PwC Treasury Broadsheet

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

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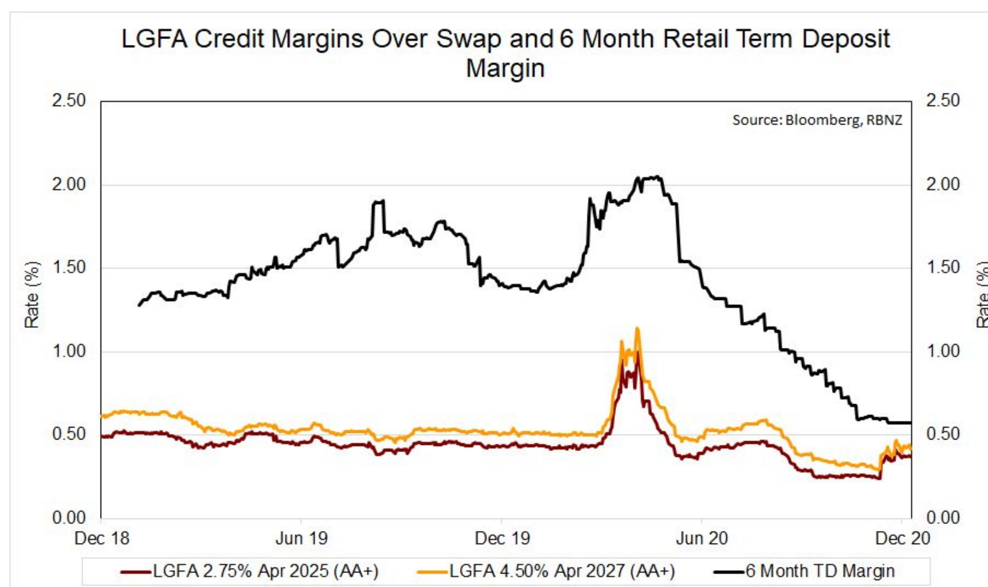
The shifting economics of pre-funding strategies

As most readers will know, the Reserve Bank of New Zealand (RBNZ) initiated extremely loose monetary policy this year by cutting the OCR to a record low 0.25%, but also through the introduction of the Large Scale Asset Purchase programme and the Funding for Lending (FLP) programme. Together, these aim to reduce retail lending rates to help stimulate the economy. However, unlike previous loosening cycles, these actions have flooded the financial system with liquidity, dramatically reducing banks' requirements for capital and forcing term deposit rates (the banks' largest source of funding), to fall sharply. The margin that a term deposit now earns (over the wholesale rate or BKBM) has more than halved over the past 12 months.

As the chart below demonstrates, this is beginning to have an adverse impact on the economics for proactive pre-funding activities, (virtually) eliminating the long-beneficial 'positive carry' – where highly-rated debt raised and placed on term deposit earns a positive return above the cost of servicing that debt. For local councils in particular, this has been a great benefit. It meant they could be proactive risk managers, raising debt well ahead of time and being paid for that proactivity. As the last year has demonstrated, such prudence is even more valuable when the credit market outlook is uncertain.



With the recent compression of term deposit rates, the economics can still work for certain deposit terms and debt tenors. However, we expect that the gradual take up of the FLP programme and ongoing elevated level of liquidity in the banking system will see term deposit margins remain under pressure over coming months (and years). Ultimately, local government borrowers will need to adjust their expectations and appreciate that this dream run has been exhausted (for now).

Even so, it does not mean pre-funding strategies should be ignored. Not only does it remain an effective risk management strategy, but it also carries significant benefits in the eyes of credit rating agencies. For example, Standard & Poor's (S&P) views prefunding as a vital pillar when assessing 'sources and uses' of cash and various liquidity metrics. More specifically, S&P considers whether an entity has already contracted short- and long-term funding available to cover spending over the coming 12 months. This underscores the importance of ensuring upcoming debt requirements continue to be funded ahead of time, even if it might eventually come at a cost.

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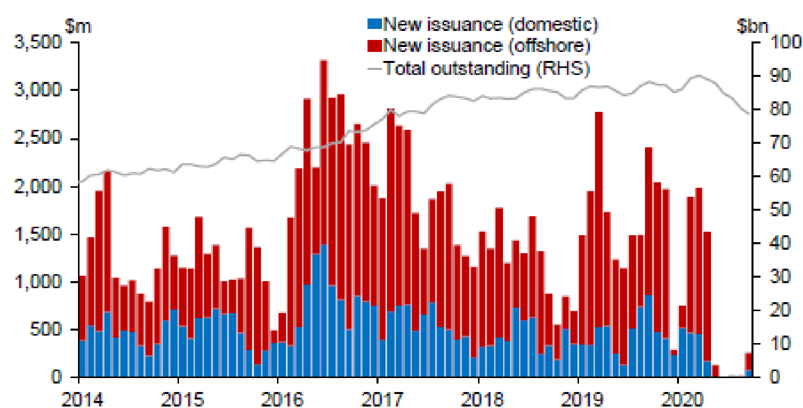
RBNZ stimulus transforming banks' funding requirements. Opportunity for corporates?

In the immediate aftermath of COVID-19, New Zealand's credit market dried up as funding conditions rapidly deteriorated. New retail bond market issuance froze, US private placement deals got parked and new bank lending became extremely challenging. The RBNZ swiftly responded by cutting the OCR to 0.25% and implementing the Large Scale Asset Purchasing Programme (LSAP). Ultimately, the intention of the LSAP was to lower interest rates across the yield curve and reinstall market confidence by buying Government Bonds in the secondary market, utilising banks as intermediaries between the RBNZ and the holders of those bonds (when the RBNZ purchases bonds it credits banks' Exchange Settlement Accounts (ESA), which are then deposited into the investors' accounts). Overall, this process has increased deposits within the banking system using the 'new' money provided by the RBNZ.

As the chart of credit spreads in the previous article highlights, funding markets are now largely functioning normally again. However, elevated deposit balances and larger ESAs have resulted in banks restructuring their funding needs (and the composition of their balance sheets). Since March, banks have not needed to issue material amounts of long-term wholesale funding (both onshore and offshore) to finance themselves or meet regulatory requirements (refer to chart below). As a result, New Zealand banks' long-term wholesale funding has fallen from circa NZD 90 billion to below NZD 80 billion over the year.

Long-term wholesale funding of New Zealand banks



Source: Reserve Bank *Liquidity Survey*.
Note: Three-month moving average issuance of wholesale funding with initial maturity greater than two years.

While this is all well and good, the key is that such changes are impacting the return on cash and deposits (refer to the previous article) as well as the flow of institutional capital through the basis market. New Zealand has historically been 'capital deficient', running a capital account deficit and needing to ship in foreign capital to fund the economy (a.k.a. our obsession with housing) and new credit growth. Because we traditionally require more capital than we provide, the NZ-US basis swap market has been structurally positive - *adding a cost* to offshore borrowers bringing capital into New Zealand (and a '*saving'* for those raising NZD debt and taking it offshore, i.e. Kauri bonds).

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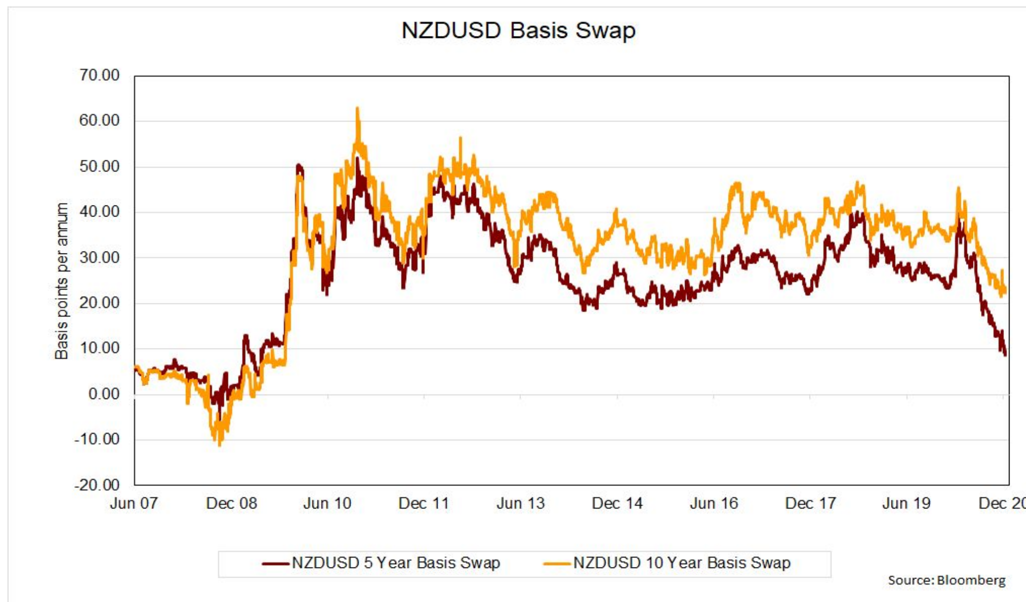
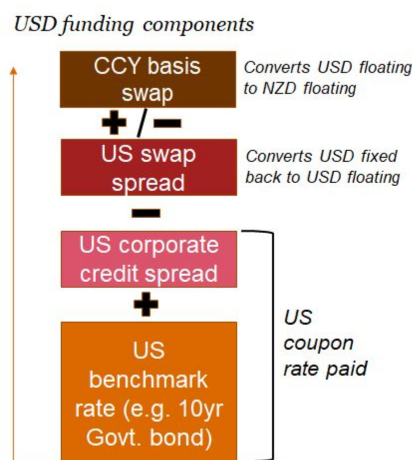


Given that banks are overwhelmingly the largest users in the basis market in New Zealand, this change has caused a dramatic drop in basis swap rates. The NZ-US 5-year and 10-year basis swap have fallen 15 and 10 basis points respectively since the beginning of 2020 (refer to chart above). Additionally, the 2 year basis swap has recently been negative, representing a rare *benefit* to NZ borrowers accessing offshore markets for short-term funding. At these levels, basis swap rates are back at pre-GFC levels (i.e. 12 year lows).

For corporates, lower (or negative) basis swap rates reduce offshore wholesale borrowing costs such as those for USPP (refer to Figure 1 below). This trend is also expected to continue as banks begin borrowing from the RBNZ's Funding for Lending Programme. With US government bond rates moving modestly higher off their lows, and US corporate credit spreads shrinking, these collective dynamics are helping make offshore funding options more attractive to New Zealand issuers. With domestic banks still cautious to lend much beyond three years, the term of offshore issuance (from 7 to even 15 years) continues to provide a valuable reason to diversify. There are a number of considerations when executing these transactions, but this year has once again highlighted the value of a diversified funding strategy and with pricing beginning to also align, it might be time for historically bank-only borrowers to do the same.

Figure 1: key components contributing to offshore funding costs



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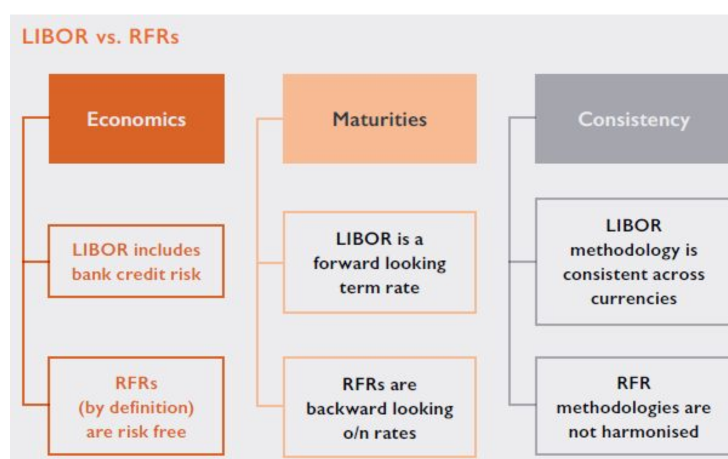
LIBOR’s transition to SOFR is not so far away

The London Interbank Offered Rate (LIBOR) is the world’s most widely used benchmark for short-term rates and its retirement is, now, imminent. Most treasurers are already well aware that LIBOR will not be around post the end of 2021, replaced by risk free rates (RFRs) or a rate derived from a RFR. The key difference between LIBOR and an RFR is that LIBOR is forward looking, so borrowers know the interest rate for a given interest 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 rate (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)

Despite RFRs being available in all five of the LIBOR currencies (as well as other countries), the uptake thus far from corporates has been poor with only a small minority having taken steps towards using them. Some RFRs, such as the UK’s Sterling Overnight Indexed Average (SONIA), are well-established. However, the USD RFR, the secured overnight financing rate (SOFR), is somewhat newer to the scene. Organisations with USD debt have been aware of the imminent change from LIBOR to SOFR for some time, but many have not proactively considered the implications or the readiness for the change. Determining how RFRs and other alternatives to LIBOR can be implemented in financial products has been, and continues to be, a challenge.

Given that the derivative market is heavily reliant on standardised documentation, the International Swaps and Derivatives Association (ISDA) recently launched the LIBOR (and other IBOR rates) Fallbacks Supplement and Fallbacks Protocol. This documentation helps reduce the systematic impact of LIBOR being retired while companies still have exposure to LIBOR. As a result, any new LIBOR-linked derivative trades will now be required to have fallbacks which cater for the replacement of LIBOR, with changes coming into effect on 25 January 2021. Post 25 January 2021, LIBOR-linked derivatives will no longer be available. In fact, the Protocol will enable corporates to take steps to actively transition or update fallbacks in any legacy LIBOR derivative documentation extending beyond the end of 2021.

Aside from derivatives, the other focus is on transitioning new and refinanced loans from LIBOR to RFRs. The existing fallbacks in these legacy loan documents are unlikely to be sufficient to cater for the retirement of LIBOR. Most legacy loans that reference LIBOR will need to be amended individually, with the nature of the amendment dependent on the type of deal. A bilateral loan may require a single

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amendment agreement detailing the required amendments. However, for syndicated loans, amendments will be trickier, with approval of the whole syndicate or specified majority required to make the amendment. Corporates are recommended to review outstanding LIBOR-linked loans, identify the alternative reference rate (RFR) to be used in its place and become familiar with how it is calculated and also how the economic difference between LIBOR and the RFR is calculated. Once this is understood, consideration should be given to the capability of treasury management systems to be ready to accommodate the alternative reference rates.

According to industry working groups that are doing their utmost to raise awareness for businesses to prepare, now is the time to ‘turbo-charge’ LIBOR transition plans. This means, starting to have conversations with the banks and any third party relied upon (i.e. treasury management systems) about the transition in order to have some form of certainty and reduce the risk of operational issues post the transition from LIBOR to SOFR. For those that are starting to think through what this transition will require, some of the key steps are as follows:

- ***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 plants, their post-LIBOR product offering 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.

Source: Association of Corporate Treasurers (ACT) & International Swaps and Derivatives Association (ISDA)

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Effective cash flow and liquidity management

This article provides some useful tips on effective cash flow forecasting during uncertain times. Cash is at the very heart of any organisation and an important financial resource that must be safeguarded and carefully monitored. Cash flow forecasting is the forward-looking piece and a vital input into the successful management of an organisation's cash and liquidity over the medium term. Importantly, effective cash flow forecasting means that a proactive rather than reactive approach is undertaken allowing a business to respond appropriately by buying time to investigate optimal cash and liquidity decisions. Ultimately, cash flow forecasting should be ingrained within (and throughout) an organisation so that it can be trusted when really needed.

With the disruptions to revenue arising from this year's lockdowns or economic slow down, many organisations have had to rely more heavily on their ability to forecast cash flows as they better understand their operating cash position and consequently their liquidity management requirements. It is times like now that organisations will lean more heavily on their financial forecasting abilities but this requires trust in the process, which often has been built up over many years as cash forecasting techniques have been fine tuned. Other stakeholders including bank lenders (ability to pay interest and principal on time), suppliers (paying invoices on time), auditors (going concern matters) and shareholders (effective use of financial resources and achieving/meeting business plans) will gather confidence from the effective management of these risks.

Success relies on the assumptions adopted within the forecasting approach. History may be a good place to start but will be unreliable in disrupted times. In an uncertain economic outlook the business will be impacted in different ways (magnitude and time period of impact) to a point that the business may need to be resized and re-shaped. Assumptions need to be realistic and not sugar-coated and not a guess so assumptions can stand up to challenge. Realistic assumptions are best achieved through the finance team engaging actively with the wider business to best understand how sales, costs, debtor and creditor ledgers for instance drive the underlying cash assumptions. Talk directly with the sales and purchasing teams and scrutinise supplier and customer contracts during times of disruption. Getting the cash conversion assumptions right is critical. For instance, a clear understanding of outstanding debtor balances and those that are unrecoverable is important.

Running different scenarios is another valuable way of understanding business outcomes, especially as the forecasting time horizon is extended out over the medium term, say 24 months. Have a base case scenario but support the base case with a best case and worst case scenario. Within this complete a sensitivity analysis to better understand which assumptions have the largest impact and matter the most.

Some observations and cautions around cash flow forecasting;

- Understand the opening cash position as it is vital to have an accurate starting point,
- At a bare minimum an organisation should have at least a rolling 13-week cash flow (by week) forecast and this should span into a rolling 12-month term,
- Test and challenge forecast accuracy, noting variances and why. This line-by-line analysis is important so create some form of forecasting tracker,
- Be wary of intra-month and peak seasonal funding gaps, the month-end position may not tell the true story,
- One-off expenditure can have a large impact on cash flow forecasts if the timing and phasing amounts are varying; e.g. capital spending programmes,

- Key senior management should be fully engaged in the cash flow forecasting process with individual responsibilities known. Eliminate potential information gaps, how best to get the information on a timely basis, who holds this information, what forum will best ensure success.

A reliable cash flow forecast that is formatted simply and is easily understood will appropriately inform the amount and term of any funding gap and the liquidity buffer amount required. There is no point in paying for excess credit limits in the form of higher commitment fees from your banks. Furthermore, with this information the structure of committed bank facilities can be better tailored to your requirements, such as, say a seasonal funding facility or a stand-by facility.

Cash flow and liquidity management is an essential, but also effective, tool that can better position an organisation as it plans to navigate through these uncertain times.

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Journeys to Treasury Report 2020

The latest ***Journeys to Treasury*** report (completed via a partnership between BNP Paribas, EACT, PwC and SAP), provided a fresh set of insights from leading treasury professionals and practitioners on the themes that are influencing treasury policies, processes, technology and resources.

A key output of the report focuses on treasury priorities over the next 12-24 months with cash flow forecasting ranking as the highest priority for fundamental review and improvement. This is unsurprising given the events of 2020 impacting on cash and liquidity profiles, supply chains and customer behaviours but is a consistent theme in other survey responses as evidenced in recent PwC Global Treasury Benchmarking Surveys.

A focus on enhanced use of technology and automation also remains a significant priority. Identifying opportunities to leverage innovative digital solutions has become more prominent amongst the Corporate Treasurer's annual goals and this continues to be evident in this survey which shows data analytics, RPA, API's and artificial intelligence (AI) are all workstreams being pursued. AI in particular has increasingly become part of banks' and technology providers' solutions, leveraging predictive analytics, cash flow forecasting, bank account reconciliation and fraud prevention tools.

The report also investigated themes and topics of interest to treasurers over the next 12-24 months with the desire for "real-time" information top of the wishlist. A strong desire to support accurate and timely cash flow forecasting was evident with information relating to liquidity as well as payments and collections being of the greatest interest. This focus will inevitably fall onto banks and technology vendors to meet the requirements of corporate treasuries.

Challenges in achieving a centralisation of the treasury function was discussed in the report. Particular mention was made in regards to difficulties in standardising process and controls, managing multiple bank relationships, juggling multiple technology platforms, handling large numbers of accounts/complex account structures and a lack of resources/buy-in from business units to support effective implementation.

In what is a growing trend across all areas of the organisation, the treasury function's role in supporting the ESG agenda was also asked of survey respondents. Over half stated that they had revised processes and controls in support of sustainability objectives and many also noted a reduction in business-related travel and greater encouragement surrounding flexible working practices. Over a quarter had plans to issue green bonds or consider other sustainable borrowing mechanisms and 20% planned to invest in sustainable investment instruments. It's clear from these responses that corporate treasury functions will be playing a key role in their organisations' climate change, environmental and social sustainability objectives on a go-forward basis.

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