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Sprats for mackerels - big changes in funds management
IFRS 16 Leases - Financial reporting impacts
Treasury management systems - show love upfront
NZ ETS - changes are coming
An introduction to SIPOs
Doing more with less
Cashflow Forecasting: The automation era

Sprats for mackerels, big changes in funds management

Last month, the funds management industry was turned on its head through a combination of events. A review of global fees illustrated that fund managers were earning billions in fixed management fees and that a good portion of these fees were associated with passive funds (simply pegging to an index) and not reflecting any performance relative to the fees charged. It was unkindly observed that this was money for jam, just chucking other people's money into blue chip holding pens and earning a disproportionate amount of its return.

Following a flurry of commentaries from leading financial media, one of the world's largest fund managers (Fidelity, with USD 2.4 trillion under management) really put the fox among the chickens by announcing that it was slashing the cost of all its index-tracking passive mutual funds to zero! Whilst these funds only represented a lost fee revenue of USD47 million (against USD5.3 billion of operating profits) the clear messaging was that people should be able to invest in blue chips without simply eroding returns on long-term investments (providing no value add).

There is a high average net expense ratio of approximately 1% in the US fund management market, which collectively manages over USD 7 trillion in US equity funds and internationally-focused funds.

Whilst the arguments have abounded from the sector that index funds are different to other funds and they are small fry relative to total funds under management, it would appear that Fidelity has used supermarket tactics using a sprat to catch the more attractive clients into their large investment door. The freebie of no fees indexed funds might lure these investors into one of their more profitable funds.

There is no doubt the stone cast by Fidelity will have a pronounced ripple effect across the fund management pond. The trend towards performance-based fees appears to be gathering momentum.

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IFRS 16 leases – financial reporting impacts

It bears repeating (as mentioned in previous *Treasury Broadsheets*) that the new lease accounting standard, IFRS 16, 'Leases', will fundamentally change the accounting for lease transactions for lessees and is likely to have significant business implications. It is effective from 1 January 2019. Almost all leases will be recognised on the balance sheet for a lessee, with a right-of-use asset and a lease liability. Lessees will also generally recognise more expenses in profit or loss during the earlier years of a lease. This will have an associated impact on key accounting metrics and clear communication will be required to explain the impact of changes to stakeholders. Treasurers at companies adopting IFRS 16 are likely to be involved in these implementations. The linked publication highlights some common issues and practical solutions relevant to treasurers. These include:

- determining the appropriate discount rate to use for lease liabilities;
- potential hedging strategies for interest rate risks inherent in leases; and
- potential hedging strategies for leases denominated in foreign currencies.

Please go to the following link for an in-depth look at current financial reporting issues. Click here

Treasury management systems – show love upfront

We've had an increasing number of conversations lately with clients about treasury management systems (TMS). For many New Zealand corporates, particularly exporters, importers and borrowers, the need for a TMS centres largely on accurately capturing, storing and valuing derivative hedge contracts. However, for an increasing number of corporates, strengthening the efficiency and visibility of corporate cash is also a key priority. Whether it's a decentralised operating structure, frustrations managing multiple online banking platforms or complex working capital and cash management arrangements, the company TMS can make life a lot easier, **but** only when set up correctly.

For many companies, finding the time and, more importantly, the resources to invest upfront when implementing a system is challenging. Indeed, even getting the time to *think* about getting a system is hard enough. What we find is that many organisations have had a 'near enough is good enough' attitude, settling for the main features they wanted from a system and not really using the rest. As time rolls on, the manual time lost from those decisions quietly adds up. Improvements in system functionality and automation have also made these costs more noticeable. In particular, recurring, mundane tasks such as reconciling bank statements with the ERP or daily cash balances can be undertaken automatically with exception reports returning only potential errors and follow-ups. Time is saved while accuracy increases. In addition, moving cash directly through the TMS can be achieved if bank connectivity is fully established, helping to reduce net interest costs and increase cash flow efficiency.

For many New Zealand companies, there are a number of 'easy wins' that can probably be achieved if they took a step back and refreshed the mandate or objectives that they wanted their TMS to deliver. As a general observation, very few companies regret the upfront cost of time and resource that integrating a system requires once it provides meaningful, fast and accurate reporting. For others, it might not even be a TMS they require. There are a growing number of start-ups and tech solutions aimed at increasing the efficiency of the treasury function in specific ways. If there is a particular frustration that you have or a process that is not working, it is worth investigating whether there are tech solutions that address it, because you can bet that you are not the only one facing the challenge. The struggle, as always, is finding the time (and clear head space) to take a look.

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NZ ETS – changes are coming

The new coalition Government has been in power for almost 12 months now and it is fair to say that they have made some significant (and some might say controversial) changes during their first year in charge.

One of the key areas they are focusing on is climate change and how to future proof New Zealand in this area. There are currently two key targets: '2030 emissions reduction target' (agreed to when they signed up to the Paris agreement) and a new 'Net zero emissions by 2050' target which the Government signaled (in December 2017) would be set out within legislation later this year. This will be largely based on the consultation work they are currently undertaking.

A material amount of resources are being applied to these policies with the government setting lofty goals of setting emission reduction targets as well as solidifying the framework for achieving them.

Under the New Zealand Emissions Trading Scheme ('NZ ETS' or 'ETS'), emitters have an obligation to obtain carbon units (namely NZUs) to surrender to the Crown to 'pay for' their emissions. These units create a financial cost to businesses which, to date has not been overly material or onerous. However changes that are likely to happen to the ETS over coming years are signaling a material change in the cost of these obligations. The consultation being undertaken this year will help to guide the Government in reaching emissions targets and will hopefully provide more clarity to business in this area.

The process to date:

- **Round one was about setting targets:** Carried out during the June – July period this year, the first consultation document was titled "Our climate Your say: Consultation on the Zero Carbon Bill" and was focused on how New Zealand transitions to a low emissions economy and setting clear emissions reduction targets.

- **Round two is about setting up the framework to meet these targets:** The second round of consultation (running currently, due to close on 21 September) is asking for feedback to improve the NZ ETS which was established in 2008. And is in response to the review of the NZ ETS that was undertaken by the previous government in 2015/16. The current consultation focuses on the framework of the ETS and is not asking for information about tactical details (e.g. pricing, quantum etc.) at this time. The outcome of this round will be used in forming legislative change in this area.

Within the current consultation, the changes that have been signaled for implementation are as follows:

- **Auctioning system -** A system will be put in place to auction carbon units in the New Zealand market in the next couple of years. The consultation is asking for public input to help shape what this system will look like. An auctioning system is necessary as the future emissions produced in New Zealand and carbon credits required to be surrendered to meet these emissions exceeds the amount of carbon credits currently forecast to be available domestically. The auction system will provide a mechanism to import carbon credits from other countries that have excess supply in order to meet domestic obligations.

- **Price ceiling -** The $25 price cap or Fixed Price Option (FPO) has been in place since 2009 and was introduced as a transitional measure to ensure the New Zealand carbon price did not get out of step with international markets. The proposed changes will see this mechanism removed and be replaced in 2020 with an alternative price ceiling mechanism called a Cost Containment Reserve (CCR). This retains the price cap concept however it will be set as part of the 5 year rolling budgeting process and will see a set number of units held in a reserve for each year with a set price that is subject to change each year. The consultation indicates the

Government's intention to start at a level above $25 and increase this each year. Actual pricing and quantum of units will be consulted on in a later document.

With the current spot price of an NZU sitting just below $25 (as at the end of August) the previously untested price cap mechanism may come in to play over the coming months. Under the current scheme, the $25 price cap acts as a back stop if an emitter cannot source units for whatever reason (i.e. lack of liquidity, pricing etc.) to settle their obligations. Instead of purchasing credits to then relinquish these to the Crown, they simply pay a flat unit price of $25 directly to the Crown. Also stated in the document, the Government has signaled that it is considering making adjustments to this price level ahead of the CCR coming in to effect in 2020 but have not disclosed a timeline.

- **International unit limits** – the previous Government put a stop to the use of international carbon credits to settle New Zealand domestic obligations under the NZ ETS. This was done for a number of reasons with the resulting outcome being only domestically sourced units can be used to meet obligations. This has contributed to the spot price for NZUs moving from ~$4 per unit to $24.80 over the last couple of years. The Government has acknowledged that there are not enough domestic carbon units produced to meet obligations over the coming years so are seeking to reopen access to international markets to source carbon units for use under the NZ ETS. Feedback is being sought on a number of topics in this area including how these units are sourced (i.e. directly by market participants or via the Government auctioning system), how to manage these units and what impact these changes will have on the New Zealand market. The consultation stresses that the Government intends to keep pricing in line with international markets.

- **Phase down of industrial allocation** – under the NZ ETS, certain industries are provided with a free allocation of NZUs for varying levels of their obligations (between 60% to 90% of total obligations). The reason for this allocation was to ensure that these industries are not adversely impacted to such a degree that they cannot compete or may go out of business due to the cumbersome liability relating to emissions. The current NZ ETS has mechanisms within it that see this allocation reducing over time but there is a lot of uncertainty around the timing and quantum of this process. Feedback from previous consultation indicated that more certainty around this is desired. The Government is therefore seeking feedback on how this is done and what impact this will have on these industries and the wider market.

- **Other proposals**: The consultation document also asks for feedback on governance, market information and compliance with the NZ ETS going forward.

It should also be noted that the current consultation is not considering either Agriculture or Forestry at this time. Both of these industries will be consulted on separately at a later date due to their nature and materiality.

The consultation process is happening right now and is open for public comment. If the above items are of interest or impact you directly, information about the consultation document and how to make a submission can be found here: Click here

With significant developments happening in this area, please get in touch if we can help you explore how these developments may impact on your business or your treasury operations now and in the future.

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An introduction to SIPOs

Regular *Treasury Broadsheet* readers will be well versed in the importance that is placed on maintaining a Treasury Policy that is 'fit for purpose'. They are however, potentially less familiar with the fact that for invested funds, this emphasis also extends to the Statement of Investment Policy and Objectives (SIPO). As professional treasury management consultants, we come across a wide range of SIPOs and note that there is a delicate balance that needs to be maintained in their construction. Documents that are too long often become confusing and restrictive in allowing the Investment Manager to complete their mandate effectively. Too many controls and they will be on the phone updating you on every Trump tweet. Similarly, documents that are too short lack robustness and may encourage excessive risk taking. Accordingly, an overview of some of the pertinent items that we believe a well-documented SIPO should consider are outlined below.

- **Objectives –** It is important that Investment Objectives are clearly defined. They must be documented in a manner that assists Investment Managers in understanding how invested funds should be managed. Identification of a return target is also important in describing the Fund's expectations, this may be stated in either gross or nominal terms.
- **Assessment of Risk Tolerance –** The assessment of risk tolerance is pertinent in defining the appropriate Benchmark Fund asset class allocation. The three factors typically considered when assessing risk tolerance are: the willingness to accept risk, the capacity to accept risk and the return requirement. These items are all assessed independently with the lowest risk tolerance factor determining the benchmark allocation.
- **Duties and Responsibilities –** Clear documentation of the expectations of each party involved in the investment process is important in ensuring that the appropriate controls are in place. A thorough description of these duties helps to eliminate grey areas and ensure that the Fund is able to function efficiently. Duties and responsibilities are typically set out for the following actions in the investment management process: the Board, the finance team, the Investment Manager, the Investment Advisor and the custodian.
- **Investment Parameters and Guidelines –** Consideration of the overall Fund circumstances is important when making investment decisions and this section of the SIPO helps to describe the framework in which investment decisions can be made. The strategic asset allocation in conjunction with the asset class guidelines forms part of this. The asset class guidelines in particular are important in ensuring that the nature of investments are appropriate for the organisation. For example, an ability to invest in opaque investment vehicles or those that utilise leverage would likely be inappropriate for those organisations with a conservative risk tolerance.
- **Ethical Investing –** An area of growing importance. A statement outlining an organisation's stance with respect to the industries it is prepared to invest in is necessary in ensuring that the Fund's investments are aligned to the organisation's values. Exclusion of this section may result in an organisation's funds being invested in a wide range of inappropriate securities (munitions etc.) which may result in unwanted attention from stakeholders. This area of investment is widening to include socially responsible and environmentally sustainable mandates.
- **Risk Management –** The development of appropriate risk management strategies is necessary in order to ensure risks are identified, monitored and, where applicable, managed. Having the appointed Investment Manager eliminate all risks is inappropriate and will result in the Fund earning the risk free rate. In other words, some risk taking within defined parameters is necessary and supports the achievement of return and other objectives, but should be consistent with the overall risk tolerance of the organisation.
- **Performance Monitoring –** The objective of performance monitoring is threefold. Firstly, it helps to understand the extent to which the Fund's investment objectives are being

achieved. Secondly, it assists in understanding the 'true' (or excess) performance of the Investment Manager relative to the agreed performance benchmark. We note that one way to assess this is through the information ratio which considers active return (returns that are in excess to the benchmark) to active risk (risk relative to the benchmark). Finally, to understand whether there are any weaknesses in the Investment Manager's strategy or investment products used.

- **Investment Manager Selection –** This section helps to provide a framework around the appropriate considerations for an organisation if they are replacing their existing Investment Manager or adding another one. It would be expected that Investment Manager roles are tendered through a Request for Proposal in order to provide some rigour to the process.

With financial market volatility, it is important that these items are effectively documented within your organisation's SIPO document. Ignoring these factors could adversely impact upon Fund performance. The regular review of the SIPO will help meet your organisation's governance requirements.

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Doing more with less

'Making the complex simple'. 'Tight budgets and big dreams'. 'Doing more with less'. These are recurring conversational themes across our client base. Whether a large, mid-sized or small international business, every treasury function is tasked with finding a more efficient and cheaper way to operate. For some, delivering value in an international environment with multiple financial risk exposures and bank accounts using a mishmash of excel spreadsheets and (often) ancient software can be difficult and time consuming. As if managing risks against a volatile political background was not difficult enough already. This begs the question whether technology can be enhanced to drive costs down, improve insights, strategy and decision making.

Those treasurers who are willing to broaden their horizons beyond multiple excel spreadsheets and embrace technology are going to be able to do 'more with less' and drive efficiency in their business. Treasurers need to have a technological vision and build a business case that the board, senior management or key stakeholders can get behind. Whether this technological vision includes the adoption of low-cost treasury management system or investing in process automation, steps to reduce human input can help treasurers re-focus labour deployed to more value-add activities. These may seem costly or fanciful at first thought, but given the tsunami of technological change and competitive tension in the global financial services industry, there are solutions that are palatable even for the smallest of organisations.

Overall, treasurers need to be agile, embrace change and be receptive to new technological opportunities that will ultimately drive better solutions for managing financial market volatility and improving financial performance for their organisation. Small steps can kickstart the process of transforming the treasury function from being perceived as a 'cost centre' and turning it into a 'value add centre of excellence'. Indeed, the next article fleshes out how cash flow forecasting could be a good place to start…

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Cashflow Forecasting: The automation era

Cashflow forecasting is a headache for most treasurers as it can be a tedious and time-consuming process, relying on accurate data and sensible assumptions. Forecasting is an essential task in the risk management process and, accordingly, there is pressure on treasurers to ensure the accuracy of these forecasts. Predicting future cashflow is increasingly difficult as financial markets show increased volatility and unpredictable behaviour. Forecasting future cashflows is never going to be completely accurate. The more confidence you have over your forecasts, the less prone you are to being surprised

by fluctuations to the cashflow. Against the backdrop of financial market uncertainty, it becomes even more important that your own data inputs are accurate.

The accuracy of data is a key component to the accuracy of a forecast. A survey by Reval, a software company that provides Treasury and Risk Management technology, showed that 72% of treasurers currently use spreadsheets to forecast their cashflows. However, spreadsheets are prone to human error such as formulas being hard-coded or fat-finger errors in input cells. This begs the question; can machine learning or artificial intelligence (AI) help treasurers improve the accuracy of cashflow forecasts by eliminating the element of human error?

In the digital age, there is no shortage of financial and data analytic tools to help automate processes such as cashflow forecasting. Corporate treasurers can use predictive analytics to improve the accuracy of their cashflow forecasts, e.g. training the model to know which customers traditionally pay late, early or erratically. In the past, predictive analysis required users to have a strong understanding of computer programming (or expensive statistical software), as well as an advanced level of skill to decipher the results. However, predictive models in the modern era are much more intuitive and wide spread, meaning someone with little or no understanding of the model will be able to use it and understand the outputs. The capabilities of these models include, but are not limited to being able to identify relationships between large sets of data, overlaying different models between subsets of data before joining the full dataset back together, identifying (and then excluding) outlying data and using historical data and events to predict the sensitivity on cashflow of future data and events (utilising machine learning algorithms).

Despite this technology now being readily available, many companies currently generate their cashflow forecasts using spreadsheets and macros. However, given the advances in predictive analytics (machine learning algorithms) and other AI tools such as Robotic Process Automation (RPA), it is likely that we will see more and more treasurers ditch the spreadsheets and adopt machine learning and eventually AI in the future. Most treasurers do not have the budget to splurge big on AI, though many tools are increasingly cheap and cloud-based, making them increasingly accessible. Adopting aspects of AI can help treasurers to cure the headache of cashflow forecasting and improve the accuracy of their forecasts.

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