LGFA FINDS AMPLE SUPPORT FOR *COMINGLED ASSET POOL* IN SUSTAINABLE DEBUT

New Zealand Local Government Funding Agency built its Sustainable Financing Bond Framework on two asset types: use-of-proceeds and sustainability-linked loans to local councils. The issuer attracted a jumbo book to its debut transaction from the framework, even though the specifics of its programme mean its deals do not fully align with international principles and it is not using the green, social or sustainability bond labels.

INTERVIEWEES

- **Mark Butcher** Chief Executive NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY
- **Mat Carter** Head of Debt Capital Markets and Syndicate WESTPAC
- **Nick Howell** Head of Sustainability NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY
- **Joanna Silver** Head of Sustainable Finance WESTPAC

KangaNews spoke to the driving forces behind the New Zealand Local Government Funding Agency (LGFA) framework and debut transaction about the nuance of the issuer's strategy, the reason it had to go beyond the platform laid by international principles, the process of marketing a novel structure to domestic and international investors, and the applicability of this approach to a wider range of issuers.

Issuer name: New Zealand Local Government Funding Agency
Issuer rating: AAA/AA+
Issue rating: as issuer
Pricing date: 12 April 2023
Maturity date: 15 May 2030
Volume: NZ$1.1 billion (US$680.9 million)
Volume at launch: NZ$300 million
Book volume: More than NZ$1.6 billion
Margin: 61bp/mid-swap
Margin at launch: 61-65bp/mid-swap
Geographic distribution: 79% Australasia, 21% other
Sustainability coordinator: Westpac New Zealand
Arranger: Westpac Banking Corporation New Zealand Branch
Lead managers: ANZ, BNZ, Commonwealth Bank of Australia, Westpac Banking Corporation New Zealand Branch
Framework: LGFA Sustainable Financing Bond Framework 31 March 2023
Second-party opinion provider: Sustainalytics

FRAMEWORK RATIONALE

One of the most notable innovations of the LGFA Sustainable Financing Bond Framework is the way it combines use-of-proceeds (UOP) loans and sustainability-linked climate action loans (CALs) in its underlying asset pool. How important was it for LGFA to achieve this outcome?

BUTCHER This approach is all about getting scale into our programme. The UOP GSS [green, social and sustainability] loans tend to be more applicable to larger councils. They are for discrete projects, and very few councils borrow on a project-by-project basis. We have been offering GSS loans since October 2021 and the take-up of these loans is gradually gaining momentum.

If we issued a CAL funding bond separate to a GSS funding bond, we would split liquidity and wouldn't get the benefits of the scale across the two. We didn't want to issue a NZ$300 million GSS loan bond and then a NZ$400 million SLL [sustainability-linked loan] bond.

Hence we combined the two types of loans into one asset pool, which formed the basis of our Sustainable Financing Bond. This structure is in line with our view that we act as an aggregator for the sector as a whole and reflects the role LGFA can play in helping the local government sector to decarbonise.

HOWELL We highlighted during the investor presentations that we wanted to be able to scale up the inaugural and subsequent transactions to benchmark size. This would have been more difficult to achieve with two separate asset pools. Combining them let us print a sizeable deal first up and, moving forward, to get its size in line with LGFA's vanilla benchmark bonds.

BUTCHER Including the CAL programme also allows us to provide a sustainable finance option to Auckland Council, our largest single borrower at 22 per cent of our total lending book. It uses its green assets for its own green-bond programme but it is represented in the CAL book. This is significant in terms of loan size and name.

Speaking of scale, the inaugural deal – at NZ$1.1 billion – significantly exceeds the volume of underlying loans the LGFA has written. Pre-deal marketing materials refer to NZ$562 million of GSS loans – NZ$176 million drawn – and NZ$256 million of CALs. Does this disparity reveal how regularly LGFA will be able to issue?

HOWELL Following the UOP concept outlined in our framework, we intend to notionally allocate an amount equal to the net proceeds of the Sustainable Financing Bond to sustainable loans within two years of issue. We have already increased the asset pool. The combined sustainable asset pool now sits at NZ$621 million, so more than half-way already.

Going forward, we expect greater scale will come from CALs than GSS loans. We are in discussion with a number of councils that have emissions reductions plans in place but aren't quite ready to meet our criteria. A couple of councils are updating their emissions reduction plans and a couple more have not yet got their last greenhouse gas inventory reports signed off. There are maybe another six or seven councils that we can potentially fast track into the pool over the next six months.

Once they are on board, volume could potentially grow more quickly. Obviously we have to grow the asset pool before we can consider going back into the market.

The inclusion of CALs in the asset pool meant it was ultimately impossible for the LGFA Sustainable Financing Bond Framework to align in full with the applicable International Capital Market Association (ICMA) principles and guidelines, or for issuance from it to be labelled as GSS bonds. The rationale for this is clear, but what did LGFA do to maximise credibility for the framework in an environment in which the buy side is particularly conscious of accusations of greenwashing?

■ **SILVER** It was important from the outset to balance innovation with integrity, to fully reflect LGFA's sustainability strategy and to align with global principles to the fullest extent possible. Sometimes innovation can come before principles are able to accommodate it: for instance, the first sustainability-linked bonds were issued before there were principles covering the instrument.

First, we pored over all of the applicable ICMA and APLMA [Asia-Pacific Loan Market Association] sustainable finance principles to ensure as much alignment as possible of the framework and the underlying sustainable loans with the globally agreed principles.

We also studied instruments used to refinance SLL portfolios issued by Bank of China and Nordea, which gave us confidence we could come up with a product that fit with LGFA's overall strategy while also being understood by investors as sustainable in nature. We had wonderful engagement with the Nordea team, in fact – they were fantastic.

On the issue of credibility and market response, we engaged with a range of market participants including a representative sample of investors in New Zealand, Australia and globally. LGFA also had extensive dialogue with the NZX on issues as detailed as how we would label the transaction, precisely because the risk of greenwashing claims was front of mind. We note that the bond was labelled as a "sustainability bond" on the NZX only on an interim basis until the exchange was able to create a new classification for the Sustainable Financing Bond in its trading and clearing systems.

Finally, the role played by Sustainalytics, as a globally respected SPO [second-party opinion] provider that had already worked with LGFA for some time, was absolutely crucial. We considered it vital that the final SPO spoke to LGFA's desire to align with the spirit and intent of the principles as far as possible.

■ **HOWELL** We undertook a detailed and lengthy process before deciding our framework approach. This included discussions with banks, our sustainability committee, lawyers, other market participants and, ultimately, our SPO provider. This strategy gave us sufficient comfort to proceed with a framework incorporating a combined asset pool.

This included Sustainalytics undertaking a review of our CAL criteria and providing us with a KPI and SPT [sustainability performance target] assessment report. We wanted this level of comfort before we went ahead with our framework.

The SPO confirms that our GSS loan criteria align to the Green Loan Principles and Social Loan Principles, and that the CAL criteria are in line with four out of the five core components of the Sustainability-Linked Loan Principles.

One component is not met: the penalty for failure to meet the CAL requirements is declassification of the CAL, not a pricing penalty. We had a lot of discussion on this front but our conclusion was that we cannot put a loan penalty in place due to existing accounting standards.

However, if a council no longer meets the CAL criteria, which Sustainalytics classified as "highly ambitious" for councils, we have the option to declassify that CAL. This also involves public notification on our website. On this basis, we were comfortable the setup is robust and motivating enough for borrowers that we could put the framework in place.

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JOANNA SILVER WESTPAC NEW ZEALAND

ISSUANCE STRATEGY

Does LGFA have a target for volume and regularity of sustainability issuance?

BUTCHER We intend to tap issue the new bond in line with the existing strategy for our vanilla bonds, and will treat Sustainable Financing Bond issuance in exactly the same way as our vanilla issuance. We always provide an undertaking that we will not issue into a bond maturity for three months after syndication.

We will make a call about whether to do a further syndication when we have enough assets to make it possible. We will also regularly update the volume of GSS loans and CALs we have made so market participants will be able to see the size of the asset pool.

We priced a large transaction relative to the existing sustainable loan asset pool in this instance because we wanted to get a new bond out with critical mass and we also know how strong the pipeline of sustainable loans is. Going forward, we would rather have the volumes of Sustainable Financing Bond issuance and the sustainable loan asset pool size a lot closer together.

How does LGFA plan to support liquidity in its labelled bonds?

BUTCHER We have issued ourselves treasury stock so we can lend bonds to the market to assist secondary market liquidity. We will also be tendering into the new bond, in line with our normal issuance practice. In short, we will treat the sustainable line as if it was any other part of the LGFA curve – including getting it to NZ$2.5 billion as quickly as we can, probably over the next 3-4 years.

We might reconsider this view in six months' time if we are not seeing large take-up of the GSS loans and CALs – this would be the most likely driver of a change in strategy. At the moment, we are seeing good take-up so it is part of the mainstream programme.

Was the way the sustainable financing bond would fit into the LGFA curve a talking point in deal marketing?

CARTER LGFA addressed this concept in the marketing of the transaction and certainly appreciated that accounts would not want this line to be considered an 'orphan bond'. The ultimate size of the transaction and the inclusion of NZ$100 million of treasury stock to support liquidity assisted this key objective.

How did the investor base respond to the LGFA Sustainable Financing Bond Framework and, in particular, the fact that it could not align in full with international sustainable finance principles?

SILVER Transparency is so important in sustainable finance. By being completely transparent with investors on how this structure works, we built a common and aligned understanding with them quickly.

It was important to convey to investors that, since there are not yet any applicable global sustainable finance principles for this structure, LGFA is not claiming direct alignment to the market standards. However, LGFA's approach to managing the proceeds from, and reporting on, its Sustainable Financing Bond aligns as closely as possible with relevant global sustainable finance market principles. LGFA has also followed good sustainable finance market practice here, including obtaining external review from a major global external reviewer at three separate times during the establishment of the programme.

Investors could see that, under this framework, LGFA is giving investors an opportunity to actively support councils in their climate transition in addition to funding sustainable infrastructure assets.

CARTER A key aspect of the overall process was the investor work undertaken to carefully explain the market-leading structure. This involved a number of domestic and global one-on-one investor meetings together with group conference calls, after release of the Sustainable Financing Bond Framework and subsequent announcement of the 2030 transaction.

This enabled accounts to do diligence on the framework and ultimately get comfortable to participate in the offering. This was perhaps best highlighted by the final execution outcome achieved.

BUTCHER We had a lot more interest in the deal and the framework compared with previous syndications – I was surprised by the level of investor interest, in fact. This included some accounts we had not previously engaged with, that wanted to understand the framework better – partly because it is novel from a global perspective but also because they have existing New Zealand dollar investments but no LGFA exposure.

As expected, a couple of investors said what we were offering was not a 'pure green bond' because the proceeds were not being directed solely toward sustainable assets, and therefore they would not participate.

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HOWELL It is also worth mentioning that the ICMA sustainable bond principles are not irrelevant to what we have done. While we couldn't align in full to the Green Bond Principles, Social Bond Principles or Sustainability Bond Guidelines, our framework is very much in line with these principles.

Sustainalytics concluded that the framework, as based on the proceeds-based pillars of the general market standards for sustainable finance, is overall in alignment with the impact and transparency principles that underpin the sustainable finance market, and that any Sustainable Financing Bonds issued under the framework will fund overall impactful social and environmental sustainable loan pools.

How did deal execution compare with a standard LGFA syndication, especially on distribution and pricing?

CARTER We have obviously gone through a recent period of material stress in the market. Overall, I am convinced the volume and pricing outcome received a strong tailwind and material benefit from the ESG format.

Investors are incentivised to participate in such deals and it was pleasing to see the granularity and quality of accounts in the orderbook, with New Zealand and Australia accounting for 79 per cent and the remainder going to other offshore jurisdictions. We also saw debut participation by a couple of new names, thereby increasing LGFA's overall investor diversification.

Another difference from LGFA's standard syndication was obtaining an exemption from the FMA [Financial Markets Authority] to come to market by way of a series notice only, without the requirement of a product disclosure statement. This will assist with the further development of the sustainable finance market.

BUTCHER This is despite ongoing market headwinds that prevented some investors from participating. To be honest, it is probably good that this was the case because otherwise we would have had an even greater issue with scaling and allocations. The new-issue concession was 0.5-1 basis points, which was a real success for this size of transaction in a difficult market environment.

WIDER USAGE

Is there potential for wider takeup of sustainability financing of SLL asset pools?

SILVER Absolutely – and this informed a lot of the thinking on the LGFA process. To take one example, the amount of time we spent considering what the bond should be called was driven by the idea of providing a structure that can be followed by other issuers, especially banks.

Combining multiple sustainable loan structures in an asset pool was certainly the most novel part of the LGFA deal. But investors got their heads round the concept very quickly, especially when they saw that the underlying sustainable loans align as far as they possibly can with the relevant sustainable finance principles. It also helps that LGFA is clearly playing an important supporting role for almost every New Zealand local authority to play its part in transition.

CARTER I agree about wider use of this approach, but it will be over time. The size of asset pools comprising these loans is, at present, generally insufficient to issue bonds. However, as the sustainable loan market grows in size – which it has certainly done over the last two years, to NZ$4 billion from NZ$100 million – and bank balance sheets aligned to sustainability increase, the structure LGFA established with its inaugural Sustainable Financing Bond will provide a robust foundation for other issuers.

BUTCHER Like us, the banks are aggregators of SLLs. The difference is that all our CALs are generic and standard in their characteristics. A bank's SLL with one borrower, I imagine, could be different from what it has with another. It could be hard for an investor in a bank bond to look through to the underlying SLL targets. No doubt we will continue to see innovation in this space.

How does LGFA manage this? Is it a matter of offering complete transparency about the underlying loans?

BUTCHER That's right. It is effectively the same as looking into a securitisation pool of mortgages or equivalent. Importantly, we have offered discounts on the GSS loans and CALs that we don't expect to get back when we issue bonds on the other side – we are wearing that cost ourselves as a means to incentivise councils to consider sustainable borrowing options. We provide a 5 basis point discount on GSS loans and a 2 basis point discount on CALs to all our council borrowers. •

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