PwC Treasury Broadsheet

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Treasury management learnings from a disrupted market

An important treasury management objective is to protect an organisation from financial market risks which can disrupt its ongoing business activities. The treasury policy is there to protect the business and instil a discipline of continually recognising and managing these underlying risks no matter what market conditions exist. As we have observed, markets can be benign one moment and severely disrupted in an instance.

Policies can't be all knowing and accurately encompass all shocks but the policy must provide the organisation time to adapt to the new market conditions. The buying of time provides the opportunity to say; seek additional liquidity and covenant relief from its bankers, review its underlying capital and cost structure, identify and remove areas of excess capacity or reshape its business strategy.

With the COVID -19 pandemic outbreak upon us, it is understandable that the intensity and magnitude of the economic shock (catastrophic for some sectors) could not be fully contemplated. Experience tells us that, although these risks are often contemplated within risk registers, the timing and magnitude of these shocks will surprise.

Shocks create immediacy, requiring urgent action so it's important to learn from these uncomfortable events.

But how can learnings from these economic and financial market shocks best challenge not only the construct of best practice corporate treasury policies but importantly be translated into sensible and measurable learnings for the future development and refinement of policy frameworks? Here are some thoughts:

- Be risk aware, challenge your organisation's attitude and appetite to risk. Does your organisation and Board fully understand the magnitude and impact of financial market and treasury risks on its business.

  Is there a well articulated and understood risk statement that transcends across the organisation and permeates into all risk policies. How does each risk manifest itself in the business, for instance; what is the materiality of impact on cash flow, earnings and bank financial covenants etc.

- How appropriate is the capital structure to provide the loss absorption buffer needed when the business is financially disrupted. Is there the appropriate mix of capital, subordinated and senior debt. Is the optimal capital structure fully understood and enduring following rigorous scenario testing of business forecasts. What is your organisation's sustainable gearing (senior debt amount) when considering shadow credit rating targets or bank borrowing limits. How do you best carve out this debt capacity limit across liquidity facilities, cash management, working capital, term debt and derivative dealing facilities. What about your future debt capacity for that rainy day or a debt cure for a wider business disruption.

- Are bank financial covenants constructed in such a way that they cope with earnings volatility, say using an average of earnings over a two year period, is there capacity within the ratios to allow for some variability. Do you fully understand your bank loan documents, terms and conditions? It's in these times that legal contracts can be under most scrutiny.

- How rigorous is your liquidity management policy? Does the policy continue to be suitable for your business and does it provide a minimum buffer amount that provides enough time whilst revenue and cash net flows are disrupted. Assuming no revenue, how many months can the business continue to operate? Is there a buffer for reasonably unforeseen cash requirements?
- Are the assumptions that have been used to support the policy still relevant and are they conservative enough? How does the liquidity policy blend with the debt funding maturity policy. Does the liquidity policy contemplate maturing debt amounts?
- Challenge the assumptions within the rolling short and long term cash flow and debt forecasts. Test the cash conversion assumptions and when debtors will convert into cash. Most importantly, challenge and carefully analyse all material financial market assumptions contained with business budgets and forecasts (i.e. Foreign exchange rates, interest costs and commodity prices)
- A key objective of a successful treasury function is the spreading and smoothing of future debt maturities. Are there appropriate mechanisms in the policy to reduce concentration risks and force a spreading of risks. What mechanisms allow for the pre-funding or early re-negotiation of debt facilities. How does this debt maturity policy link in with the time period in which you are forward managing liquidity risks.

These are some of the questions that organisations should be asking and challenging themselves around their treasury management practices. We say that treasury policies are living and breathing documents and are unique for all organisations. In the best interests of shareholders and stakeholders, treasury policies and the management approach should be robustly challenged by Boards and management to ensure the organisation's financial and treasury objectives are being met.

At these challenging times, it's the proactive recognition and management of financial market risks that will ensure continued treasury management success.

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Investment Fund Management "Strategic Heads Up on Policy Reviews"

We recommend that Trustees, Directors, Councillors and managers of fixed income fund portfolios review the counterparty credit control limits contained within their investment policies in anticipation of a general downturn in global credit ratings.

Many investment policies were slow to respond to the impacts of the Global Financial Crisis (GFC) especially when considering the seismic fall in the credit ratings of banks following this crisis. It is our observation that nearly all investment policies have investment limit controls that restrict investment amounts and maturities to minimum credit rating settings with investment grade (BBB- and above) the minimum rating setting.

Post COVID-19 global impacts to credit ratings will be more widespread than the GFC. The GFC was essentially a financial market crisis with a focus on "banks behaving badly" and the corporate sector came away comparatively unscathed.

COVID-19 impacts are hurting corporate earnings and values, the anticipated tsunami of credit rating downgrades will be all embracing and will include sovereign and semi government, financial (banks) and corporates.

We are already observing a number of global banks provisioning significant loan losses and Fitch recently downgraded the 4 Australian banks from AA- to A+.

Investment policy counterparty credit limits will get tested as rating downgrades fall through rating thresholds; for example many policies provide for dollar value or portfolio percentage limits based on individual counterparty ratings and if these counterparties fall from AA to single A or single A to BBB the permitted investment limits similarly fall creating breaches within existing portfolios. Of real concern is the possibility of current investment grade investments falling below policy minimum investment criteria.

The above mentioned stakeholders are advised to forward plan for this credit rating downturn given their significant fiduciary responsibilities.

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Foreign exchange insights and management techniques in Covid-19 environment

For exporters and importers where expected cash flows are lower than prior forecasts, and accordingly FX hedging may be above those requirements, below are some considerations/ techniques of how to deal with these situations, noting company situations and bank responses will differ:

- It is potentially beneficial to use/pre-deliver near-term hedges as much as you can (to 'free-up' future capacity (both in terms of policy and credit limits) in event of future slowing of activity).
- Typically banks will respond better to earlier notice/information and will consider the reasons (e.g. short-term adjustment, delay or gap in cash flows rather than more permanent displacement/ curtailment of activity).
- It may be more practical to push out more contracts for longer (and only doing so once) rather than going back to the bank(s) on multiple occasions (noting future bank responses may also differ).
- Typical methods to achieve these ends include historical rate rollovers (HRR) where the future (i.e. longer) maturity is adjusted by the current forward points. This is usually constrained by banks to 90 days (in some cases 180 days), however, there may be flexibility in the current environment.
- Credit/market risk considerations from the bank will likely form part of the response to restructured hedges, especially if the hedges have negative marked-to-market values.
- Where importers have positive marked-to-market positions on excess cover, closing out and monetising these contracts provides a useful liquidity tool.
- It is also possible an exporter could enter an offsetting 'importer' contract to the same maturity date (rather than close out the underlying contract at a cash flow impact 'today'). Advantage being, it delays the cash flow. Disadvantages being, it grosses up the size of the overall hedgebook, and will also likely pay (unnecessary) market execution spread at this time and utilise valuable credit limit.
- Where an exporter has both USD receipts and USD costs it may be possible to deliver all gross USD receipts earlier (to use contracts) and fund future USD expenses from NZ, or with a USD working capital facility.
- Exporters with collar options maturing and having the NZD "Puts" exercised might consider rolling these out to longer dates using FECs.
- Note many/most of the above work for an 'importer' in reverse. Existing importers contracts are more likely to be 'in the money' from a marked-to-market perspective (hence cash inflow received from counterparty is a viable approach).

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New Zealand's wholesale money market is finally going digital

Over the past 5 months Imperium Markets have been engaging with New Zealand regulators, banks and wholesale term deposit (TD) investors about digitising the New Zealand wholesale money markets.The response from the regulators, banks and a number of our investor clients has been overwhelming in support. Last week the NZ FMA granted Imperium Markets with Markets Licence "exemption" to operate a wholesale market in bank deposits and bank issued debt securities commencing April 20.

Imperium was the first Regtech to be granted a Markets Licence in Australia by their regulators and has been operating a market in Australia for 3 years. In granting Imperium a Markets Licence ASIC cited the need for greater transparency and efficiency in a market that historically has been notoriously opaque and dysfunctional.

During the current COVID-19 Crisis the multitude of problems with the market remaining analogue have been amplified for which Imperium have been in detailed conversations with the RBNZ and RBA on. Before, people used to debate the merits of digitisation, COVID-19 has now shown the clear necessity.

Key things that digitisation via the Imperium platform will solve in the NZ money markets going forward are:

- Secure cloud-hosted technology that can provide for remote access (for banks & wholesale investors);
- Direct access to transact between banks and investors on deposits and money market securities electronically;
- Price transparency/discovery that gives banks and wholesale investors real-time market data about where they win/lose quotes;
- Deal capture (all transactions time & date stamped) for compliance and risk (especially pertinent when working remotely);
- Superior Cybersecurity environment than phone, email and chat transacting; and
- Regulatory oversight in real-time.
- Provides investors with real time investment policy safeguards in terms of counterparty limits and dealing transparency.
- Streamlines and fully automates AML compliance.

The market platform delivers wholesale investors with an exceptional portfolio management tool and deal execution experience. The best news is that it is free to investors.

See following link and introduction video for more details: https://imperium.markets

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Unconventional monetary policy in New Zealand

Within our August 2019 Treasury Broadsheet we highlighted the changing landscape of global central banks, and relevance to New Zealand. The context was the Reserve Bank of New Zealand had reduced the Official Cash Rate to 1.00% and indicated it had been undertaking developmental work around potential unconventional monetary policy (including negative interest rates and quantitative easing) in conjunction with the Department of the Treasury.

Some of the main points from our article included:

- We suggested there might be less concern around central banks and governments working more closely together (provided decision making independence and credibility remained in place) - that situation might be better than not working together or being uncoordinated in objectives and application.
- In addition to monetary policy considerations, 'stimulus' could be afforded in NZ through infrastructure/government/fiscal spending (including borrowing at very low rates of interest) and given presently low government debt levels.
- We noted events occurring in monetary policy, low interest rates and investment markets are a global phenomenon with NZ part of it.
- We thought further reductions in interest rates/loosening of monetary policy in NZ (and elsewhere) seemed very likely even if it had a limited impact in lifting inflation.
- Finally, with interest rates (short and long-term) nearly everywhere converging to zero, credit risks/premiums could become the differentiator in determining risk/return compensation.

The prospect of negative interest rates then largely dissipated from December through to February. However, it was also generally understood the RBNZ had been continuing to work on such measures of unconventional monetary policy 'just in case'.

Throughout the last six to eight months our sense has been the RBNZ probably wouldn't take the OCR/90 day bank bills into negative territory to any material extent over time, as among other things, the potential for this to provide distortions (between bank lending arrangements and derivative/interest rate swap arrangements for risk management) now seems better appreciated by the authorities. Further there are other technical impediments to interest rates below zero (including banks own systems) and likely distortions to spreads / limited pass through to lower retail interest rates (much reduced efficacy).

With domestic interest rates now **effectively at the zero lower bound** (following the OCR cut to 0.25% on March 16) and with the RBNZ having also issued **forward guidance** (pledging to maintain the OCR level unchanged for 12+ months), what now is the forward playbook of the RBNZ?

- Subsequently in March we (and others) anticipated the next 'cab off the rank' for unconventional monetary policy would likely be **Quantitative Easing (Large Scale Asset Purchases**) mainly of New Zealand government bonds.
- Additional issuance of government bonds (to fund fiscal deficits impacted by Covid-19) would otherwise push these yields higher due to additional supply (lower prices).
- Quantitative Easing (if implemented by the RBNZ) would then push these yields back lower again (with additional demand pushing the prices higher).

- In this regard the RBNZ are now purchasing central and local government bonds 'across' the yield curve in the secondary market (not directly from government issuance/tenders) with another goal of providing extra liquidity into the economy/financial markets as well as assisting long-term interest rates back lower.
- The RBNZ also indicated they could buy other assets - presumably buying Corporate Bonds/debt down the line is theoretically possible (as the Fed has moved to).
- Other tools within the prior (10 March announcement) tool kit of the RBNZ also remain possible including the RBNZ having indicated they might participate in the interest rates swaps market (receiving fixed) in the two year to five year maturities to ensure lower interest rates also flow through for household mortgage fixing purposes (if required).
- While not currently front of mind there is also the possibility the RBNZ could enable the facilitation of preferential or targeted lending to some sectors. (This could take the form of provision of collateralised long-term loans to banks provided with conditions that require banks to increase their credit supply). While we have seen elements of this in recent weeks, transmission, practicalities and uptake through the private sector appear far from smooth.
- Despite these other potential unconventional monetary policy alternatives it appears modestly negative interest rates may still not be ruled out. As of the 16 March RBNZ monetary policy announcement negative interest rates were not strongly considered as 1) the forward scenario unfolding with the coronavirus was seen as requiring a more immediate impact (i.e. Quantitative Easing) and 2) operational readiness across the financial system is not yet consistently available to actually practically implement negative interest rates. Of course the question is whether this would actually do much in a positive vein. However, as a base case, a period of very low interest rates for an elongated period is to be expected.
- In our view, corporate borrowers are more likely spooked by the prospect of negative interest rates as the outcome of BKBM (borrowing reference rate) will deliver more uncertainty and negative impacts to cash flows and forward planning than the very limited monetary policy benefits anticipated by the RBNZ.

The point of all of this being that (despite clearly challenging and largely unprecedented times) it is far from clear that the RBNZ is out of ammunition. Further, we already appear to be moving towards a period of increased Central Bank/Government coordination in New Zealand with the next installment likely around the May 14 budget where increased government expenditure would come with increased bond issuance. Further announcement of the RBNZ stepping up the quantitative easing programme will also be expected.

This then raises the prospect of direct financing (monetisation) of government deficits via the central bank (RBNZ) as being possible. This could not be ruled out, however one key problem is it would cut out the price and supply/demand signals contained in primary issuance, and where otherwise the RBNZ would be buying off private agents in the secondary market. Also, the independence of the central bank from the government would be under severe question. However, some have noted this could be alleviated by the decision of whether to stimulate (directly buy government bonds to finance/monetise the government deficit/spending) lies with the central bank, while the government decides how/where/when to spend and stimulate.

Of course this then also raises the prospect of future generations repaying enormous government debt, via taxes or other means. While this sounds intuitive, whether this will actually happen remains to be seen, an alternative being the commitment/balance/transaction sits on a financial system somewhere essentially for perpetuity (as it would presumably elsewhere around the world). It is recognised this probably wouldn't be too different from

creation of the fabled ‘helicopter’ money - created from and dropped out of thin air. The point being that central banks/governments always have alternatives/means.

A further question would be concerns of elevated inflation with all of this. However, we note inflation has been low and lower over recent decades - much for structural reasons we have previously discussed, and perhaps we should be so lucky if central banks find a way to derive higher inflation (if indeed that is still their objective). Separately, higher inflation would rebase the debt balance lower in real terms - to the extent debt is expected to be repaid (versus perpetual or convertible).

As before, the intention of this article is to be open minded about the future of central banking and its relationship with other public and private agencies within the financial economy; change was afoot prior to the COVID-19 outbreak and those changes have only been accelerated in many ways and directions. This might also include further mingling of public and private interests from a credit/equity/investments perspective; the ‘excess reach’ of larger government is recognised here.

Pandora’s box is understandably being opened and the lid will likely be hard to put back on.

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How low global yields are creating challenges with offshore NZ borrowing

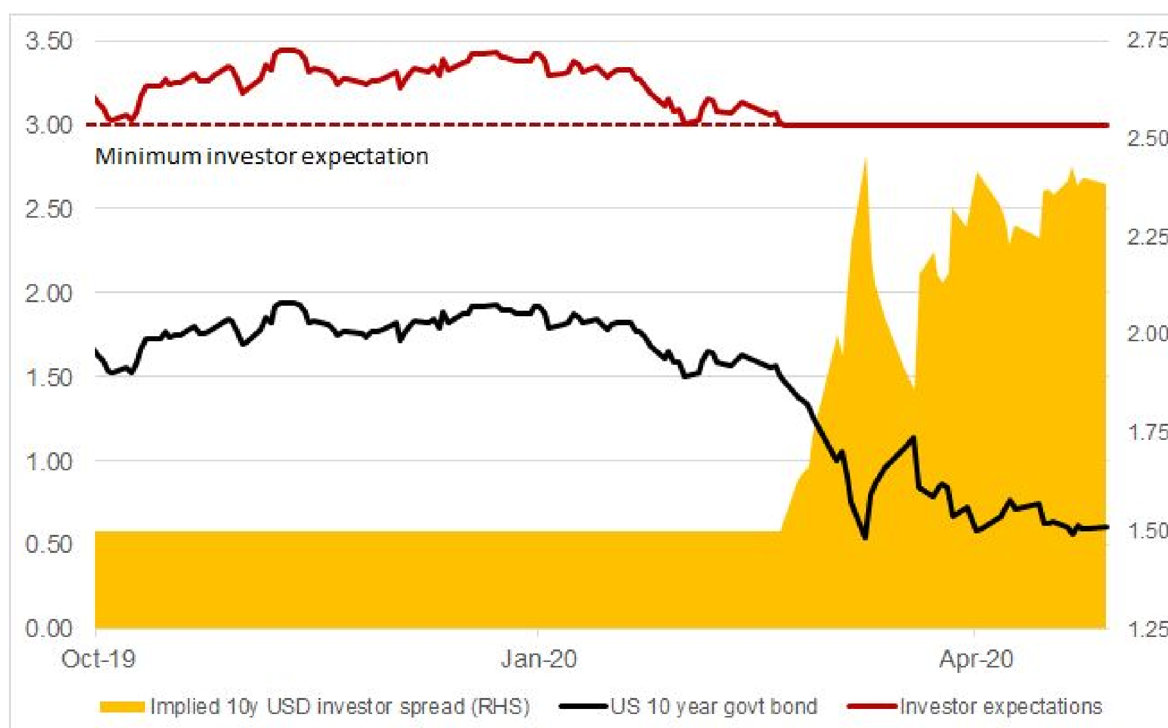
At face value, the sharp movement lower in global long-term bond yields suggests it is a great time to borrow. However, as most corporate borrowers know, especially those that have been through a few crises, that the cost of credit is equally as important as the cost of the wholesale interest rate (once the access to that funding has been agreed!); and the two tend to move countercyclically to each other.

For corporate bond issuers, there is also an important question about what yield they can 'get away' based on the expectations of investors. As interest rates have moved sharply lower following the outbreak of COVID-19, this is starting to create tension - borrowers want to take advantage of the sharp movement lower in yields, while investors don't want to accept the full amount that wholesale interest rates have declined. Furthermore, the new environment suggests that lending for a long-term period (e.g. out 10 years) carries significantly more risk now that the global economy is heading into recession; investors want to be compensated accordingly.

For longer-term New Zealand borrowers looking to get US private placements away, this is starting to create a challenge. Where investors used to settle on the ***spread*** over US Treasuries (UST, e.g. 150 basis points over the 10-year US Government bond yield), they are now pushing back and not accepting deals below an ***absolute yield floor*** (e.g. 3.00%, including the Government bond yield).

As you can see in the chart below, given how quickly the drop in yields has come about, this has created a sharp increase in credit spreads for corporate borrowers. Where a typical BBB credit might have previously been able to agree to a margin of (for argument's sake) ~150bps over USTs, the use of an outright yield floor (e.g. at 3.00%) has created a sharp jump in the credit spread that investor is requiring in order to make good the minimum yield floor.

Chart 1: US 10 year Government Bond yields and illustrative investor expectations and spread



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The challenges with the above for the corporate borrower are threefold: first, the borrowing is committed for the full term - it's rare that these types of deals are repaid early or ever structured for such. Secondly, the higher cost of the spread then carries the whole way back to the spread paid over NZ BKBM post currency swap. Finally, converting that USD debt back into NZD has become more expensive as a result of the basis swap (albeit the pressure is starting to ease) and credit charges.

Chart 2: NZ-US 10-year basis swaps (in basis points)

Chart source: Bloomberg

The issue is also expected to be prevalent in the domestic bond market once issues start to re-emerge for corporates. While we have seen short term deposit rates decline since the RBNZ slashed the OCR, it remains to be seen whether investors are willing to accept comparably low outright yields. Our gut feeling is that the attractive credit spreads seen by corporates during 2019 are unlikely to return and, instead, likely see investors require adequate return for risk and only gradually accept lower outright yields. Funding margins will likely contribute more to total interest costs than wholesale rates for the foreseeable future.

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