

# PwC Treasury Broadsheet

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

November 2019



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# Digital platform finally here for wholesale term deposits?

## Overview

It looks like New Zealand's financial system will finally catch up with the digital age on term deposits. New Zealand's debt market (circa \$550 billion) is predominantly funded by bank balance sheets (90%) and within that, more than two thirds are sourced from term deposits, roughly \$330 billion worth. Despite its size, the term deposit market is also an antiquated and time intensive market for most participants. Corporates managing cash are typically required to ring or email their bank counterparties, collect (and assess) the results and then initiate the deposit process. For the banks, it has been especially cumbersome as they wrestle manual systems that are not real time and desperately need efficiencies and pricing transparency. Pricing is regularly quoted but often the banks don't know where the transaction has gone or how much they missed out by. This is especially pertinent as their balance sheet becomes more heavily regulated and costs associated with the upkeep of that balance sheet more acute in terms of sustainable income margins.

While technology has streamlined the execution of payments, foreign exchange and interest rate hedging transactions, deposits have always been a little unloved, until now (or more precisely, *soon*). A new platform from [Imperium Markets](#) is aiming to digitise the placing, management and reporting of money market investments for both banks and corporates. The platform allows banks to easily connect, quote and transact money market investments with wholesale investors. The core focus here is term deposits - enabling corporates to find the best price for their money (with the agreed/permitted banks they can deal with) and then initiating the process for the deal to be completed.

## What are the benefits?

The major benefits for investors/corporates are:

- Ease of execution, significant time savings when balances are material.
- Powerful reporting (including ensuring policy compliance by term, counterparty and credit rating band).
- An audit trail for year-end reporting, allowing you to review a record of the historical portfolio for auditors and accountants to reference.
- The tool is free for investors to use.

The major benefits for banks are:

- Significantly more efficient quoting and deal execution.
- The ability to learn how much they win or lose on each bid (provided they have been invited to bid and on a confidential/'no names' basis).

The final point above cannot be overstated. We regularly see a wide spread between quoted rates from banks for a set range of terms. On a regular basis, this spread can exceed 20 basis points. Whilst this currently can be an advantage for the canny (and thorough) wholesale investor taking advantage of the current lack of transparency, we feel that the adoption of this style of platform is likely to be inevitable. Accordingly, we expect that term deposit spreads will tighten over the next 12-24 months as volume begins to flow through the platform and banks begin to get some visibility into the demand and supply of term deposits across different tenors.

There are also some major benefits for regulators, particularly because this market is currently very opaque and only ever seen in arrears through bank reporting. To the extent that the platform is widely adopted by banks, the RBNZ and FMA will potentially have the ability to see and assess the strength of financial conditions in real-time.

## What is the status of the platform?

From our latest conversations with [Imperium Markets](#), the platform is already live and authorised in Australia, with the FMA currently reviewing its New Zealand trading licence application. The company expects that the platform will be live and registered in New Zealand in early 2020.

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# Survey confirms activity in global derivatives markets remains very healthy

The Bank for International Settlements (BIS) recently released its Triennial Central Bank survey of turnover in global FX and over-the-counter (OTC) interest rate derivatives markets.

## FX activity

Daily trading in foreign exchange markets has reached (USD equivalent) \$6.6 trillion, a 30% increase from \$5.1 trillion per day of the prior survey three years ago. The increase was centred on growth in FX derivatives (outlined below) rather than spot trading. The percentage share of spot transactions now makes up 30% of turnover, down from 33% three years ago. In contrast, FX derivatives (such as Forward Exchange Contracts, FX Swaps and FX options) increased to 70%, from 67% three years ago.

Within total turnover, the prominence of FX swaps (typically short-dated at <7 days) was notable making up 49% of activity. FX swaps are typically used for funding liquidity management and FX risk purposes.

## 2019 Daily Average FX Turnover (USD equivalent billions, % are rounded) [i]

	Spot	FECs	FX Swaps	Options (and others)	Total
USD amount	1,987	999	3,202	294	6,590
% of total	30%	15%	49%	4%	

Relative to levels of three years ago, trading in outright forwards (FECs) rose by 43% to \$1 trillion per day – 61% of this turnover is for maturities between 7 days and 3 months and, interestingly, a relatively low 12% of the \$1 trillion per day activity in FECs is for maturities beyond 3 months. Trading in OTC FX options grew by 16% from three years ago to \$294 billion per day. Lack of comparative increase in FX options versus the 30% increase in total turnover of all FX products over the period is perhaps surprising given low volatility has reduced option premiums, which could have made these a more attractive proposition.

As expected, the USD retains its dominant status within global FX markets by far – being on one side of 88% of all trades. The volume of EUR trading increased to 32%, although the volume of JPY reduced to 17%. Less volatility in USD/JPY was seen as the reason for reduced JPY activity. Other heavily traded currencies include GBP (13%) and AUD (7%) while the RMB is 4%. [ii]

The USD is on the 'other' side of 95% of RMB transactions, i.e. there is no significant proliferation of RMB usage versus other currencies and cross rates.

The NZD features in 2.1% of all FX trades, making it the 10th most actively traded currency (the same position and percentage as three years ago). This in spite of New Zealand being only around the 50<sup>th</sup> or 60<sup>th</sup> largest economy in the world (depending on the method of measurement) and making up approximately 0.2% of the global economy. Accordingly, this shows the considerable and disproportionate sensitivity of the NZD and the New Zealand economy to global FX markets.

### Interest Rate Activity

The accompanying OTC interest rate derivatives activity report shows \$6.5 trillion daily average activity – up considerably from \$2.7 trillion three years ago. \$4.1 trillion of this average daily turnover was in swaps, which was approximately evenly split between Overnight Indexed Swaps (OIS) and ‘traditional’ longer-dated interest rate swaps. Forward Rate Agreements (FRAs) made up \$1.9 trillion of the total.

Collectively, the ‘short-term’ instruments of FRAs and OIS made up 61% of total activity and longer dated interest rate swaps were 33% of the total. Activity in interest rate options was \$456bn (or 7% of the share, up slightly from 6% previously).[iii]

### 2019 Daily Average OTC Interest Rate Turnover (USD equivalent billions)[iv]

	FRAs	OIS	Swaps	Options (and others)	Total
USD amount	1,900	2,045	2,099	456	6,501
% of total	29%	31%	32%	8%	

Specific USD interest rate product share was \$3.3 trillion (more than 50% of the total) while EUR was equivalent to \$1.6 trillion (or 24%). The US share of OTC interest rate derivative activity was the same as three years ago and well above the approximately 30% from the two prior triennial surveys (i.e. the 2013 and 2010 variants). This rising share indicates that US interest rate risk has perhaps been the most prominent of interest risks to be managed in recent years.

Separately, NZD interest rate activity is 0.9% of total global flow, similar to the NZD FX share of 2.1% (when one-sided versus two-sided currency flows are considered within the information).

### Concluding comments

Arguably most interesting from this latest BIS analysis and update is that, despite relatively low volatility and ‘contained’ financial market movements for much of the last 12 to 24 months, FX (and perhaps even more surprisingly interest rate) derivative activity has continued to grow. The mitigation of risk and provision of certainty remain key considerations.

Another conclusion is that the liquidity and depth of global financial markets remain very healthy and show no signs of reducing. For corporates, this is a reminder that for long-dated FX or interest rate hedging, New Zealand benefits from the liquidity provided by global speculators. This liquidity is gradually enabling a wider pool of currencies for long-dated hedging (such as the NZD/CNH, which previously was very constrained.)

[i] Table detail does not include \$108bn of currency swaps

[ii] Note the percentages for all FX activity would add to 200%

[iii] Note rounding of percentage shares in this paragraph means these don’t sum exactly to 100%.

[iv] Table detail does not include \$108bn of currency swaps

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# Private credit funds – an alternative debt funding source?

Like us, you may be hearing more in the marketplace around the offerings of private credit funds. Such funds provide an alternative funding source to traditional corporate bank lenders. The reason why there is a greater awareness of the offerings from private credit funds is that the traditional bank lender may become a less reliable source of debt funding as pricing, tenor and terms become less attractive for some medium-sized corporate borrowers.

A private credit fund is just that, normally funded from private investors that, by their very nature, do not necessarily have the regulatory framework around them that a traditional bank lender may have. These funds not only provide debt financing to leveraged private equity transactions, but could reasonably provide senior secured lending to the mid-corporate sector. Borrowers typically have a sub-investment grade credit profile and are growing, positive cash-flow generating businesses. They do not lend on distressed debt.

Spawning from the Australian market (although there are New Zealand equivalents), these funds, although potentially more expensive than traditional bank lending, provide a debt funding solution which can be structured to the needs of the business on a bi-lateral basis. Large transactions are likely to be on a syndicated basis. As a general guide, lending margins are 5% p.a. over wholesale base rates. Other features can be attractive, such as no principal amortisation or covenants that provide flexibility given the business' life cycle stage.

Much like traditional lenders, these funds like to understand the business, completing detailed due diligence and extensively understand the fundamentals, financial and credit profile of the business. They will have preferred sectors that they lend into. They generally have an intention to provide funding for a period of greater than three years, typically five years. As these funds seek a high, stable yield to maturity, their intention is to remain as a committed term debt lender.

We will soon hear from the Reserve Bank of New Zealand about the changes to the bank regulatory capital framework in New Zealand (5th December 2019) and alongside that, understand how the Australasian banks will respond. These credit funds will be keenly watching the outcome, given that corporate lending markets are already under pressure and corporate borrowers may be seeking alternative debt lenders, such as these funds, to support their existing bank funding arrangements going forward.

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## Carbon update - 2020 is going to be busy

In our May 2019 Treasury Broadsheet, we discussed the fast approaching deadline for New Zealand to establish its updated Emission Trading Scheme (ETS) by 2021 (click here to read [Is carbon on your radar?](#)). This article covered the updates from the Government's recently-released reports on the intended structure of the ETS, as well as important considerations of how the market will operate in the future. However, it did not clarify the practical details of how the exchange will function, how and when it will be implemented and who will be responsible for its operation and compliance. So, with the end of 2019 rapidly approaching, we thought it was valuable to check in and provide an update on progress and the current state of play as well as what corporates need to be thinking about from a policy perspective.

In short, visible progress has been slow. Following the updated reports in early 2020, the Government has been working through the finer details but there remains some material gaps in establishing the infrastructure and marketplace needed to go live by 2021. The key gaps relate to clarifying how the future ETS will ensure that it transitions from Kyoto protocols to those set out in the Paris Accord. In particular, unresolved issues remain regarding the process of voluntary offsetting and eligibility of the use of non-NZU units for settling obligations under the NZ ETS. As has been previously announced, the Government will outsource the management of the carbon auctioning platform, however there has been no announcement on how or who will be managing this process (this is currently under consultation). Accordingly, it appears that 2020 is going to be a very busy year.

For corporates and other organisations, we are continuing to see more active recognition of carbon risks and some on-going internal debate as to where these risks should be managed. As we mentioned in May, a lot of the risk management characteristics align with the underlying purpose of treasury; namely:

- **Transaction/price risk** - carbon prices are market driven and act like foreign exchange or commodity markets. This makes it relatively easy for treasury to assimilate the management of carbon exposure risk. The instruments available to help hedge these risks are also very similar in design to traditional hedging instruments.
- **Funding/liquidity risk** - accessing carbon units may be challenging in an environment of restricted supply. Consideration will need to be given to the future cost of carbon units (likely higher from the current market price) and the associated funding needs.
- **Counterparty credit risk** - carbon hedging contracts will need to be monitored and managed in the same way as traditional hedging contracts - one of the primary remits of treasury.
- **Compliance risk** - there are significant costs for not meeting the deadlines or not being compliant with the ETS. These costs act as a heavy 'stick' and naturally align with treasury maintaining oversight in the same way that bank covenants are covered.

Outside of treasury, forecasting and measuring carbon emissions (i.e. the exposure) and associated reporting needs to be performed by suitably qualified personnel. Pragmatically, this will often be done by the business unit responsible for those emissions.

Taken together, organisations are designing policies that help to identify exposures and then manage and/or mitigate the risks associated with their carbon exposures. The latter is commonly housed within the Treasury Policy given that many of the above factors are already well covered for other similar risks. It also acts as a way of centralising the group's view of the risks and acting accordingly (rather than in silos). 2020 offers a good chance for corporate to ensure they are ready for the 2021 changes.

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# Environmental, social and governance (ESG) investing

## A new era of environmentally sustainable investing

Historically, environmental, social and governance (ESG) investing was about excluding undesirable entities from portfolios in order to meet socially responsible investment principles. The focus now for investors is on investment activity that meets ESG criteria alongside financial considerations.

For the corporate treasurer, issuing green bonds (a fixed-income instrument designed to fund specific environmental or green projects) has largely been seen as a way of diversifying the investor base and potentially reducing borrowing costs via a 'greenium' (an expected pricing discount for a green investment).

The assumption that green bonds could attract cheaper funding hasn't been the case in the New Zealand market (yet) and many corporates globally have found that the overall effect of issuing green bonds has been cost-neutral at best. Issuing green bonds has resulted in more effort and higher costs for corporates due to the additional layers of due diligence required to validate the green credentials both initially and on an ongoing basis. In some cases, funds raised through green bond issuance need to be segregated from general corporate purpose funding, requiring additional reporting and monitoring, and thus further cost.

There has also been scepticism over the true impact on the environment of green issuance as many investments made and bonds issued were to hit internal targets rather than for genuine effect. There has been a temptation for companies to engage in 'greenwashing' when more time and money is spent claiming to be green than in actually implementing practices that minimise environmental impacts.

Despite evidence of increased issuance costs to date and potential 'greenwashing', the green bond market has grown exponentially, with new variants including 'blue', 'sustainability' and 'social inclusion' bonds. Behind this growth are key factors including:

- Fixed interest investment managers and their clients increasing portfolio allocation requirements
- Corporate responsibility measures increasing desire to play a part in meeting ESG objectives
- Reduced issuance costs
- Growth in market maturity and comfort in following the lead of others.

Investment managers have maintained an ESG agenda for some time, but this has typically been associated with a small proportion of their portfolio. In recent years, there has been a renewed focus driven by various initiatives. European markets are leading the way in ESG issuance, supported by investors who now carry out much more thorough ESG credit analysis. ESG investment is no longer a token gesture with serious investment in staff and methodologies now undertaken.

For corporate treasurers considering green bond issuance, a key requirement is the creation of a green bond framework to communicate the key concepts behind the bond to investors which details how the funds are used. Guidelines from the International Capital Market Association (ICMA) are commonly used and while the ICMA Green Bond Principles provide a framework for issuance, these are voluntary and there is still some ambiguity as to what defines a green bond.

Currently, issuers create their own framework, which allows for a broader range of interpretation. The framework then typically requires an independent organisation to verify project KPIs and provide



ongoing monitoring. The EU is working on a standard taxonomy (due later this year) for green bonds, introducing minimum standards that will offer clarity on the definition of what constitutes green issuance.

Expect to see increases in ESG, sustainable and green bond issuances in the New Zealand market, following the examples of Contact Energy, Argosy Property, Housing New Zealand and Auckland Council.

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## LIBOR reform - treasury fish hooks that NZ issuers should look out for

In our March 2019 Treasury Broadsheet, we discussed the fast approaching 2021 LIBOR reforms (click here to read [LIBOR Reform: Are you ready?](#)) This covered some of the potential challenges and opportunities New Zealand corporate treasuries may face as LIBOR reference rates are replaced.

The LIBOR reforms will impact New Zealand issuers that have long-dated derivatives such as cross currency interest rate swaps and foreign currency denominated debt. Regulators and industry bodies have identified alternative methodologies for the existing interbank offer rates (or "IBORs") that align more closely with transaction-based (and typically risk-free) rates. In the US, IBOR rates will be replaced with SOFR, in Europe with ESTER, Japan with TONAR, and the UK with a Reformed-SONIA.

Now the LIBOR reform is further down the track, it is important to be aware of some of the most recent developments, as well as the potential fish hooks that New Zealand issuers may come across throughout the reference rate transition period.

*As a quick aside, we apologise in advance for how quickly this article gets technical. Hopefully it serves as a useful resource for those readers who are familiar with the context (and need to know the details.)*

### Managing the difference in structure of reference rates

LIBOR is a forward-looking unsecured interest rate which includes bank credit and liquidity, whilst SOFR is a secured overnight Treasury rate. Although SOFR is risk free, it is sensitive to a change in bill supply and balance sheet capacity.

Earlier this month, ISDA (International Swaps and Derivatives Association) published a report summarising responses to a consultation on the final parameters of adjustments that will apply to derivative fall-backs for certain IBORs in the event they are triggered (i.e. the change from retiring IBOR rates to the new risk-free rates and the interest rate calculations applied to these risk free rate).

Using the feedback collected from respondents, ISDA expects to implement a historical median spread adjustment over a five-year look-back period. Respondents also supported a two-bank day backward shift adjustment period. The spread adjustment will be applied on a compounded basis (in arrears) with the applicable calendar to be determined and announced by Bloomberg prior to implementation.

Following these results, ISDA will make the relevant amendments to the 2006 ISDA Definitions to incorporate fall-backs with these adjustments for new IBOR trades. ISDA will also publish a protocol to enable market participants to include fall-backs within legacy IBOR contracts if they choose to. Both the

amended Definitions and the Protocol are expected to be finalised by the end of this year, with implementation in 2020.

With the absence of forward-looking new reference rates, it is imperative for corporates to focus on ensuring there is suitable fall-back language in all existing contracts. The potential differences between the adjustment calculations for cash and derivative instruments should be taken into consideration. This will help to reduce the potential basis risk that could arise between various financial contracts whilst navigating the transition to alternative reference rates.

### ***Matching the timing difference between shifting reference rates for cash instruments and derivative instruments***

There are likely to be two sets of triggers for when a contract or derivative moves from the old reference rate to the new reference rate - those that would apply *when* LIBOR production has stopped (known as 'cessation triggers') and those that could be triggered *before* LIBOR ends ('pre-cessation' triggers).

A pre-cessation trigger may be beneficial, allowing for an orderly unwind of LIBOR-based inventory before publication stops. Specifically, the early opt-in for bank loans could avoid potential disruption from attempting to re-work thousands of loans simultaneously at the LIBOR cessation trigger date.

If LIBOR's regulator (FCA in the US) publicly states that the rate is no longer representative of the underlying market, this would initiate a switch to a new benchmark before LIBOR publication has stopped. While this would mean organisations would no longer be able to enter into new derivatives or securities transactions referencing LIBOR, in theory it is possible that some unsettled derivative contracts would continue to reference LIBOR. This could create a potential mismatch between the turning off of LIBOR for cash instruments but leaving it on for uncleared derivatives during the transition of reference rates. Key message: care should be taken around all trigger dates (and approaches) for all relevant documentation.

### **Managing counterparty engagement risks**

The operational risks of each counterparty need to be considered just as much as the economic risks. Contracts need to be amended to maintain economic parity and to keep the current provisions clear in order to reduce the potential for contract disputes. Consistent language should be used across product contracts to reduce misinterpretation and future legal disputes. It is important to ensure that every stakeholder is involved to make sure accountabilities are established from all impacted areas of the counterparty for the duration of the transition. Begin to design a programme that will help navigate the upcoming transitional period.

Will a similar reference rate reform happen in New Zealand? For now, it appears likely that BKBM will remain New Zealand's key reference rate. The New Zealand Financial Markets Association (NZFMA) is looking at a multiple rate approach similar to that of Australia. This would keep BKBM, making sure the fall-back benchmark interest rate is reliable enough whilst keeping in line with International Organisation of Securities Commissions (IOSCO) principles. The objective of this exercise is to ensure that BKBM remains a valid global benchmark for international use, without making wholesale changes.

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