PwC Treasury Broadsheet

Quarterly newsletter of snippets and stories from the world of treasury management by PwC Treasury Advisory

June 2021

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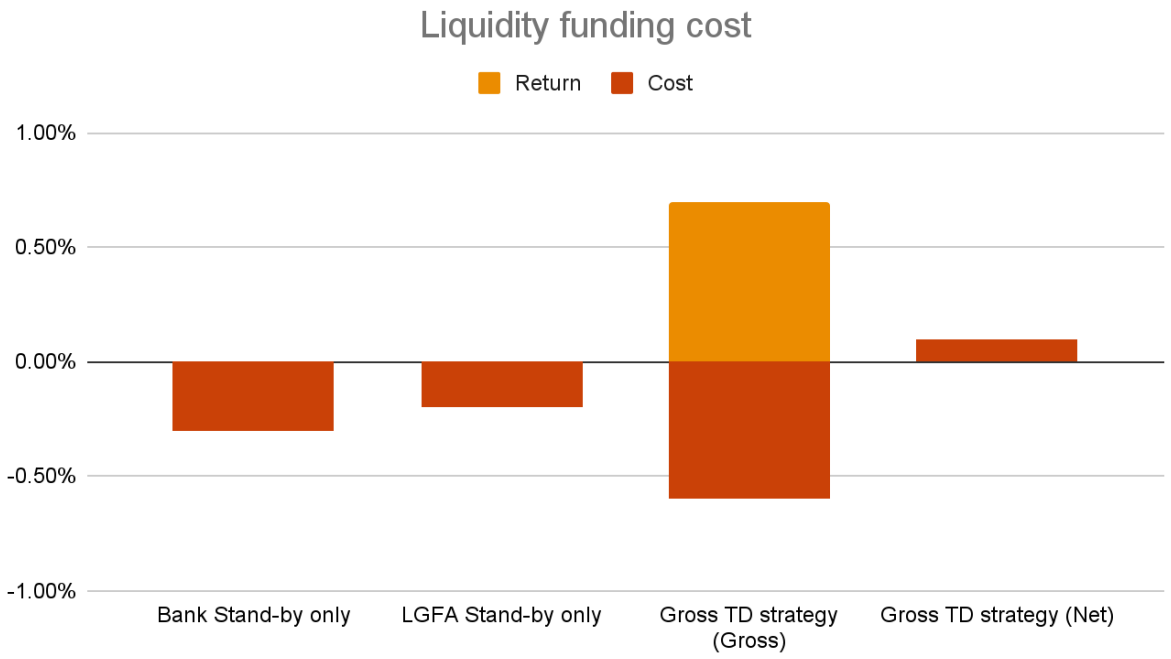
Alternative liquidity options for local government

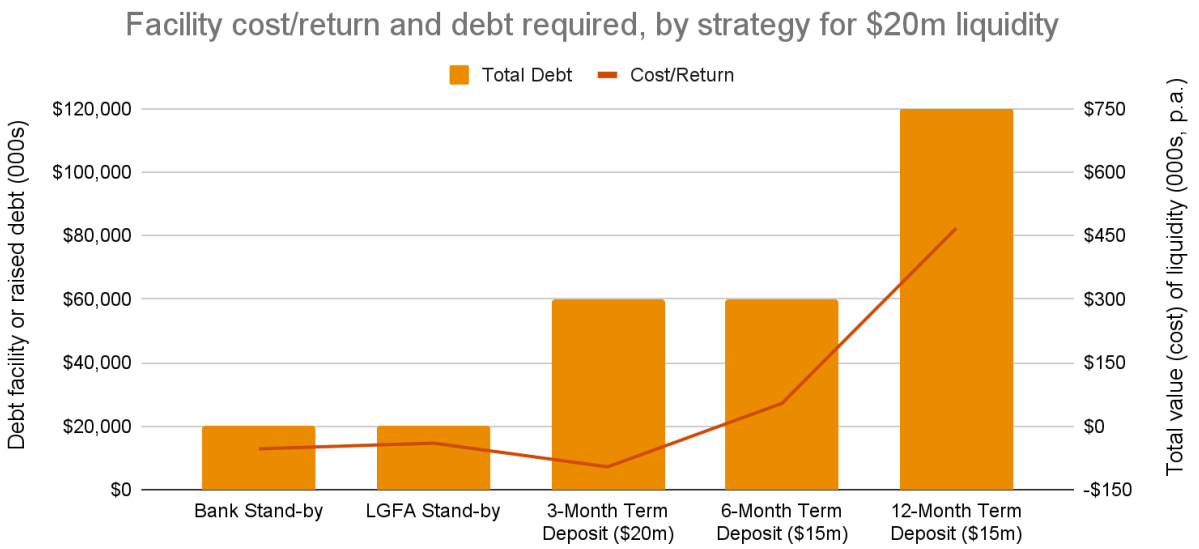
The collapse of wholesale interest rates has created a few issues for local governments (refer to our **December 2020 Broadsheet** for a discussion on the breakdown of pre-funding economics). While interest rate risk management has broadly reduced in materiality terms, both liquidity and funding have been affected. In this article, we investigate the ability for local governments to try and alleviate some of the pressures on liquidity - especially where councils have upward sloping debt forecasts.

The default position for councils managing liquidity is with the use of bank stand-by facilities and short-term deposits. The intention of stand-by facilities is to never use them, but they are there if required. The pricing of these facilities matches those intentions (with a low line fee and high margin) and they work very effectively. Similarly, term deposits have been a cornerstone of liquidity risk management. However, the tougher regulatory / capital stance by banks has (a) made breaking term deposits early all but untenable and (b) significantly reduced the returns for deposits less than 90 (and currently even 180) days. Following the collapse in wholesale interest rates, this means that councils (or indeed all organisations) managing liquidity are in a quandary - you can keep the cash short-term (i.e. less than 31 days) and get nothing for it, or you can put it out longer but risk being left short if you need liquidity at short notice.

Weighing up these conditions has made us consider whether there is a better way to manage liquidity. One approach, which involves funding liquidity with short-term LGFA debt, can actually reduce the carry cost of liquidity, even when compared to an LGFA stand-by facility. By borrowing short-term (i.e. 2-3 year) debt from the LGFA (at an approximately spread of 25 bps over BKBM, or 0.55% to 0.60% all up), councils are able to reinvest that for between 3-6 months (e.g. at 0.50% to 0.90%) and still receive a positive net margin.



The main challenge to overcome is the 31-day restriction that most treasury policies have defining what can be included as 'liquid assets' (or ' liquid funds', 'cash and cash equivalents', etc.). As discussed, in order to achieve a positive net return from term deposits, councils need to invest for greater than 90 days, and realistically greater than 120-150 days given current term deposit rates. In order to do this, and ensure a steady supply of short-dated deposits that *are* within 31-days, councils can raise more debt than the liquidity buffer they require and stagger the maturities so that each month a new term deposit becomes a 'liquid asset'.



As demonstrated in the chart above, this approach involves grossing up the balance sheet - akin to pre-funding maturing debt. Because the raised funds remain as investments (as defined by the LGFA) it does not adversely affect net debt to revenue covenants. Where councils have increasing debt forecasts, it also allows some additional breathing room given that some pre-raised funds could be tipped from 'liquidity' to more 'core' funding when needed. Borrowing can also be done on a fixed rate basis, given term deposits are also fixed for the term. Based on the view (and market pricing) that the OCR will rise over the next few years, this should also help improve the economics of the strategy as the term deposits gradually reprice higher while the underlying cost of debt does not (when fixed).

Overall, this approach does not replace the need for standby facilities but can help reduce the reliance on them, particularly where growing debt forecasts may imply a need for additional facilities in the future. It can be implemented with relative flexibility, for example where quarterly rates instalments might reduce the 'need' for evenly-staggered liquidity then the deposit maturities can be aligned with the cash flow forecast

To discuss this strategy in more detail, please contact your Primary Advisor.

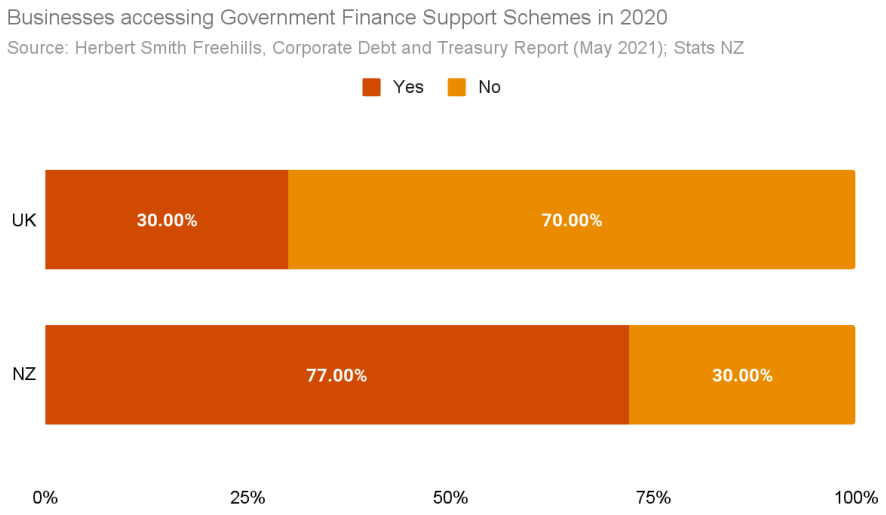
Authored by Tom Lawson, tom.f.lawson@pwc.com, and Cameron Scott, cameron.b.scott@pwc.com

Herbert Smith Freehills Corporate Debt and Treasury Report May 2021

Progression in the rollout of **Covid-19** vaccinations, particularly among major economies, has prompted the market to look forward to a "post-Covid" world. In its latest annual report, Herbet Smith Freehills, in partnership with the UK-based Association of Corporate Treasurers, has provided research and insights from leading treasurers and other senior finance professionals from over 100 large listed corporates (and equivalents), on the key issues currently at the forefront for treasurers and their businesses.

Reflecting on the chaotic past year, most treasurers surveyed were successful in managing the liquidity challenges presented by the pandemic. Substantial contingency planning in the years following the 2008-09 Global Financial Crisis meant treasury teams were relatively well prepared to deal with the crisis. We also observed that this trend played out in New Zealand last year.

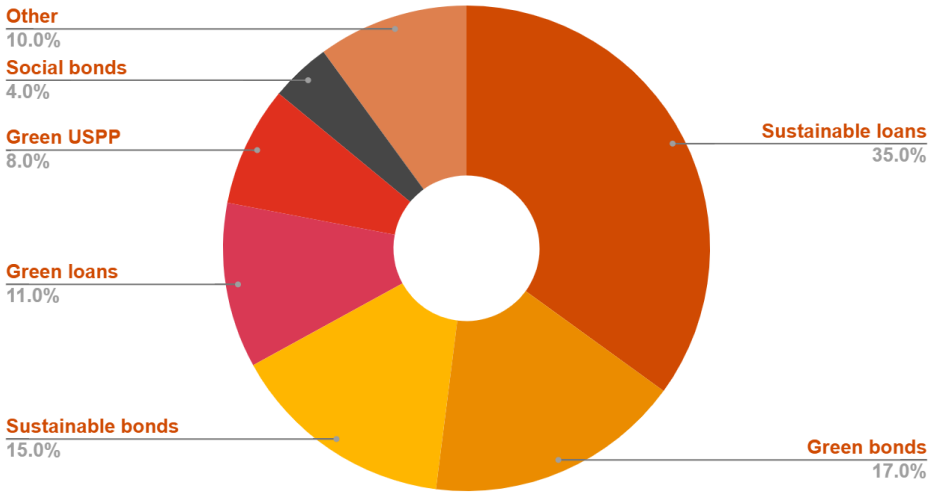
The nature of the Covid-19 crisis necessitated an increased focus on proactive cash management, cash collection and additional debt raising. In saying this, while a large proportion of corporates registered for the schemes, the majority of UK businesses (70%) did not make use of them; most deterred for fear of it being viewed as an admission of 'not having one's house in order' and finding sufficient liquidity from bank and debt capital markets. This strongly contrasts businesses in New Zealand, where 77% reported having accessed Covid-19 related financial support from the Government in 2020.



In pulling out what were the most valuable or effective steps treasury teams took in response to Covid-19, three major areas emerged: forecasting, liquidity, and cash management. In addition, becoming more data driven stood out and ties into providing opportunities to further sharpen and enhance those three mentioned workstreams. The report also recognised how the pandemic has only accelerated the evolving and expanding role of treasury. Notable areas this applied to across the businesses included: ESG, funding, banking relationships, FX, and cyber-crime.

ESG has been rising up the agenda and, as we detailed in our last **Treasury Broadsheet**, is a growing focus for bank corporate lending and debt markets in New Zealand. Europe continues to lead the way in ESG and sustainability-linked finance and while the UK's green ambitions are trailing, the insight of UK treasurers are valuable nonetheless. There was a limited uplift in the percentage of respondents who had *already begun* integrating ESG into their decision-making processes (26% in 2020, 29% in 2021) and/or making use of ESG/sustainability financings over the last 12 months (26% in 2020, unchanged in 2021). However, there was a marked uplift in those *planning* to make use of ESG in their next round of financing (50% in 2020, 65% in 2021). When considering which ESG financing options they were likely to use in the next 12 months,

sustainability-linked loans were the preferred choice, reflecting a greater understanding of the product and less stringent covenant reporting. A complete breakdown is provided in the chart below:



Source: Herbert Smith Freehills, Corporate Debt and Treasury Report (May 2021)

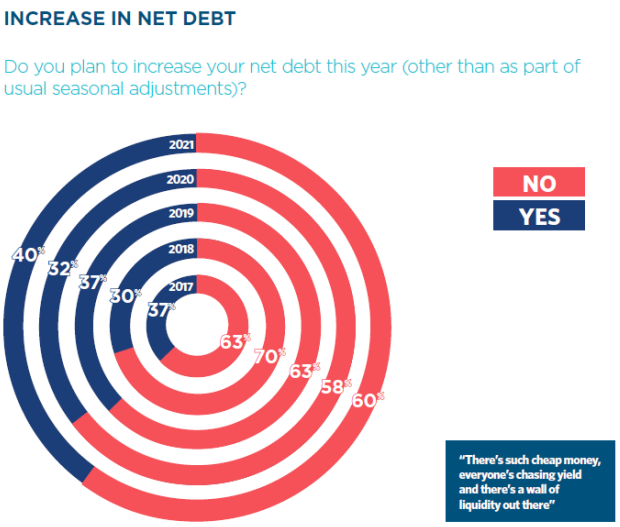
Taken together, the above chart highlights 50% of respondents planned to use either sustainability-linked loans (SLLs) or bonds (SLBs, note slight difference in terminology between the UK and New Zealand). These proportions are above what we have observed in New Zealand over the past 12 months. Notably, we see sustainability-linked discussions taking place, and a growing number of SLLs have been (or are being) arranged, but the emergence of SLBs remain elusive in the local market to this point.

Most respondents identified an emphasis on ESG from customers, investors and other stakeholders as the biggest driver of including ESG features into their next round of financing. Better pricing was not a major driver at all, as price reductions from sustainability-linked loans in the UK were currently insufficient to drive an ESG agenda itself. These trends are also very evident in the local New Zealand markets.

Nonetheless, the ESG agenda is progressing and the impacts of Covid-19 have only accelerated this trend. It was most prominent among the surveyed treasurers that the *impediments* to incorporating ESG financing continue to weaken. As markets shape and refine what this new environment of ESG financing should look like, a standardised approach and understanding of how ESG financing would work in the context of one's business, is becoming more clear.

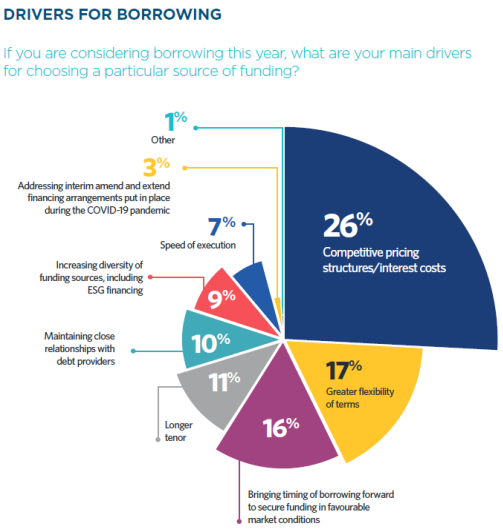
Debt Financing

Low interest rates have ensured appetite for new issuance remains robust as the global economy recovers, with 55% of survey respondents looking to refinance debt and a further 38% wishing to raise new debt. However, there were concerns that the current deep pool of liquidity represents a risk for a potential debt bubble. 40% of respondents indicated their net debt levels increased over the last year, and this was a greater increase than most respondents had initially expected.



Source: *Herbert Smith Freehills Corporate Debt and Treasury Report (May 2021)*

Notably, corporate borrowers are increasingly being pushed to debt capital markets (DCM) to raise new debt where possible as UK and European banks began tightening lending availability. Furthermore, the private placement market (PP) became harder to access during the pandemic as investors stood hard and fast to their covenants or return expectations. This made debt raising more difficult, particularly for company's whose credit rating was negatively affected. This in turn increased the attractiveness of debt capital markets for any funding needs. The primary considerations when borrowing have largely remained the same since the pandemic began, with competitive pricing structures/interest costs taking top spot for a quarter of respondents. Again, it was noted that banks are becoming less reliable for corporates wishing to borrow as tenors shortened and transaction timelines were extended. Albeit most respondents were unphased by this change as it was easy enough to look elsewhere.



Source: *Herbert Smith Freehills Corporate Debt and Treasury Report (May 2021)*

Expectedly, upon a reopening and recovering global economy, respondents noted that Covid-19's impact on their credit strength was a greater worry than the prior survey's top spot of economic uncertainty in certain regions/globally. However, respondents noted improved optimism regarding debt raising as they'd been able to do so relatively easily within the throes of the pandemic.

Co-authored by Grace Lewis, grace.h.lewis@pwc.com and Stephanie Blackwell, stephanie.z.blackwell@pwc.com

Implications of FX forward point volatility

Arguably the most notable aspect of last month's Reserve Bank of New Zealand's (RBNZ) Monetary Policy Statement (MPS) was the inclusion of an 'OCR track'. Rather than a firm forecast, the track should be viewed as a general indication of the future intent of the RBNZ. Setting aside the specifics of the timing and pace of increases to the official cash rate, the track indicated the future intention of the RBNZ is to lift base interest rates back toward a neutral level - the point at which the Official Cash Rate is neither supporting, nor slowing the economy. The most obvious implications of this intention relate to the shape and elevation of the interest rate swap curve. Slightly less obvious, and slightly more caveated, is the potential impact upon foreign exchange risk management through FX forward points.

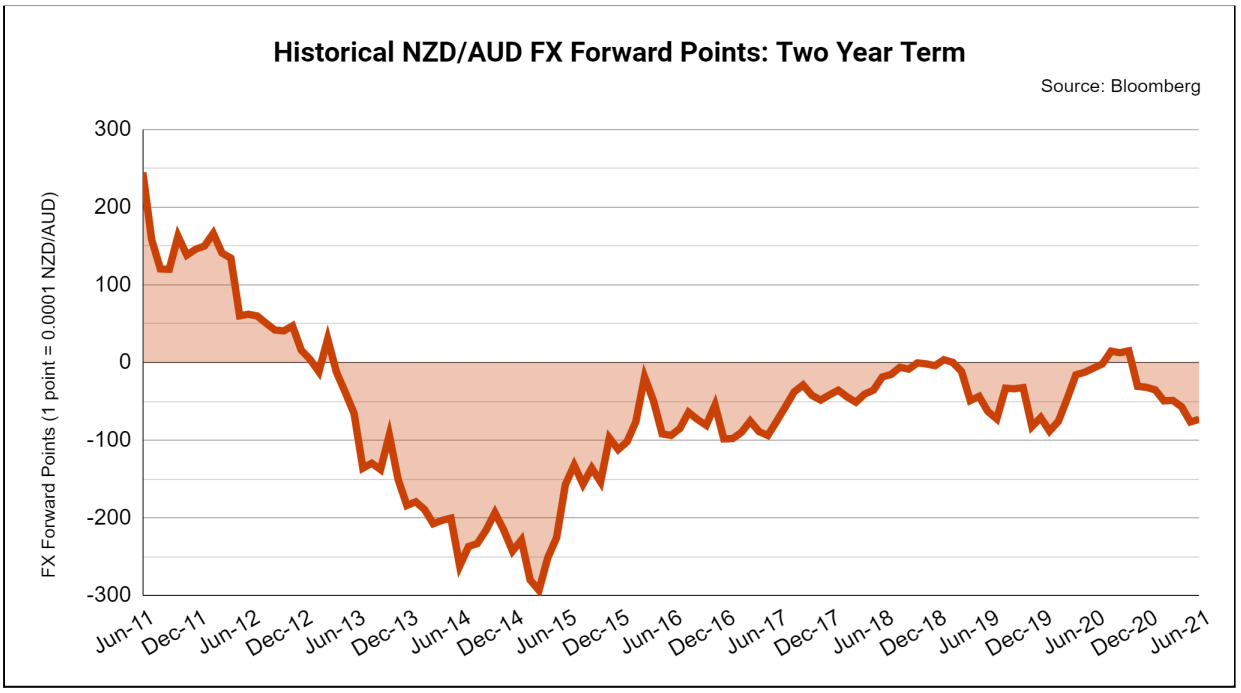
Through the indirect announcement of an intention to increase the OCR from mid-2022, the RBNZ have shone a light on the looming return of impactful interest rate differentials with our major trading partner economies. Those differentials are reflected in currency markets as FX forward points, serving to represent a cost or benefit for corporates seeking to hedge FX exposures.

For the majority of those employing FX hedging tools to manage exposures out as far as six months, FX forward points are an issue on the horizon rather than something requiring consideration for hedging trades enacted today. For longer-dated hedging, however, they are now very much a factor - both for entering new hedging and the marked-to-market value of existing FX hedges.

For the purposes of example, we will focus upon NZD/AUD FX forward points and their application to the Forward Exchange Contract (FEC) hedging instrument. As a quick recap on the basic mechanics:

- **Positive FX forward points** occur when the interest rate of the base currency (i.e. NZD) is lower than the comparative interest rate of the exposure currency (i.e. AUD). Positive FX forward points favour, at the point of trade inception, importers enacting FEC's with a forward rate above spot.
- **Negative FX forward points** occur when the interest rate of the base currency (NZD) is higher than the comparative interest rate of the exposure currency (AUD). Negative forward points favour, at the point of trade inception, exporters enacting FEC's with a forward rate below spot.

FX forward points are not static, they evolve with the underlying interest rate differentials. An FEC enacted today with a term of two years would be transacted at an outright rate ~75 points below the current spot rate:



The above chart is indicatively based off the following pricing:

- NZD/AUD spot rate: 0.9300
- Two-year forward (or FEC) rate: 0.9225

This represents a benefit, relative to the current spot rate, for exporters and, conversely, a relative cost for importers.

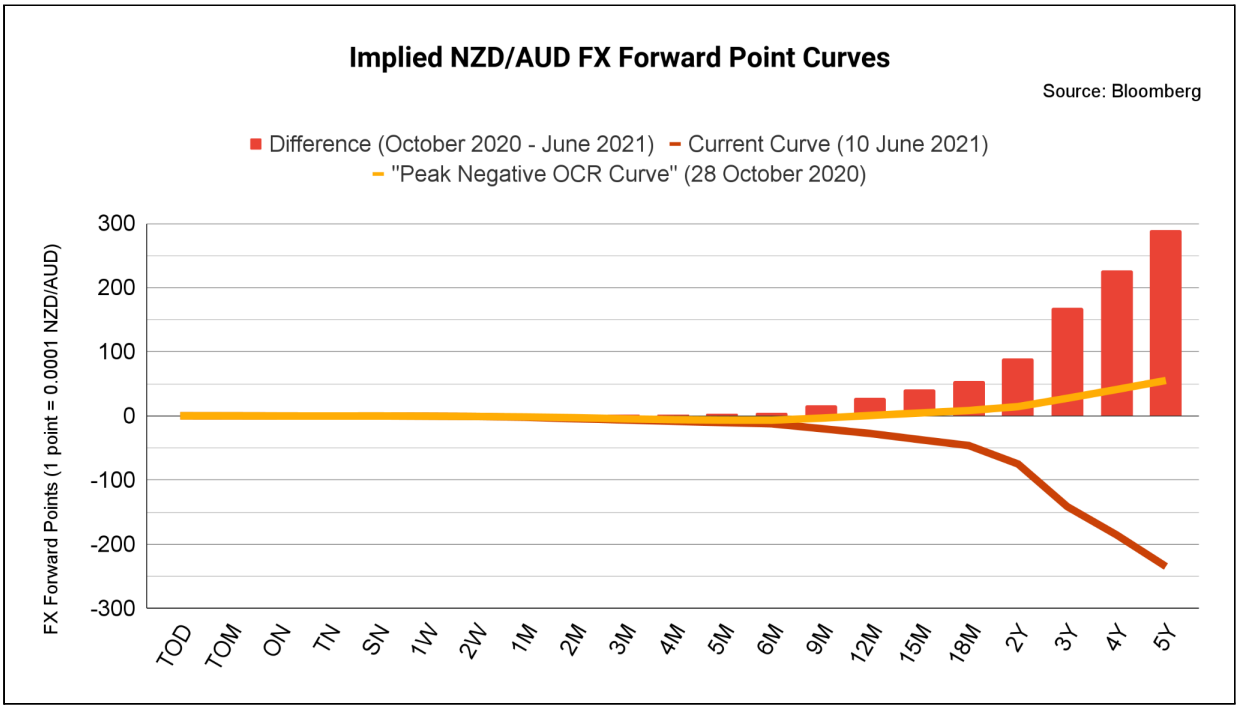
From the perspective of a single FEC, FX forward points should not be a major factor in determining whether to hedge an exposure, but as they represent an additional layer of cost / benefit, they should be a consideration for product pricing. When viewed through the lens of a portfolio of FEC hedges, where decision making extends to managing existing FECs, FX forward points require additional consideration.

Enacting an FEC essentially serves to substitute FX spot rate risk for interest rate differential risk. Certainty is only achieved if the contract is held to maturity. Should an FEC be pre-delivered, the FX forward point adjustment is based upon the current market rather than the historical.

Recycling the above example, an exporter transacting a two-year FEC today, from a spot rate of 0.9300, would achieve a contract FEC rate of 0.9225. If that exporter was to pre-deliver that contract tomorrow, assuming no material shift in interest rate differentials and ignoring spreads and bank margins, their pre-delivered rate would be very close to 0.9300 given that the forward points are ***added back to time zero***:

0.9300 (spot) - 75 FX points = 0.9225 (FEC) => 0.9225 (contract) + 75 (back on) = 0.9300 (close out)

When pre-delivering an FEC, current market FX forward points are applied, with the polarity reversed (the sign is switched). This becomes a material consideration when FX forward point curves have moved materially, as they have since late-2020.



The current intentions of the RBNZ and the Reserve Bank of Australia (RBA) are observable and clear. The RBNZ intends to lift the cash rate in 2022; the RBA intends to lift its cash rate in 2024. Comparatively higher interest rates in New Zealand result in negative NZD/AUD FX forward points for long-dated FEC's.

In October 2020, the consensus market view was for the RBNZ to lower base interest rates into negative territory. At that point the stance of the RBA was as it is today - the cash rate on-hold until 2024. An

expectation for New Zealand interest rates falling below the comparative Australian interest rate prompted positive NZD/AUD FX forward points in late-2020.

An exporter enacting a three-year FEC in October 2020 would have achieved an outright rate that was unfavourable by 28 FX forward points, relative to the spot rate.

- NZD/AUD Spot Rate (28 October 2020): 0.9400
- Three-year FEC Rate (28 October 2020): 0.9428

Should the exporter wish to pre-deliver that FEC today, eight months after inception, they would be subjected to the current FX forward point curve which suggests a level of -95 points (straight-line interpolation).

0.9400 + 0.0028 = 0.9428 | 0.9428 + 0.0095 = 0.9523

This calculation has been intentionally simplified for illustrative purposes - we have ignored modification due to the change in the relative level of the NZD/AUD spot rate, as well as bid / offer spreads and applicable bank / counterparty margins.

Intuitively, the calculation makes sense. The exporter is seeking to receive a higher yielding currency today, rather than at a point in the future. The counterparty will in turn seek to be compensated for the net loss they suffer through forgoing the high-yielding currency (NZD) and generating a return on the comparatively low-yielding currency (AUD). From the exporter's perspective, they will benefit from receiving a higher yielding currency today, though the benefit is spread over time and the associated cost is realised immediately.

From a cash flow standpoint, it may be more beneficial for the exporter to transact at the current spot rate today, leaving the FEC in place until maturity, though there may well be additional considerations that prompt the exporter to action the pre-delivery and transact at the higher exchange rate. For example, from a counterparty facility perspective, the mark-to-market component of the FEC will utilise a greater proportion of available credit lines, potentially restricting the ability of the exporter to transact additional FEC's.

Should these trades have been enacted by an importer, the situation would be reversed. The importer would have received a relative benefit at inception of the FEC, and would receive a further benefit through pre-delivering today.

Our example is fairly extreme, though the swings in FX forward point curves have been equally extreme over the past eight months.

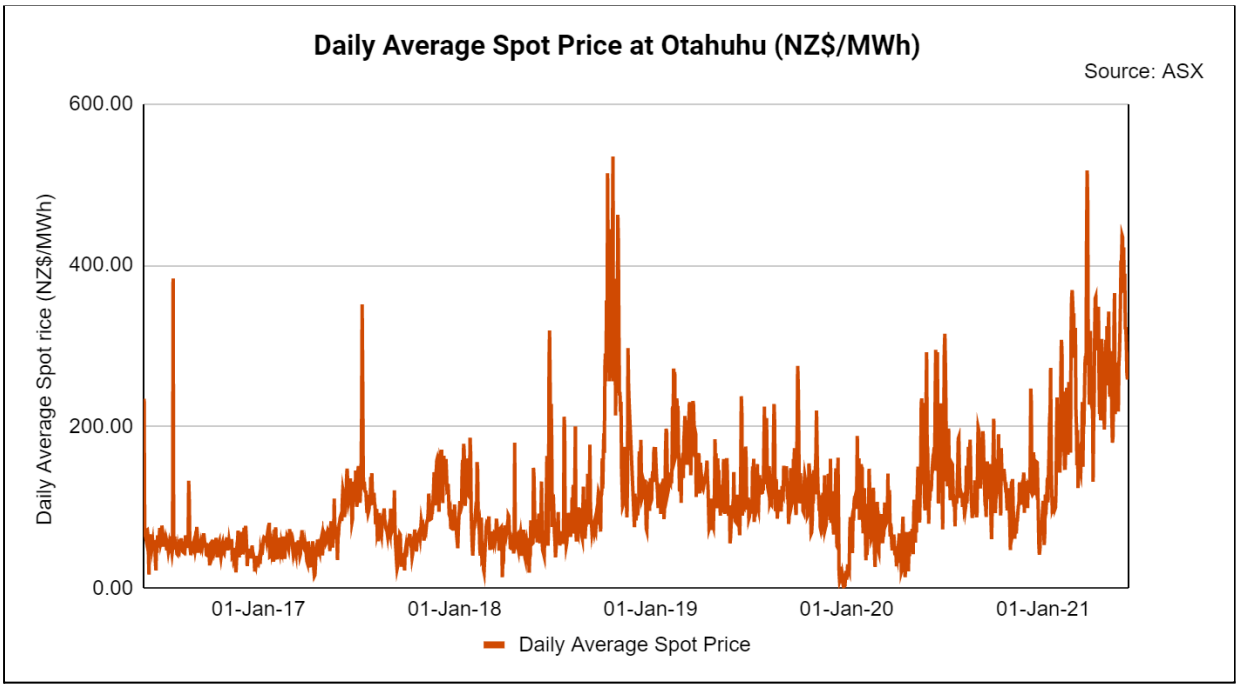
An FEC serves to replace an exchange rate risk with an interest rate risk, providing absolute rate certainty only if the FEC is held to maturity. While the swings in FX forward points have been notable since late last year, over the same period the NZD/AUD spot rate has traded a 450-point range. The observable movements in FX forward points should not discourage hedging (when appropriate), but rather provide a timely reminder of the risks associated with transacting long-dated FEC's - and one that is not often covered or discussed in great detail.

Authored by Mike Shirley, mike.c.shirley@pwc.com

Electricity risk management of growing significance

In light of the sustained increase in domestic wholesale electricity spot and forward prices since the start of 2021 (see below chart), management of this risk has become an increasing focus for major electricity users as they experience a sharp increase in their electricity procurement costs. Good practice, as it is for treasury management, is to not only provide cost certainty but to ensure a spreading of repricing risks so that an organisation's financial performance is not unduly compromised from external market shocks. Traditionally, electricity exposures have been managed within the procurement function and the question being asked is whether these exposures should form part of a centralised treasury management function.

The matter of extreme volatility within the wholesale electricity market (and its potential impact to corporates) was initially discussed in the **May 2019** issue of our Treasury Broadsheet where, after a period of much higher prices, it became apparent that management of electricity exposures within a formalised policy is an important consideration for corporates by providing them with a level of cost certainty and risk spreading.



Managing electricity price risk

Corporates should first gather an understanding of the business' materiality and sensitivity (e.g. as measured relative to net profit before tax) to fluctuations in electricity prices. If electricity price risk is considered significant, a policy framework that articulates the risk, centralises the measurement, monitoring, management and reporting of these risks is necessary. The policy should be Board-approved and implemented by management in accordance with the appropriate delegations. In managing electricity price risk, an approved list of instruments should be well understood, as they will have different impacts on liquidity, cash flow management and counterparty exposures.

The ASX provides a platform on which electricity futures and option contracts are traded (quoted in NZD) and can be accessed through a broker. ASX futures are standardised contracts that require the contract holder (the buyer) to pay a predefined price for electricity at the contract expiry date, regardless of the prevailing spot price. These can be either 'base load' or 'peak load' contracts. A peak load futures contract hedges 1 Megawatt of electrical energy per hour over the contract period, where 'peak load' is defined as the National Electricity Market (NEM) load from 07:00 hours to 22:00 hours, Monday to Friday (and excluding public holidays). In contrast, a base load futures contract hedges 1 Megawatt of electrical energy per hour over the contract period, where 'base load' is defined as the NEM load from 0:00 hours Monday to 24:00 Sunday, over

the duration of the contract. This therefore provides risk managers with a hedging instrument that can better 'match' their organisation's electricity exposure (i.e. consistent 24 hour usage vs weekday/working hours).

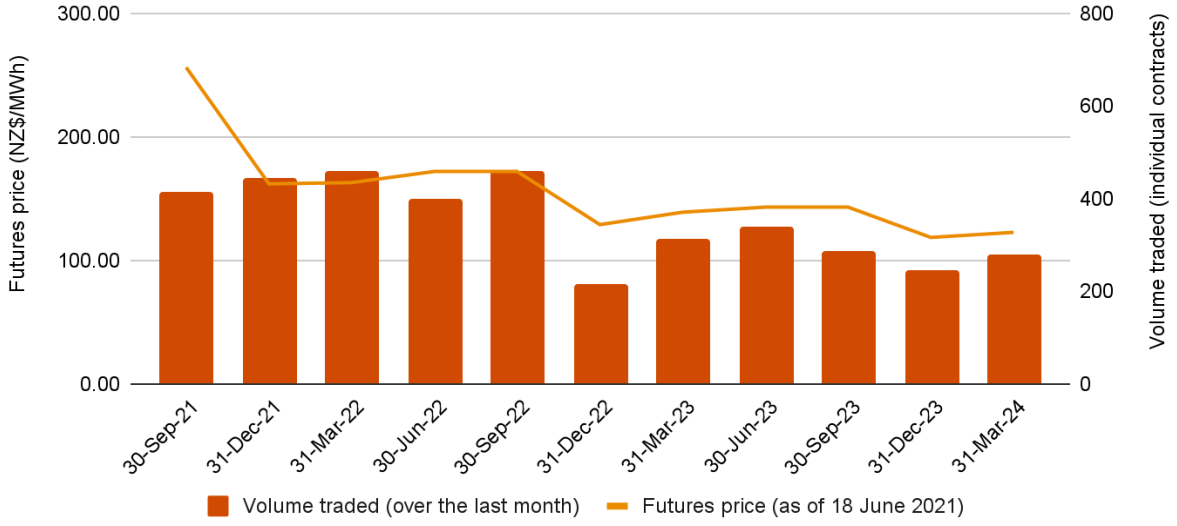
In contrast, an option on a futures contract gives the contract holder the *right*, but not the obligation, to pay a predefined spot price over the contract period. The contract holder is 'insured' against spot price volatility by giving the holder the ability to 'opt out' of the contracted price if it is unfavourable relative to the prevailing spot price. However, this flexible 'insurance' comes at a cost to the contract holder in the form of an upfront option premium amount.

In addition to this, exchange-traded futures and options contracts require participants to post 'initial margin' and 'variation margin' over the contract life, thereby adding an additional layer of cash flow risk that must be considered. 'Initial margin' refers to the collateral that must be posted with the ASX in order to meet the exchange's credit requirements. It is calculated as a percentage of the price of the contract, and increases as the time to contract expiry gets closer. This collateral is not recovered until after contract expiry and no interest is earned over the holding period (limiting investment returns). 'Variation margin' refers to the daily profits and losses associated with the futures and options contract that must be posted over the contract period. The requirement for contract holders to square their losses on a daily basis heightens this cash flow risk due to the very short window of time provided to settle the account.

It should be carefully noted that whilst these futures and options contracts provide a market reference price, risk is not totally removed between the instrument and the underlying physical spot market. 'Transmission risk' resides between the specific nodal reference of the buyer and the benchmark reference price. Transmission or nodal risk refers to the risk faced from large, unpredictable differences in wholesale electricity prices between two nodes on the grid. This can be mitigated by Financial Transmission Rights (FTR) offered by Energy Market Services. FTRs are futures contracts that pay the buyer the difference between spot prices in one location and another. Not only does this provide more tailored hedging, it also encourages competition between generators across the whole of New Zealand, rather than individual regions. Financial Transmission Rights are offered for six different nodes across New Zealand; so, while not every nodal exposure can be hedged using FTR's, the six options offered by Energy Market Services can still provide organisations with a reasonably effective hedge (due to the variety of nodal options), given that nodal risk is typically driven by the energy that is lost travelling across the grid.

NZ Electricity Otahuhu Base Load Quarterly Futures Contract

Source: ASX



Other risk management instruments include bi-lateral contracts with generators, who both buy and sell spot electricity risk based on their individual forward net risk position. These offerings include:

- **Contracts for difference** (CFD), results in receipt/payment of the difference between the contracted price and the spot price where the spot price is higher/lower than the contracted price, such that the effective price received/paid is that specified in the contract.
- **Fixed Price Fixed Volume** (FPFV) contracts give the user the ability to fix their electricity price up to a specified consumption threshold. Any electricity usage above this threshold will be priced at the prevailing spot rate in the market.
- **Fixed Price Variable Volume** (FPVV) contracts provide full price-risk insulation by fixing the price of all electricity supplied over the time period covered by the contract.

A benefit of the above over-the-counter bi-lateral hedging instruments is the ability to specify the terms of the contract such that any nodal exposure and load shape can be hedged (in contrast to the exchange-traded futures mentioned above which are limited to two nodes - or up to six if supplementing with FTR's - and provide limited options as to the cover period).

That being said, risk managers need to be conscious of the counterparty risk arising from the use of non-exchange traded, bi-lateral contracts. Exchange traded instruments mitigate against this risk due to the 'initial margin' and 'variation margin' that must be posted with the exchange on a daily basis over the life of the contract. Accordingly, risk managers should consider minimising this counterparty risk by transacting with at least investment grade counterparties and spreading bi-lateral contracts across various counterparties.

Finally, risk managers should spread and smooth the maturities/contract periods of the hedge portfolio so as to minimise repricing risk (i.e. the risk of the hedge portfolio rolling off at a time when wholesale electricity spot and forward prices are trading at unfavourable levels).

With ongoing wholesale electricity price volatility and the significant impact this may have on an organisation's input costs, a proactive forward management approach is best in order to provide the certainty and smoothing of costs to protect budgets and business plans.

Authored by Keegan Robbins, keegan.g.robbins@pwc.com and Brett Johanson, brett.a.johanson@pwc.com

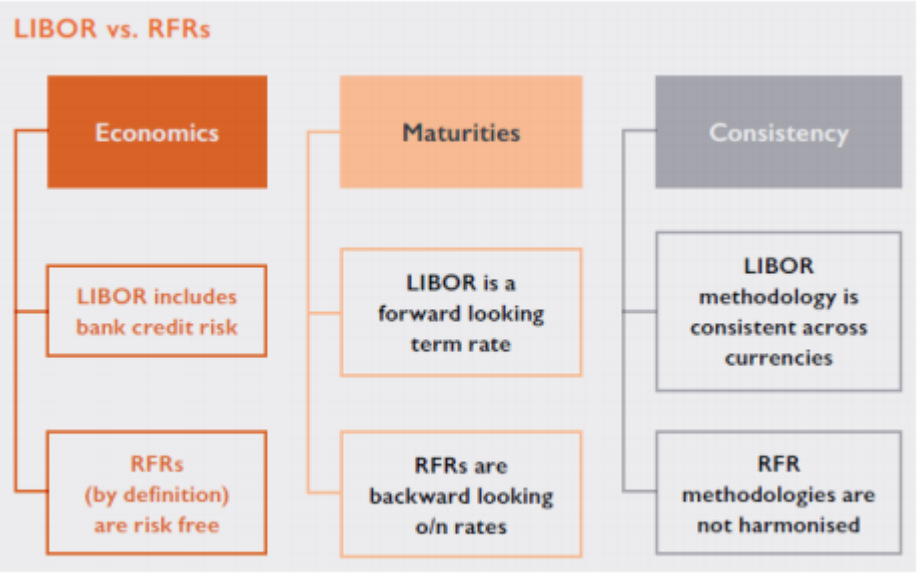
(Still) approaching the end of LIBOR

As outlined in the **December 2020 Broadsheet**, the London Interbank Offered Rate (LIBOR) is being subbed off after a long stint as the world's most widely used benchmark for short-term interest rates. The replacement risk free rates (RFRs) eager to get off the bench and make an impact have had limited uptake thus far. Whilst most treasurers are aware that the cessation of LIBOR is fast approaching, many have not yet executed or even considered a RFR or alternative rate transaction. In the recent Herbert Smith Freehills Corporate Treasury and Debt Report (as referenced above), 84% of respondents said they had not executed a RFR transaction. LIBOR in all other currencies other than USD will cease to exist by December 2021, so treasurers should be actively considering the transition away from LIBOR.

Many corporate treasurers responded in the survey that they are "not as ready as they need to be" and that deadlines would need to be extended. However, lack of readiness is understandable given the delays in phasing out of LIBOR and standards and conventions still being set even though we are fast approaching the date where LIBOR will cease to exist. Many banks themselves are readying themselves for the challenges ahead as the market-wide LIBOR transition occurs. The decision to push the USD LIBOR cessation back to June 2023 has likely allowed corporates to remain 'patient' for a while longer.

Some banks have taken proactive steps to communicate with their borrowers, whilst some are yet to do this. The approaches taken by the banks have varied, with some opting to offer a degree of flexibility (and accompanying complexity), whilst others are offering more standardised terms. This is why we believe it is vital that corporate treasurers with LIBOR exposures start communicating with their bank counterparties about the LIBOR transition. The survey showed that 57% of respondents have had discussions with their bank counterparties about amending legacy contracts to include a RFR or other alternative rate. The volume of LIBOR led amendments which must be executed this year are likely to place a lot of pressure on bank resources - likely causing bottlenecks by the end of the year.

As a recap from the December edition, the key difference between LIBOR and a RFR is that LIBOR is forward looking, so borrowers know the interest rate for a given period at the beginning of the period. LIBOR also includes a credit risk premium due to bank-to-bank lending being unsecured. By comparison, RFRs are secured, backward-looking overnight risk-free rates (based on actual transactions). The RFR will be available only at the end of the day to which it relates or the beginning of the next day. The chart below illustrates some of the differences between LIBOR and RFRs:



Source: Association of Corporate Treasurers (ACT)

For those that are starting to think through what this transition will require, some of the key steps to take include the following:

- **Identify outstanding LIBOR exposures** - Review existing contracts to determine the size of outstanding LIBOR exposures. Review the number of counterparties involved and the size and currency of the exposure, the maturity of such exposures and any fallback provisions. Consider hedging the linkages between products or at least quantifying the potential difference.

- **Understand alternative rates** - Familiarise yourself with RFRs (as well as other alternative rates), how they differ from LIBOR and the calculation conventions that can apply.

- **Monitor market developments** - Monitor how relevant product markets, jurisdictions and other corporates are approaching LIBOR transition. Draw on information/guidance from industry bodies, trade associations and your advisors.

- **Engage with counterparties** - Productively engage with lenders and other counterparties to better understand their transition plans, their post-LIBOR product offerings and what this means for your business.

- **Engage internally** - Implement a communication/education strategy for internal stakeholders (including business leadership) to increase understanding and awareness where relevant throughout the business.

- **Create a project plan and timeline** - Consider what steps you and your counterparty need to take to be ready and able, operationally and otherwise, to transition away from LIBOR. Form a view on the extent to which active transition (in advance of cessation) is feasible and if so, when it should take place.

- **Consider systems/infrastructure updates** - Consider the updates required to your treasury management system (TMS) to accommodate alternative rates. Proactively engage with your TMS provider to understand what it is doing to accommodate alternative rates and expected timeframes for, and costs of, implementation.

- **Consider accounting/tax implications** - Understand the tax and accounting implications of LIBOR transition. Engage with your tax advisors/accountants where necessary.

For those that have thoughts, comments and queries on the above should get in touch.

Authored by Rajeev Verma, rajeev.c.verma@pwc.com

PwC Treasury Advisory contacts

Alex Wondergem
Partner
T: +64 21 041 2127
E: alex.j.wondergem@pwc.com

Brett Johanson
Partner
T: +64 21 771 574
E: brett.a.johanson@pwc.com

Tom Lawson
Director
T: +64 27 421 0733
E: tom.f.lawson@pwc.com

Mike Shirley
Associate Director
T: +64 27 480 9770
E: mike.c.shirley@pwc.com

Rajeev Verma
Senior Analyst
T: +64 21 024 86011
E: rajeev.c.verma@pwc.com

Samuel White
Senior Analyst
T: +64 21 023 69953
E: samuel.j.white@pwc.com

Keegan Robbins
Analyst
T: +64 21 823 739
E: keegan.g.robbins@pwc.com

Cameron Scott
Analyst
T: +64 21 831 796
E: cameron.b.scott@pwc.com

Stephanie Blackwell
Analyst
T: +64 21 181 0008
E: stephanie.z.blackwell@pwc.com

Hamish McCarroll
Analyst
T: +64 21 859 901
E: hamish.d.mccarroll@pwc.com

Grace Lewis
Analyst
T: +64 21 859 614
E: grace.h.lewis@pwc.com