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1. Description

Debt is an important source of funding for the maintenance and growth of businesses and governments. Debt instruments represent a financial commitment by the borrower. Typically debt instruments pay interest at set intervals and return the face value to the holder at maturity. Debt securities rank ahead of equity and may vary in seniority.

Domestic and international capital markets are an important source of long and short term funding for public borrowers. Major corporations can also take advantage of their credit ratings by accessing the international capital markets.

Participants in the debt capital market cover a wide spectrum. Major participants include banks, investment banks, brokers, governments and government agencies, other institutions and clients, and international investors including central banks and funds managers (including hedge funds).

Liquidity is determined by supply and demand. End investors influence liquidity through demand for securities. Investors purchase securities through intermediaries, usually banks or investment banks. These intermediaries hold inventory for sales and trading purposes and also in certain instances for regulatory capital purposes. Trading occurs through market making activities and broker screens.

2. Products

2.1. Domestic Commercial Paper (CP)

Commercial paper (CP), also known as promissory notes (PN), is an unconditional order to pay a fixed amount (face value) on the due date. CP is issued in bearer form at a discount and is drawn in accordance with the Bills of Exchange Act. CP is issued from 2 to 364 days (1 day less than a year). CP may be issued through a dealer panel by either competitive or unsolicited bidding. Paper is normally denominated in face value amounts of NZD$100,000 and NZD$1,000,000.

Paper is lodged with and settled through NZClear. The paper stands solely on its credit rating. Investors will use the credit rating in the investment choice. CP is issued by credit worthy corporations. The majority of paper issued is in the A1+ to A1 short term credit rating range, but some A2 and A3 short term rated paper is issued.

Electronic promissory notes (EPN) are debt obligations of an issuer created by contract, as evidenced through the NZClear regulations (see Section 9.8 of the November 2009 NZClear rules) and take the form of electronic promissory notes in the NZClear discount security system. Rights under the NZClear regulations are only enforceable against members and not against non member third parties, which is why only NZClear members can issue or trade in EPN.
2.2. Floating Rate Notes (FRN)

Floating rate notes (FRN) do not have fixed coupon payments, but have a fixed coupon margin set off a floating rate index. The payments are reset at specific intervals, typically on a quarterly basis. The coupon is expressed as a margin either above or below a specific short term reference rate, eg Libor for those issued in a foreign currency or NZ Bank Bill if issued in New Zealand Dollars. Some mortgage backed securities (MBS) can be considered FRN and are generally reset every 3 months.

2.3. Capital Inflation-Indexed Bonds (CIB)

Capital inflation-indexed bonds (CIB) feature quarterly indexation of the outstanding capital or principal value, which is repaid in full at maturity. The indexation factor is usually based on the rate of consumer price inflation represented by the New Zealand Department of Statistics’ CPI, although other price and wage indices are used. A coupon interest rate on the bond is set at issue. Interest payments will vary over time in line with the indexed capital or principal value.

CIB provide the investor with inflation protection. Nominal bond returns are subject to erosion from inflation. CIB returns are linked to the inflation rate to ensure that the real return expected by the investor over the life of the bond is maintained.

2.4. Interest-Inflation Indexed Bonds (IIB)

An interest inflation-indexed bond is structured so that the interest payments have a fixed rate component (coupon payment) and a floating component which is added to the fixed coupon payment. The latter varies with the indexation adjustment which is usually the inflation rate. The principal is repayable at maturity at the original face value. The market for these bonds has been very limited in New Zealand.

2.5. Medium Term Notes (MTN)

Medium term notes (MTN) are debt obligations of an issuer, and according to the notes issued, may rank pari-passu with other senior debt or may be subordinate to senior debt. The bonds are constituted by a deed poll and take the form of entries on a register, eg. domestic corporate bond market.

MTN are issued in a series. Each series may comprise one or more tranches issued on different dates. These subsequent series may be fungible with earlier series, but fungibility is not guaranteed. MTN may be issued depending upon documentation as a number of different instruments as allowed under its documentation or program.
2.6. Asset Backed Securities

Asset backed securities are supported by defined assets such as credit receivables which are usually held by way of a trust arrangement. Obligations to investors are met solely by the defined assets and resultant cash flow. An example of an asset backed security is a mortgage backed security (MBS) or collateralised debt obligations (CDO).

Asset backed securities may also be backed by credit cards, car loans, commercial loans and consumer loans or a portfolio of debt obligators in the case of a CDO.

2.7. Mortgage Backed Securities (MBS)

Mortgage backed securities (MBS) is a generic name for any bond or other style security issued by a mortgage provider and credit supported by pools of mortgages or specified mortgages. In New Zealand MBS are generally structured as FRN, reflecting the rate basis and prepayment options of the underlying mortgages.

2.8. Subordinated Debt

A debt facility that ranks behind all other forms of debt in terms of security, but ranks ahead of equity. In the event of the failure of the issuer, subordinated debt holders would not receive any payment until all legally defined creditors, including unsubordinated debt holders, are repaid in full (i.e. they rank behind holders of unsecured notes). There may be various repayment rankings within the subordinated debt category (eg. senior and junior subordinated debt).

2.9. Convertible Bonds and Warrants

Convertible debt instruments are debt instruments which contain embedded options. The holder has the right to exchange the bond for equity in the issuing company at certain dates in the future according to a determined ratio. Most convertibles are callable, enabling the issuer to repurchase the outstanding bonds at a certain price and date. Once the bonds have been called the holder may choose to convert prior to repurchase by the issuer. The call allows the issuer to repurchase the bonds at an earlier date. A convertible can be thought of a bond plus an equity call. Warrants contain an option for the holder to convert the bond and receive the redemption proceeds in another form. In equity related convertible debt, the owner has the option to convert the bond into equity of the issuer at a predetermined price and time. Warrants may be issued with a bond, from which they can be detached and exercised or traded separately from the bond. Alternatively, the warrants may be issued separately. Warrants are essentially call options on the stock of a specific corporation that provides the holder with the right to purchase other specified securities at a specified price on or by a specified date or within a specified period.
2.10. **Debentures and Unsecured Notes**

A debenture is a document evidencing an acknowledgment of a debt which a company has created for the purposes of raising capital. Debentures are issued by companies in return for medium and long term investment of funds by lenders.

The debenture provides that the borrower must pay to the holder a regular stream of interest payments during the term of the facility and receive the face value on the loan at the maturity of the contract. Debentures are secured by a charge over the issuing company’s unpledged assets and/or specified revenues. Unsecured note refers to loans made on an unsecured basis. Debentures and unsecured notes are usually transferable.

2.11. **Euro Commercial Paper (ECP)**

Euro commercial paper (ECP) is an unsecured short term promise to repay a fixed amount on a certain future date offered outside a borrower’s country of domicile. ECP is issued in bearer form at a discount. ECP generally is offered off a program. A dealer group, which is responsible for the marketing of each tranche, is selected. Some programs allow reverse inquiry. Issues normally are 364 days or less to maturity. ECP investors are ratings driven and therefore normally only well rated companies can access the ECP market.

2.12. **Eurobonds**

Bonds issued into the international market. The lead managers prepare the bond issue, set the final conditions of the bond, and select the underwriters and selling groups. Eurobonds pay a fixed rate of interest that is set at the time of issue (zero coupon eurobonds are also available). Coupons are generally paid annually in arrears. Maturities usually range from 3 to 10 years, but some high quality government agencies have issued longer. Most issues are structured with a bullet repayment.

3. **Dealing**

3.1. **Methods of Dealing**

The main methods of dealing within the debt capital markets consist of:

- Directly with clients via the telephone
- Directly with other market professionals via the telephone
- Through the broker screen market
- Electronically via Bloomberg and telephone confirmed
- Other electronic intermediary such as the internet
3.2. Electronic Dealing

May occur through interbank web sites, but all deals must be confirmed by telephone or in writing.

3.3. Business Days

3.3.1. Good Business Day

A good business day is defined as any day on which banks in New Zealand are generally open for business.

Essentially, New Zealand business days are weekdays (Monday to Friday) other than New Zealand public holidays as gazetted.

That said New Zealand OTC markets generally tend to operate in a reduced capacity on gazetted Wellington and Auckland anniversary day holidays.

3.3.2. Non Business Day

A non business day is defined as any day on which banks in New Zealand are generally obliged or permitted to close, including Saturday and Sunday.

In general, NZFMA recommends that transactions should not be negotiated for settlement or price fixing (rollover) on a non business day.

3.4. Standard Transaction Size (market parcel)

Generally, minimum market parcels vary with specific products and issues. Minimum parcels and denominations should always be confirmed prior to dealing. Common denominations are NZ$ 500,000 to NZ$ 1,000,000.

3.5. Two Way Pricing

The corporate market convention is for participants to declare their intentions either to buy or sell.

3.6. Quotation and Dealing

The government debt securities market are yield driven, however these securities are often quoted as a yield to maturity. Corporate paper is normally quoted as a spread over the interpolated swap rate.

FRN is commonly quoted as a traded margin. CP is quoted as a spread to NZ Bank Bill curve.
Near maturity bonds, specifically those entitling a purchaser to only the final coupon payment and repayment of principal, are priced as discount securities.

Convention for calculating settlement price of a fixed rate callable bond in its last coupon period prior to call date
With regard to callable bonds traded in the last coupon period prior to the call date:

- If the callable bond is priced and transacted on the basis of Yield to Call then the convention for calculating the settlement price should be calculated as per RBNZ operating rules for a bond in its last coupon period. I.E. as a discount instrument.
- If the callable bond is priced and transacted on the basis of Yield to Maturity then the convention for calculating the settlement price should be calculated as per RBNZ operating rules for a normal bond with more than one coupon payment to maturity.

3.7. Other Instrument Conventions

3.7.1. Bond Fungibility

New issues can be brought to the market that are fungible with currently available issues. Details should be checked first as even though bond characteristics may appear similar the bond may in fact not be fungible.

3.7.2. Closed Book and Ex-Interest Periods

It is a recommendation of the NZFMA Rates Committee, that:

- the ex-interest period of all NZD non government bonds issued in the New Zealand Capital Markets be standardised to a market convention; and

- the market convention be subject to a full 9 calendar day ex-interest period for all NZD non government bonds issued in the New Zealand Capital Markets:

  - For fixed rate bonds this means the close book period begins at the close of register on the 10th calendar day prior to the coupon payment date; and
  - For floating rate bonds, if the coupon payment date is not a business day, the close book period begins at the close of register on the 10th calendar day prior to the actual coupon payment date as determined in the specific interest payment terms governing that bond.

3.8. Basis

All fixed rate securities are quoted on an actual, 365 day fixed basis. The standard convention denominator doesn’t adjust for leap years unless otherwise stated.

The price of the fixed rate securities is calculated using the RBNZ tender stock method formula.
3.9. Maturity Conventions in Relevant Market

For floating rate instruments the most commonly used convention is the *Modified Following Business Day* rule. Relevant maturity conventions should be checked on a case by case basis.

For fixed rate securities, the *Following Business Day* convention applies.

3.10. Settlement Rate or Index

Floating rate securities are set against NZ BANK BILL. Indexed securities are generally set with reference to the lagging CPI.

3.11. Premium Payment Date(s)

OTC - by negotiation.

3.12. Expiry Conventions

Not applicable.

3.13. Broker/Trading Conventions

In this market traders act as principal.

There are no specific broker conventions.

3.14. Confidentiality

Refer to the NZFMA Code of Ethics & Code of Conduct.

3.15. Credit

The ability to deal is subject to available settlement delivery limits and credit limits for the particular securities. Dealers should advise up front to the counterparty if they are unable to deal due to credit constraints.

3.16. Exercise of Options

There will usually be a defined notice period and procedure prior to the calling of an issue that can be at the borrowers or investors option.
3.17. **Data Source**

Daily revaluations of corporate bond rates are displayed on NZdata page NZ Credit Market Pricing Service.

Inflation indexed bonds are displayed daily on NZdata page NZ Credit Market Pricing Service.

3.18. **Pricing Formulae**

3.18.1. **Debenture or Unsecured Note**

\[
P = [FV(1 + i)^{-n}] + (C \times A_n^i)
\]

- \(P\) = price of the debenture or unsecured note
- \(FV\) = face value of the security
- \(i\) = current interest rate for the period expressed as a decimal
- \(n\) = number of periods in which cash flows occur
- \(C\) = periodic coupon payment amount
- \(A_n^i = \frac{1 - (1 + i)^{-n}}{i}\)

3.18.2. **Capital Indexed Bonds**


3.18.3. **Floating Rate Notes**

\[
P = \frac{Z(b + IM) \times \frac{d}{365} + \left(\frac{IM - TM}{k}\right)A_n^i + 1}{1 + (r + TM) \times \frac{f}{365}} \times 100
\]

- \(P\) = price per $100 per face value
- \(Z = 1\) if there is an annuity payment to the purchaser at the next annuity payment date, 0 if there is no payment to the purchaser at the next annuity payment date
- \(b\) = the floating benchmark rate from last interest reset date to next interest rate date
- \(d\) = number of days in current interest period
\( IM \) = interest margin (as a percentage) paid in addition or deduction from the floating benchmark

\( TM \) = trading margin (as a percentage) paid in addition to the floating benchmark

\( r \) = the floating benchmark rate to the next interest rate reset date

\( f \) = number of days from pricing/settlement to next interest payment date

\[
A_n^i = \frac{1 - (1 + i)^{-n}}{i}
\]

\[
i = \frac{s + TM}{k}
\]

\( k \) = payment frequency of FRN (eg. 2 = semi-annual, 4 = quarterly)

\( s \) = yield from settlement to the maturity of the FRN (with frequency \( k \))

\( n \) = number of complete interest periods to maturity as at the next interest payment date

Reset and payment dates are all subject to the Modified Following Business Day rule.

Market participants are under no obligation to use the benchmark rates referred to above if the market has moved since the benchmarks were set.

When the floating reference rate being used is the NZ BANK BILL rate, \( b \) and \( r \) should be the average figure quoted on Reuters page BKBM/Bloomberg page NZFM1 to two decimal places. \( s \) should be the rate quoted on Reuters page NZSWAPSCLOSE, ensuring rates used are of similar frequency (or converted) to the FRN, then straight line interpolated to the maturity date if necessary, then rounded to two decimal places. The FRN price should be calculated to three decimal places.

**Interpolation**

- Dates for NZ Bank Bills and NZSWAPSCLOSE are based on the modified following business day basis.

- Actual next interest payment date and maturity date are used.

- When interpolating \( r \), BKBM is supplemented by the RBNZ target cash rate (RBNZ02) with a date of the next business day.

- When interpolating \( s \), NZSWAPSCLOSE rates are supplemented by the 1 to 6 month NZ Bank Bill rates converted to quarterly rests.

- Linear interpolation is used unless otherwise stated and agreed.
4. Confirmations

Refer to the New Zealand Dollar Debt Instrument Confirmation & Settlement Standards.

4.1. Timing

As a minimum, all trades entered into must be bilaterally confirmed, either electronically or in writing, by both parties on the day that the transaction was executed. Ideally, it is recommended that all trades entered into be confirmed, either electronically or in writing, by both parties within one hour of the trade being agreed and finalised.

Where the instrument traded requires two or more counterparties parties to agree a cash settlement price, particularly when traded via a screen broker, then the cash price should ideally be agreed within one hour directly with counterparty(s) in writing or electronically or via the screen broker.

4.2. Obligations of Dealers

Dealers should ensure that dealing tickets are produced in a timely fashion to allow for compliance with Section 4.1.

4.3. Documentation

For secondary markets, various issue specific documentation is available, including information memorandum, pricing supplements and original deal issue documentation.

For primary markets please refer to the Recommendations for New Zealand Wholesale Debt Capital Markets Documentation.

5. Settlements

Refer to the New Zealand Dollar Debt Instrument Confirmation & Settlement Standards.

Prices are based on information available on the day the deal is struck. No adjustment is made for changes occurring between deal date and settlement date.

5.1. Physical Settlements

Settlement dates on debt securities are open to negotiation, however the following times are standard.
Security Settlemen Period

<table>
<thead>
<tr>
<th>Security</th>
<th>Settlement Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Paper, T-Bills &amp; Bank Bills</td>
<td>Same day settlement</td>
</tr>
<tr>
<td>Government Bonds</td>
<td>T + 2</td>
</tr>
<tr>
<td>Corporate Bonds with &gt;6 months to maturity</td>
<td>T + 2</td>
</tr>
<tr>
<td>Indexed Bonds</td>
<td>T + 2</td>
</tr>
<tr>
<td>Mortgages Backed Securities</td>
<td>T + 2</td>
</tr>
<tr>
<td>Eurobonds</td>
<td>T + 2</td>
</tr>
<tr>
<td>Government Bonds Issued by Tender</td>
<td>T + 3</td>
</tr>
<tr>
<td>T-Bills Issued by Tender</td>
<td>T + 1</td>
</tr>
</tbody>
</table>

Settlement procedures for onshore/onshore NZD fixed interest securities are covered under the New Zealand Dollar Debt Instrument Confirmation & Settlement Standards.

Settlement procedures for other securities are negotiated at the time of dealing. Generally settlement procedures for all non domestic NZD securities (ie. Euromarket) follow those for Eurobonds. Settlement for Eurobonds is T+5 and via Euroclear or Clearstream.

5.2. Cash Settlements

Not applicable.

5.3. Premium Payments

Not applicable.

5.4. Exercise of Options

Not applicable.

5.5. Settlements Failures

If failed settlement occurs the deal will settle on the following business day with no rate adjustment, i.e. at the original agreed settlement price. If settlement continues to fail the settlement price does not alter unless the two parties agree. This is in fact a penalty to the defaulting party as one days interest is accrued to the buyer.

Dealers should be aware if a particular line of stock is in short supply. If the repo rate on a particular line falls this is an indication of illiquidity and dealers should ensure that they have stock available for future settlements. Dealers should not sell stock if they believe that they cannot deliver that stock at settlement.

5.6. Coupon Payments

For conventions on closed book and ex-interest periods in relation to coupon payments, see Section 3.7.2.
6. Glossary

• Single Monthly Mortality (SMM) - Proportion of the monthly balance outstanding at the beginning of the month that repays during that month.

• Constant Prepayment Rate (CPR) - Annualised SMM.

• Weighted Average Life (WAL) - The average time that a dollar of principal remains outstanding.

• Weighted Average Maturity (WAM) - Average of the remaining terms of the underlying loans, weighted by the outstanding loan balances.

• Seasoning - Average age, since inception, of the underlying loans, weighted by the outstanding loan balances.

• Bond Factor - Proportion of the original principal balance outstanding as at the factor date.

• Call Date - The date (or dates) on which a tranche or whole issue may be called by the issuer.

• Call Amount - Percentage of outstanding collateral that will allow the issuer to call the issue.

• Step-up - The basis point increase in coupon at and after non-exercise of the call on the call date(s).

• Near Maturity Bonds – bonds with one remaining coupon payable.