations at attractive rates and on longer terms than usual as uncertainty increased in March 2020. It also provided three-year funding via the TFF from early April. The aim of the TFF was to lower funding costs for banks and encourage them to continue lending at the height of the pandemic, benefiting households and businesses.

Banks have historically held a significant presence in the Australian non-government bond market. But the availability of both the TFF and ample low-cost deposit inflows meant that banks required less new funding from this market for an extended period. You can see this trend clearly in Graph 4. Bond issuance was well below the average of previous years until quite recently, after the TFF closed to new drawdowns in June this year.[3] You can also see that larger banks did continue to issue Tier 2 hybrids.[4] Issuance in mid-2020 achieved spreads close to 2019 levels, and later issuance was at narrower spreads.

Graph 4

Australian Bank Bond and Hybrid Issuance

Australian dollar equivalent; monthly*



*   Last month is month to date

**   Includes senior unsecured and covered bond issuance

Sources: Bloomberg; Private Placement Monitor; RBA

I'll now turn to non-bank lenders. Non-bank lenders rely heavily on securities markets. They use warehouse facilities to fund the origination of loans, and subsequently package the loans into asset-backed securities (ABS) to be sold to investors.

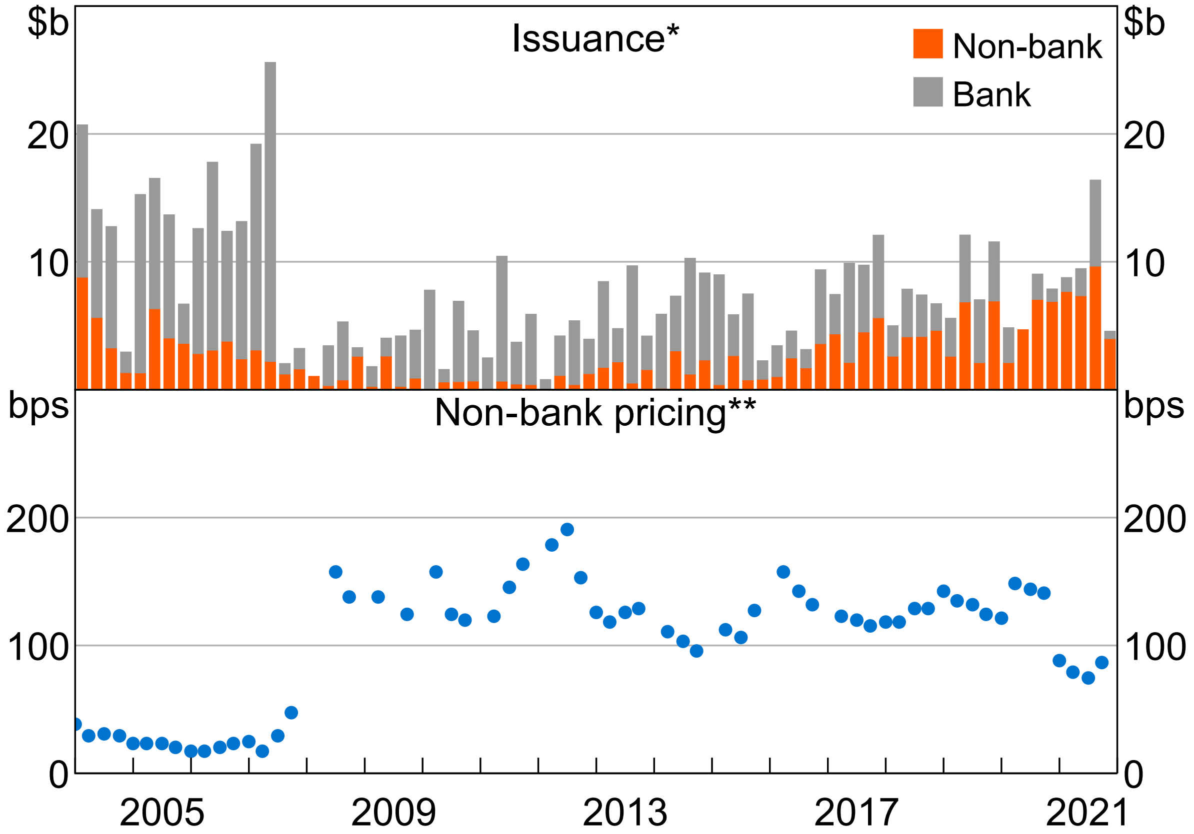
In the uncertainty of the early stages of the pandemic, many investors tried to sell their holdings of ABS, creating an overhang in the secondary market. This raised questions about the market's ability to absorb new issuance and, in turn, non-bank lenders' ability to fund new lending. If market conditions had not improved, non-bank lenders might have responded to their lack of funding by tightening their lending standards or increasing their interest rates so as to slow the flow of new loans. Ultimately, this turned out not to be necessary. And, to the extent it did occur, it did not last for long.

Market conditions improved, at least in part, because of the Structured Finance Support Fund, through which the AOFM invested in public and private securitisation markets. This participation reassured investors that deals were likely to be a success, and helped to restore confidence in the market.

Volumes of ABS issuance by non-bank lenders picked up by the second half of 2020. Graph 5 shows that it has remained high throughout 2021, with a record volume of non-bank lender issuance seen in the most recent quarter. Spreads have also narrowed to their lowest levels since 2007. The low levels of bond issuance by banks have reportedly contributed to these narrow spreads, as investors moved into residential-mortgage backed securities (RMBS) instead.

Graph 5

Australian RMBS



* Latest quarter is quarter to date

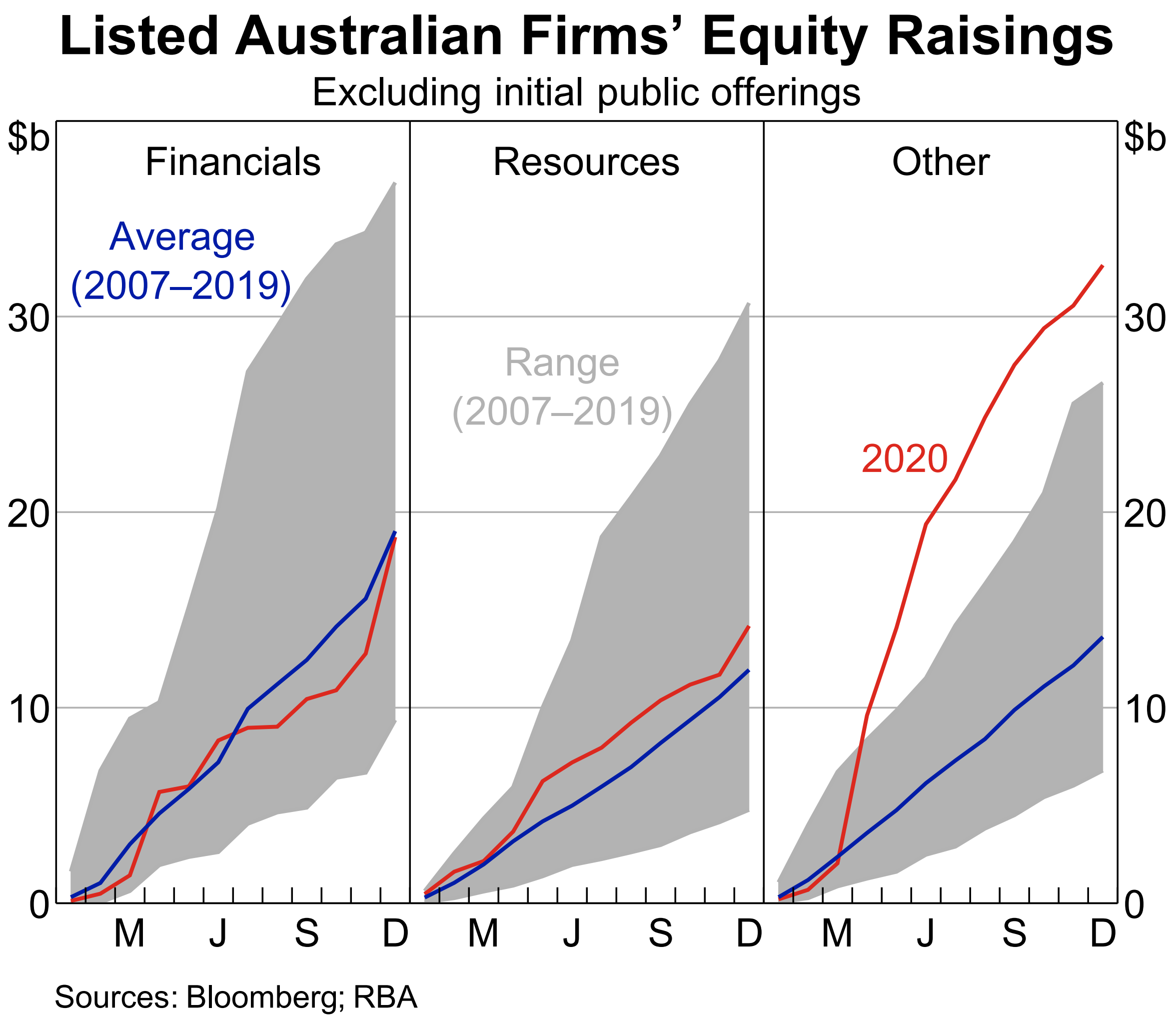
** Face-value weighted quarterly average of the primary market spread to BBSW for AAA-rated notes

Sources: Bloomberg; KangaNews; RBA

What about non-financial businesses? Non-financial businesses first turned to banks for liquidity. Facing a potential decline in cash flow, some firms temporarily drew down existing lines of credit and some sought higher credit limits as a precaution. The TFF supported banks in providing business credit, in particular. Most businesses had repaid these temporary drawdowns by mid-2020.

In late-March 2020, listed firms began to raise equity in large volumes. Firms issued equity primarily to increase liquidity and to shore up their balance sheets. Activity was dominated by firms in the 'Other' category in Graph 6, which includes sectors such as industrials, real estate and consumer discretionary. These sectors had some of the largest initial share price falls.

Graph 6



Several non-financial firms postponed bond issuance that they had planned for February and March 2020. In addition to the general increase in spreads, there was a high degree of uncertainty about how much funding firms could raise, and at what price. [5]

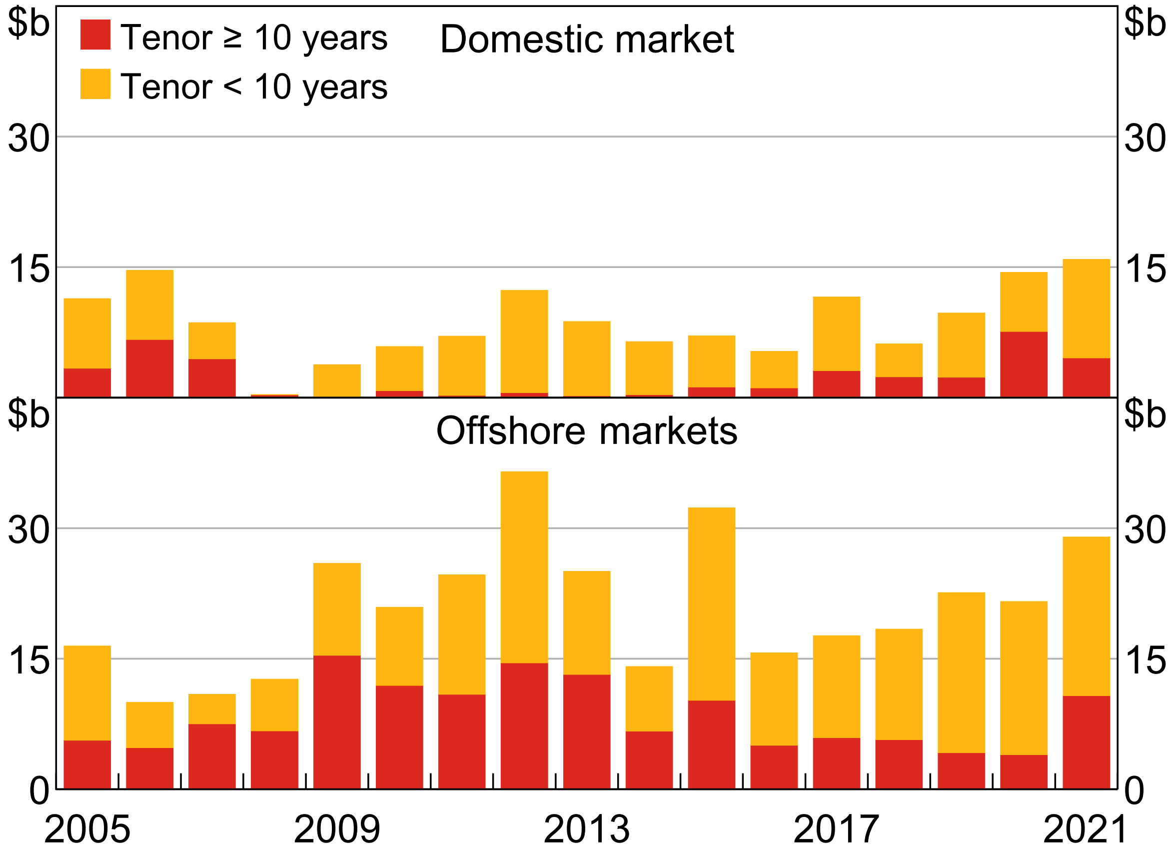
In May 2020, the RBA broadened the range of eligible collateral for open market operations to include non-bank bonds with an investment grade credit rating (BBB- or above), rather than a AAA rating. This change in policy aimed to assist with the smooth functioning of Australia's private-sector bond markets. Liaison suggests the change boosted sentiment among some issuers, although it's difficult to quantify the effect on issuance or pricing. [6] In any case, corporate bond issuance in the domestic market started to pick up soon after the RBA announced the change.

In 2020 as a whole, bond issuance by non-financial corporations in the domestic market was above the average of the past decade, as can be seen in Graph 7. You can also see that roughly half of the issuance in 2020 was at a tenor of 10 years or more, which is a much greater share than usual. Notably, the domestic corporate bond market recovered more quickly than it did after the global financial crisis (when issuance didn't recover until the second half of 2009). [7]

Graph 7

Non-financial Corporate Bond Issuance

Gross issuance, Australian dollar equivalent*



* 2021 figures show year to date

Sources: Bloomberg; Private Placement Monitor; RBA

Securities markets in the years to come

That brings me to the end of my discussion of Australian securities markets through the pandemic. I'd now like to turn to the future and discuss a few areas in securities markets that we at the RBA will be keeping an eye on over the coming months and years.

One area of focus stems from the current historically very low interest rates. Asset prices increase when risk-free rates are low, and this is part of the monetary transmission mechanism. However, as we've highlighted in recent *Financial Stability Reviews*,[8] over time it also raises the prospect of ‘search for yield’ behaviour, where investors bid up the price of risky assets to the extent that risk may no longer be adequately priced. This, in turn, increases the risk of a sharp correction down the road. So, it's important to closely monitor risk premiums to judge whether asset prices appear to be sensibly valued. While bank bond spreads are around their lowest level in over a decade, it's difficult to know whether this is not aligned with fundamentals. Measures of equity risk premiums remain within their typical range.

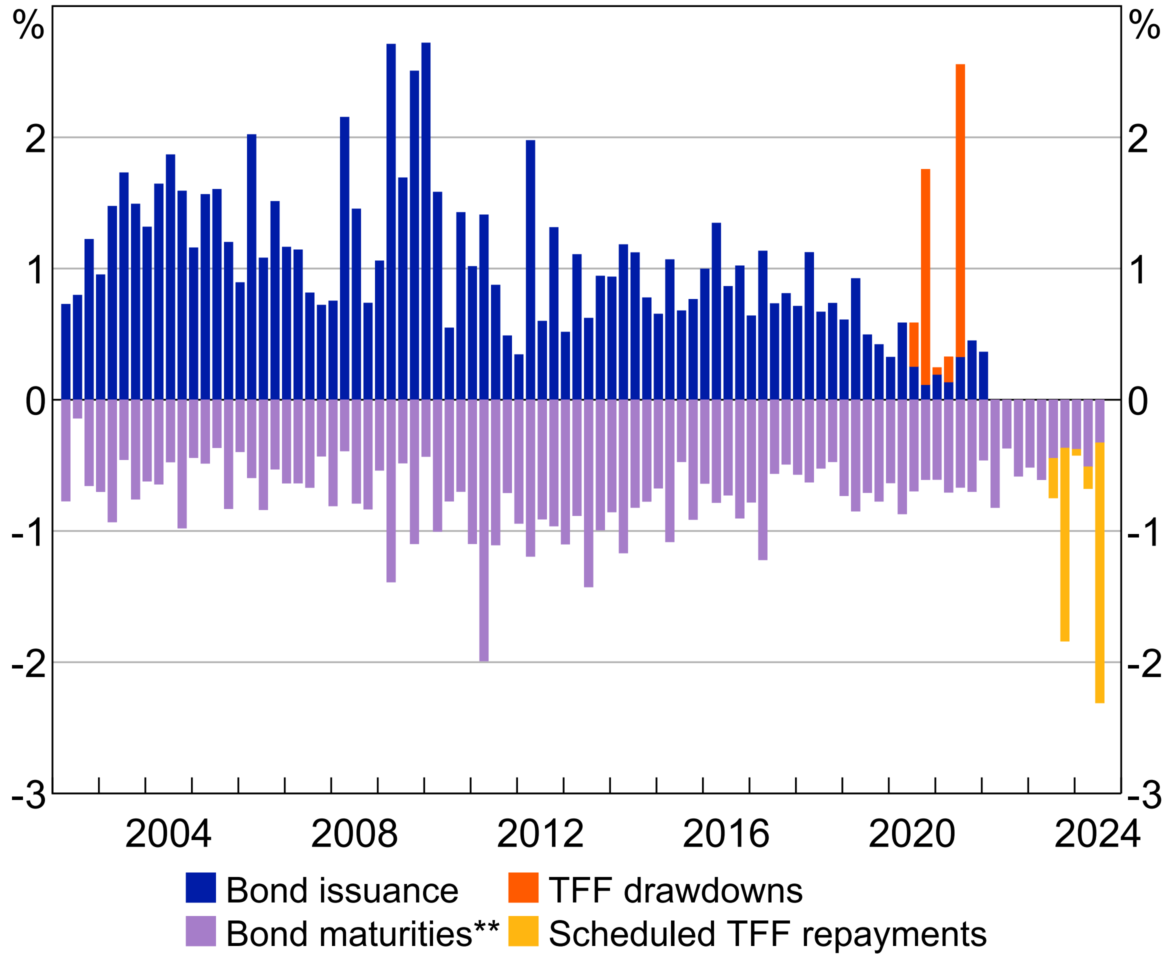
Another area of focus will be possible changes in supply and demand in security markets as the Committed Liquidity Facility (CLF) is being phased out. Over the past two years, the stock of government debt has increased sharply, funding the fiscal response to the economic effects of the pandemic. This increase in High Quality Liquid Assets (HQLA) has allowed the Australian Prudential Regulation Authority to phase out the use of the CLF over the coming year. The facility, which is provided by the RBA, allows banks to hold collateral other than HQLA, including bank bonds and RMBS, to fulfil their required liquidity coverage ratio. Given the changes in the CLF, banks might decrease their holdings of these securities. At the same time, banks are likely to increase their holdings of HQLA, which could be funded in part by increased bond issuance.

A third area of focus is the bank bond market and the refinancing of the TFF. As you can see in Graph 8, the TFF maturities are large and concentrated in the September 2023 and June 2024 quarters. Banks can meet this refinancing task in a number of ways, including sources of funding such as deposits. But it's likely that they will raise a sizeable amount of funds from bond markets to repay TFF funding.[9] If banks issue new debt to replace TFF drawdowns in the quarter of maturity, this would require quarterly issuance as a share of assets at levels not seen in over a decade. However, in liaison banks have indicated plans to issue bonds earlier than, or 'pre-fund', scheduled TFF maturities. Banks can also repay TFF funding early without any additional cost. These strategies would allow banks to spread the refinancing task over a period of time, and would serve to reduce the effect of refinancing on market conditions.

Graph 8

Bank Bonds and the TFF

As a share of assets*



* Assumes 4 per cent annual asset growth

** Excludes buybacks

Sources: APRA; Bloomberg; RBA

This brings me to the end of my talk today. Concerns around the economic effects of COVID-19 and the associated rise in uncertainty caused a sharp adjustment in securities prices, although the period of volatility was brief. Risk premiums have increased in the initial phase by much less than during the global financial crisis, and were elevated for a shorter period.

Public policies have played a large role in ensuring that markets continued to function well. Fiscal and monetary policies have also played a large role in cushioning the economic impact on households and businesses. In particular, the RBA's package of measures has lowered funding costs across the economy and supported the availability of credit for households and businesses.

Thank you.

Endnotes

[*] I thank Claire Johnson, Kevin Lane and Nina McClure for their invaluable help in preparing this speech.

[1] For a discussion of conditions in the market for Australian Government bonds, see Finlay R, C Seibold and M Xiang (2020), 'Government Bond Market Functioning and COVID-19', RBA *Bulletin*, September.

[2] There are many benefits to funding through securities markets. For example, issuing bonds may allow non-financial businesses to obtain larger volumes and longer tenors than is available through bank credit. Securities markets may also provide funding where the owner retains more control over the business than with other sources of capital, such as private equity. In addition, securities markets provide competition to bank funding, and allow firms to diversify their funding sources.

[3] January is typically a month with high bank bond issuance. Issuance in January 2020 was unusually high, which provided banks with some buffer for the following months.

[4] Hybrid bonds have a mixture of debt and equity features, and so can be used to meet certain capital requirements. These capital requirements are set to increase in 2024.

[5] A few Australian firms issued into overseas markets, particularly in euros, in March and April 2020. Australian firms often access offshore markets in normal times. And, at this point, these markets were performing well, helped in part by purchases of corporate bonds by central banks such as the European Central Bank and the US Federal Reserve.

[6] Conditions in the secondary market had started to improve at around the same time, although – because the market was so volatile – it is difficult to definitively judge how much effect the change in repo eligibility had on the bond market. See Lim J, E Liu, N Walsh, A Zanchetta and D Cole (2021), 'Corporate Bonds in the Reserve Bank's Collateral Framework', RBA *Bulletin*, June.

[7] For a discussion of fixed income markets throughout the global financial crisis, see Black S, A Brassil and M Hack (2010), 'The Impact of the Financial Crisis on the Bond Market', RBA *Bulletin*, June.

[8] RBA (2021), *Financial Stability Review*, October.

[9] For more discussion of the TFF, including the refinancing task, see Black S, B Jackman and C Schwartz (2021), 'An Assessment of the Term Funding Facility', RBA *Bulletin,* September.

The Reserve Bank of Australia acknowledges the Aboriginal and Torres Strait Islander Peoples of Australia as the Traditional Custodians of this land, and recognises their continuing connection to Country. We pay our respects to their Elders, past, present and emerging.