# *Managing financial risk in a volatile world*

# New Zealand treasury survey

*Inaugural PwC New Zealand treasury survey*

*March 2012*

pwc

# Welcome to our first PwC New Zealand treasury survey

## *The purpose of the survey is to provide some valuable insights into what New Zealand organisations are doing to manage their financial risk and give some interesting food for thought on how treasury functions can enhance their reputation for adding value throughout the business.*

The survey was completed during the latter part of 2011 and is the first of a series of PwC New Zealand treasury surveys to be performed on a periodic basis. Given that it is typically larger organisations that maintain a dedicated treasury function and are associated with treasury industry matters, we were delighted with the response rate for a New Zealand focused survey of this nature, with 95 respondents from a wide variety of industries and organisation sizes. Not surprisingly, 73% of the responses were from medium to large sized organisations with turnover greater than $100 million.

The survey highlights that plenty of risk challenges remain post the global financial crisis (GFC). Whilst the initial window of opportunity for securing additional investment on treasury capabilities may have passed, we believe that the continuing market volatility and significant impact that risks such as foreign exchange, interest rates and commodities can have on the bottom line necessitates the treasury investment decision being revisited on a regular basis. Treasury functions need to evolve with the times and boards and management need to ask themselves whether the technology and manpower being applied to the management of their financial risk remains appropriate in what is an increasingly volatile and complex world.

We believe it is better to make continual advancements to your risk management approach, capabilities and toolkit than be overwhelmed by the need to make a transformational change following a crisis event. We recommend that the route map to best practice is developed and shared with those responsible for governance. The dialogue should identify areas of focus and priorities for investment, whether it is implementing a new treasury management system to improve controls and analytical capability, overhauling the treasury policy, upskilling staff, developing an outsourcing solution or deep-diving into specific areas such as commodity risk management, working capital improvements or cash management structures. The business case in terms of improvements to efficiency, insight, value-add and the bottom line is likely to make compelling reading!

Thank you to all participants for your time and effort in completing the survey. We hope this is an interesting and thought-provoking read. Please feel free to contact us if you would like to provide feedback or discuss any of the topics covered.

# Key findings

- Although the impact of getting the management of financial risk wrong can be significant, over 87% of respondents have an annual spend on treasury operations of less than $500,000.
- The last two years have seen 72% of respondents change their treasury policy.
- 74% of respondents consider their treasury function to be a value added cost centre.
- Working capital management tops the list of important treasury activities across all respondents, particularly for small to medium sized organisations.
- The most important banking relationship attribute is quality of service/advice.
- Organisations are hedging more risks related to off-balance sheet (unrecognised) exposures such as committed orders (59%) and forecasts (48%) than on-balance sheet exposures (36%).
- The larger the organisation, the greater the proportion of interest rate exposures being fixed compared to floating.
- While 65% of all respondents have a significant exposure to commodity risk, only 34% are actually managing commodity risk.
- Security is the number one investment principle for 70% of respondents, with liquidity and yield each ranked top by 15% of respondents.
- 53% of respondents said that it is either easier or somewhat easier to get funding than two years ago and 76% either have a longer debt profile (44%) or no change to their debt profile (32%).

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# Breakdown of respondents

## Industry sector

*Respondents were asked to categorise which industry sector their organisation primarily sits within.*

The options available were the same as those used in the PwC Global Treasury Survey 2010. The results show a wide distribution of responses with nine industry sectors having five responses or more and the top three industry sectors being manufacturing (19 responses), utilities (12 responses) and energy & mining (9 responses).

**Breakdown of respondents**

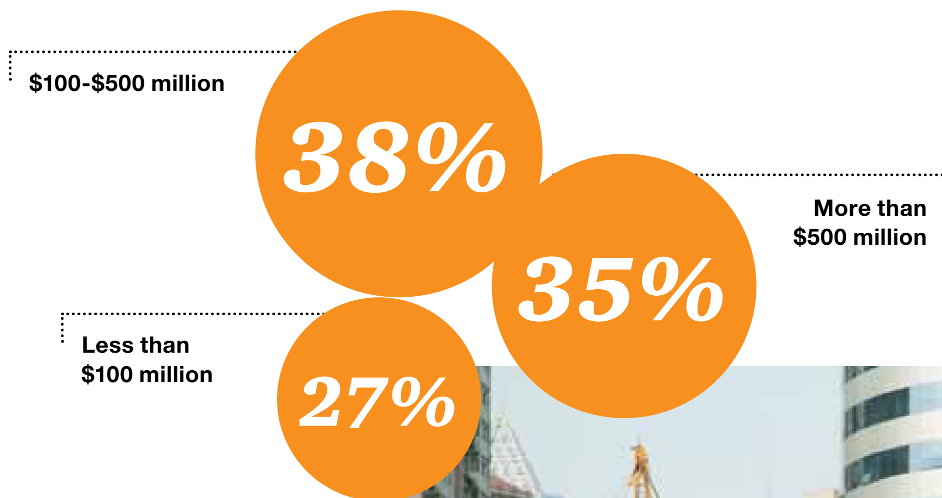
| Industry sector | No. of respondents |
|---|---|
| Accommodation & food services | 2 |
| Automotive | 2 |
| Construction | 3 |
| Consumer products | 8 |
| Energy & mining | 9 |
| Financial services | 4 |
| Healthcare | 5 |
| Manufacturing | 19 |
| Real estate | 5 |
| Retail | 6 |
| Services | 6 |
| Technology | 2 |
| Telecommunications | 2 |
| Transportation & logistics | 7 |
| Utilities | 12 |
| Undisclosed | 3 |
| **Total** | **95** |

*Please contact us if you are in interested in further analysis being performed for specific industry sectors.*

# Annual turnover

*To enable us to provide further analysis in terms of size, selected results have been divided into small, medium and large organisations.*

For the purposes of this survey, small organisations are regarded as those with a turnover of up to $100 million, medium organisations are regarded as those with a turnover of between $100-$500 million, and large organisations are regarded as those with a turnover greater than $500 million. The survey population covers a significant proportion from each category of turnover size with 27% of responses from small organisations, 38% from medium organisations and 35% from large organisations.



# *Treasury resources*

## 1 Annual cost of treasury operations

*87% of respondents operate with a budget of less than $500,000 in terms of the annual cost of treasury operations, including staff, hardware and system costs. In terms of full-time equivalent treasury staff, 67% of respondents to this question operate with one full-time equivalent person or less.*

Less than $500,000 — 87%

More than $500,000 but less than $1 million — 8%

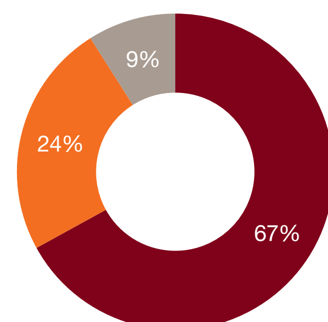
More than $1 million — 5%

# 2 Full-time equivalent treasury staff

Consistent with the findings of the PwC Global Treasury Survey 2010, treasury functions in New Zealand are often small and arguably under-staffed and under-funded, with resource pressure being a key challenge in the management of such a highly sophisticated area.

On the other hand, the flow-on effects from the 2008-09 GFC and subsequent Eurozone sovereign debt crisis must surely result in a greater realisation by boards and executive teams of the scale and importance of risks being managed by treasury including funding, liquidity, interest rate, foreign exchange commodity and counterparty. The key challenge for New Zealand treasury teams is getting an opportunity to present the case for an increased budget to implement best practice and demonstrate how the treasury function can deliver positive value for the business and enable it to achieve its strategic goals.

Full-time equivalent treasury staff



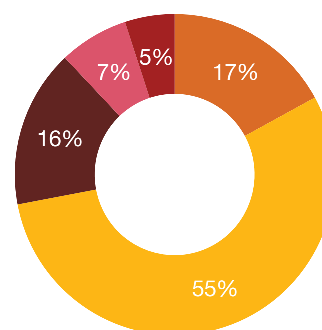
# Treasury policy and technology

## 3 Changes in treasury policy

***The last two years have seen 72% of respondents change their treasury policy, either via a complete overhaul or by undertaking some changes in relation to specific areas.*** Other points to note are that of the 16% (15 respondents) that are about to review their policy in the near future but have not reviewed their policy in the last two years, six of these are large organisations and five are medium organisations. Of the 12% (12 respondents) who have either not changed and have no intention to review their treasury policy in the near future, or do not have a treasury policy at all, eight of these are small organisations.

It is important that a treasury policy exists and is reviewed at least annually by the board because we operate in an increasingly dynamic and complex environment. Policies can quickly become outdated following fundamental changes in the business, markets and/or regulatory landscape. If the treasury policy does not evolve with the business, this can have an adverse impact on earnings, cash flow and shareholder value. Understanding and approving the treasury policy at least annually should therefore be considered an essential part of discharging corporate governance oversight at the board level.

Changes in treasury policy




- It has undergone a complete overhaul
- There have been some changes in relation to some areas
- It is to be reviewed in the near future
- There has been no change and no intention to review in the near future
- We do not have a treasury policy

# 4 Changes in Treasury Management System

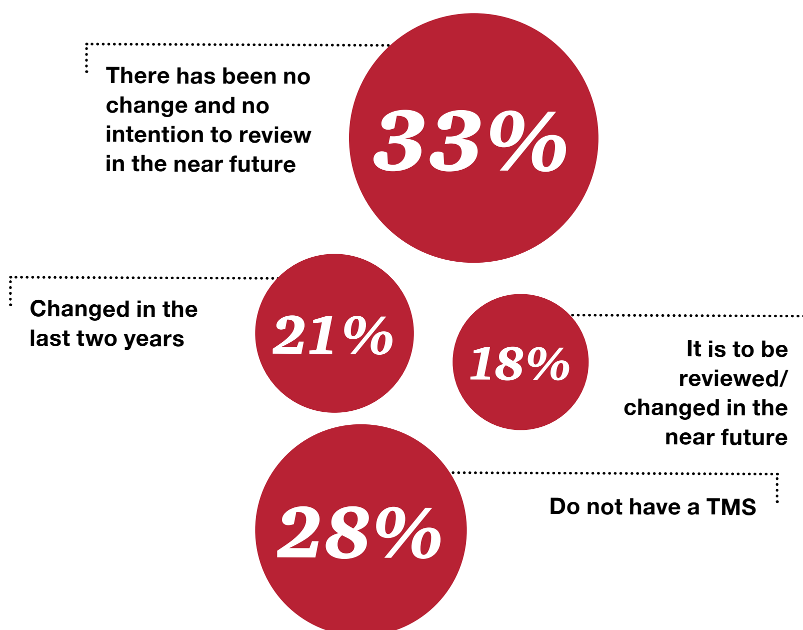
***39% of respondents have either changed their Treasury Management System (TMS) in the last 2 years or it is to be reviewed/ changed in the near future.***

This level of change in the key system infrastructure of the treasury function can be interpreted as another indicator that the management of financial risk is moving up the corporate agenda following the market turbulence of recent years. However, by making this investment, management and the board will be expecting benefits to be realised including process efficiency improvements and an increased level of sophistication in analysis and reporting that will enable better decisions to be made.

Of the 28% (27 respondents) that do not have a TMS, six were large and eight were medium sized organisations. The number of respondents without a TMS is likely to be higher as some indicated that their TMS was actually an excel spreadsheet. Treasury technology is another area where value can be added to both the control environment and the bottom line.

Benefits of a properly designed and effectively implemented TMS include:

- Improved treasury control environment through automated notifications and enforcement of controls including segregation of duties in relation to approvals and confirmations;
- Efficiency in process with deals input only once, thereby minimising the need for further manual intervention and improving the accuracy and levels of straight-through processing in the organisation;
- More sophisticated risk management analytics and reporting to better support the needs of key decision-makers;
- Enhanced cash management to reduce cost of borrowing;
- Efficiency in process with reports generated on a timely basis and "at the touch of a button", thereby eliminating unnecessary work effort and allowing more time to actually manage treasury risk and communicate with the business; and
- Better record keeping and audit trail.



# Treasury model

## 5 Model that most strongly aligns to your treasury function

The results to this question show a clear majority (74%) perceive themselves to be a value added cost centre. By this we mean working actively to reduce the overall risk exposures faced by the business. This involves using the skills, experience and judgement of the treasury to decide what, when and how to hedge in order to give the best advice and assistance to the business.

Overall, the results were fairly consistent with the PwC Global Treasury Survey 2010, although there are less profit centres in New Zealand (2%) as a proportion than there are globally. Surprisingly, of the 24% (23 respondents) that perceive themselves to be a cost centre, ten were large organisations and five were medium organisations. Under our definition, this means simply capturing the exposures of their business and passing these on to the market in a back-to-back fashion without looking for internal improvements or netting opportunities.

There is a clear opportunity here for some significant New Zealand organisations to enhance their treasury function and drive value. In addition, whilst not all treasury functions will be suited to becoming a strategic treasury (refer to diagram opposite), we believe that all treasury functions should challenge themselves to move up at least one notch along the treasury development cycle from a transactional treasury, through to a process efficient treasury, a value enhancing treasury or a strategic treasury. A business case will need to be presented that articulates the actions and investment to make this happen and the value that can be delivered (including quantification of benefits where applicable).

**Value added cost centre** 74%

- supports businesses strategically and tactically, no speculation

**Cost centre** 24%

- no decision capability, simple pass through/execution centre

**Profit centre** 2%

- trading actively/speculatively

# What treasury is right for you?

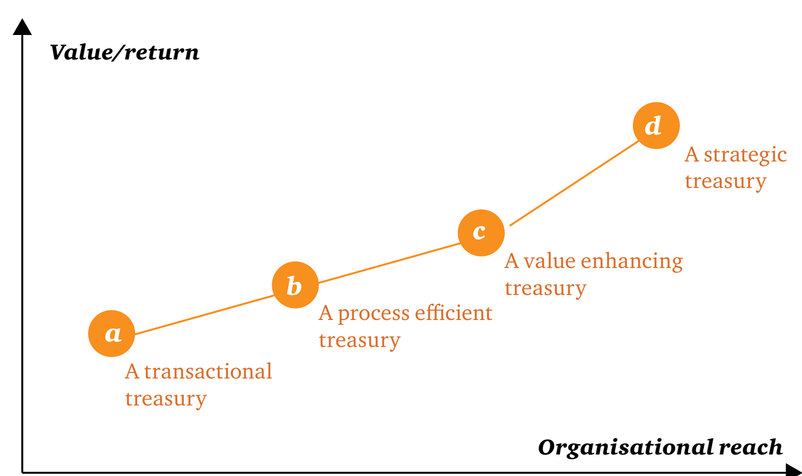
## a A transactional treasury

### What it delivers

A treasury that plays a focused execution role, enabling the business to carry out necessary transactions; primarily impacting financial functions.

### What you can get

- Increased control.
- Improved compliance.
- Visibility of risk and funding.
- Centralised expertise.




Please note: the curve's gradient is dependent upon your organisation's specific circumstances.

## b A process efficient treasury

### What it delivers

A treasury that provides excellence in execution, ensuring optimal use of cash via integration with underlying finance processes and banking providers.

### What you can get

- Visibility and control of group-wide cash.
- Improved management of liquidity.
- Lower treasury operating costs.
- Straight-through processing.
- Single version of the truth.

## c A value enhancing treasury

### What it delivers

A treasury that delivers quantifiable value for the whole business, optimising financial flexibility and efficiency, and acting as an enabler to the business to achieve its strategic goals.

### What you can get

- Lower cost of funding.
- Lower business operating costs.
- Stronger credit rating.
- Lower earnings and cash flow variability.
- Effective financial reach in new markets.

## d A strategic treasury

### What it delivers

A treasury that actively contributes to the strategic decisions of the whole business and provides financial leadership.

### What you can get

- Increased operating revenue.
- Improved competitive positioning.
- Improved customer and supplier relationships.
- Balance sheet aligned with business dynamics.
- Improved business unit cash flow.
- Finance expertise deployed to business units.

# Treasury's overall risk approach

## 6 Risk approach

***This question asked about the organisation's overall risk approach in relation to managing foreign exchange, interest rate and commodity risk.***

For the purposes of this survey, the standardised approach is defined as hedging within well defined and narrow limits, with limited decision power left to the treasury function. The active approach is defined as dynamically hedging risks within flexible risk limits and timeframes. The aggressive approach is defined as decision power being left to the treasury function with limited constraints and with an appetite for maximising market opportunities.

The results show that when the exposure is managed, the standardised approach is the most common across all three risk classes. Although we do not have comparative data to identify any trends, the PwC Global Treasury Survey 2010 identified that in relation to both foreign exchange and commodity risk, there was a definite trend toward moving away from a mechanistic standardised approach to more active and value-adding strategies where treasurers can use their knowledge to lock in some competitive advantage.

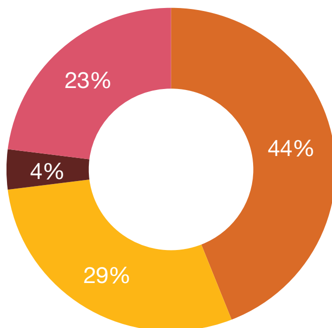
Another observation from the results was that where the exposures are managed, there were 27 examples where the risk approach was not consistent across risk classes, particularly for large (11 examples) and medium-sized (14 examples) organisations. This demonstrates that New Zealand companies are likely to be tailoring their approach to each risk class, rather than applying the same approach across the board without due consideration.

**65%** of all respondents have significant exposure to commodity risk

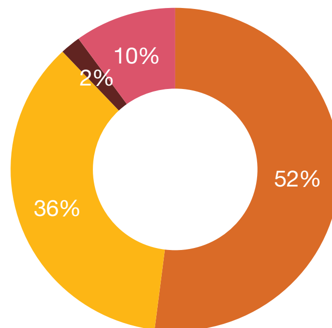
**34%** of all respondents manage commodity risk

The last significant observation was the variance between the number of organisations managing commodity risk (34%) and the number having significant exposures to commodity risk per section 13 (65%). This could suggest that either the exposures are not considered material enough to be managed or there is insufficient capability in the New Zealand market in relation to commodity risk management. Whilst there is no denying that this is a complex area which requires an understanding of a number of factors including how the organisation is directly and indirectly exposed to commodity risk, the nuances and correlations of hedging in specific commodity markets, longer-term macro-economic supply and demand issues, basis risk, and the inter-play with the physical supply chain, this is a significant opportunity for New Zealand corporates to better protect their cash flows and profit margins.

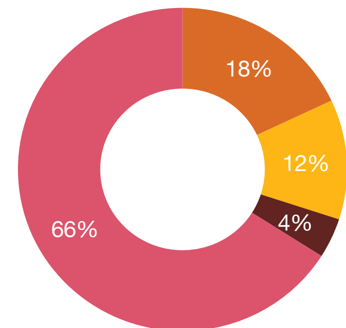
**Foreign exchange risk**




**Interest rate risk**




**Commodity risk**




- Standardised
- Active
- Aggressive
- Not managed

# Use of derivatives

## 7 Derivative instrument usage

***Foreign exchange forwards and interest rate swaps are the most common derivative instruments used with 75% of all respondents using foreign exchange forwards and 69% using interest rate swaps.***

***81% of all respondents use at least one class of forwards, 79% use at least one class of swaps and 51% use at least one class of options.***

It will be interesting to see the movement in derivative instrument usage in New Zealand over the next few years with some significant accounting and regulatory changes approaching. In particular, there is expected to be substantial changes to the hedge accounting rules, which have often been criticised by the treasury community and others. The introduction of NZ IAS 39 *Financial Instruments: Recognition and Measurement* in the mid-2000s saw a trend toward using more vanilla derivatives rather than structured derivatives.

This was because achieving hedge accounting treatment (and therefore reducing volatility in the income statement) was deemed impossible or very costly in relation to many of these products, even where the risk management strategy was economically rational and arguably better practice. Will the proposed relaxation of requirements for hedge effectiveness assessment and consequently the eligibility for hedge accounting see an increase in derivative usage and in particular more structured derivative products?

| Overall | Foreign exchange risk | Interest rate risk | Commodity risk |
|---|---|---|---|
| ***Forwards*** | | | |
| Used 81% | 75% | 25% | 15% |
| Not used 19% | 25% | 75% | 85% |
| ***Swaps*** | | | |
| Used 79% | 31% | 69% | 13% |
| Not used 21% | 69% | 31% | 87% |
| ***Options*** | | | |
| Used 51% | 39% | 23% | 7% |
| Not used 49% | 61% | 77% | 93% |

At the same time there are reforms happening globally in relation to the over the counter (OTC) derivative markets and Basel III which will also impact New Zealand. The G20 has previously communicated that all standardised OTC derivative contracts should be traded on exchanges or electronic platforms, where appropriate, and cleared through central counterparties by the end of 2012. The impact in New Zealand will depend, to a large extent, on the approach adopted in Australia as this is the most significant G20 market associated with our banking system. In addition, the Basel Committee on Banking Supervision released the new global regulatory standards for bank capital adequacy and liquidity in December 2010 (commonly known as Basel III standards).

In the context of derivatives, it is expected that bespoke non-cleared OTC-trade derivatives such as long-dated cross currency interest rate swaps will be subject to higher capital requirements that could make them more expensive for users, potentially prohibitively so. This may have a knock-on effect on New Zealand corporates ability to access global capital markets within board approved risk parameters at affordable cost. The Reserve Bank of New Zealand has begun to review the local capital adequacy framework in light of Basel III, with their review continuing throughout 2012.

***Whatever way you look at it, the world of derivatives is about to change for treasurers and it will be fascinating to see the trends in usage over the next few years.***

**Respondents use at least one class of forwards** 81%

**Respondents use at least one class of options** 51%

**Respondents use at least one class of swaps** 79%

# Treasury activities

## 8 Importance of treasury activities

***Respondents were asked to rank eight categories of treasury activity in order of importance with 1 being the most important and 8 being the least important.***

With 36 points to be allocated (1 + 2 + 3 + 4 + 5 + 6 + 7 + 8) by each respondent across eight categories, 4.5 (36/8) represents an average score. The mean was then determined for the 95 responses for each category and ranked in order of importance.

A subset of the results by size of organisation was also determined which shows some interesting variances. Overall, the following observations were made in relation to this question:

- Working capital and liquidity risk management were both included in the top three important treasury activities for small and medium sized organisations, with working capital management being the most important treasury activity overall. Clearly, cash is still king and small to medium sized organisations are prioritising their need to improve their working capital efficiency as a way to lower their operating costs and reduce the pressure on external funding requirements. The importance of working capital management was also highlighted in the PwC Global Treasury Survey 2010 with the proportion rating it as a high priority almost doubling post-crisis versus pre-crisis. Given its importance, it may be an opportune time for some organisations to invest in making long-term structural changes to the way they manage working capital to drive improved financial performance.

***Overall***

| | | |
|---|---|---|
| 1. | Working capital management | 3.74 |
| 2. | Liquidity risk | 3.75 |
| 3. | Funding risk | 3.85 |
| 4. | Interest rate risk | 3.90 |
| 5. | Bank relationship management | 4.35 |
| 6. | Foreign exchange risk | 4.40 |
| 7. | Counterparty risk | 5.95 |
| 8. | Commodity risk | 6.06 |
| | | 36.00 |

***Large organisations***

| | | |
|---|---|---|
| 1. | Funding risk | 3.21 |
| 2. | Liquidity risk | 3.97 |
| 3. | Foreign exchange risk | 4.03 |
| 4. | Interest rate risk | 4.21 |
| | Working capital management | 4.21 |
| 6. | Bank relationship management | 4.91 |
| 7. | Commodity risk | 5.43 |
| 8. | Counterparty risk | 6.03 |
| | | 36.00 |

***Medium organisations***

| | | |
|---|---|---|
| 1. | Working capital management | 3.72 |
| | Interest rate risk | 3.72 |
| 3. | Liquidity risk | 3.89 |
| 4. | Foreign exchange risk | 4.08 |
| | Bank relationship management | 4.08 |
| 6. | Funding risk | 4.14 |
| 7. | Counterparty risk | 5.98 |
| 8. | Commodity risk | 6.39 |
| | | 36.00 |

***Small organisations***

| | | |
|---|---|---|
| 1. | Working capital management | 3.15 |
| 2. | Liquidity risk | 3.27 |
| 3. | Interest rate risk | 3.77 |
| 4. | Bank relationship management | 4.00 |
| 5. | Funding risk | 4.27 |
| 6. | Foreign exchange risk | 5.31 |
| 7. | Counterparty risk | 5.81 |
| 8. | Commodity risk | 6.42 |
| | | 36.00 |

- The most important treasury activity for large organisations was funding risk management. These are the organisations most likely to use global debt capital markets, and as such, we believe the reasons for this being the most important treasury activity are two-fold. First, the turmoil in Europe has been creating significant uncertainty in overseas funding markets. While this has a direct impact on large organisations issuing debt directly to overseas investors, international markets are also an important source of funding for our domestic banks, with bank funding costs anticipated to increase in 2012. The second reason is the much-publicised global wall of refinancing has now arrived, with substantial debt maturities from pre-GFC vintage occurring over the next few years and putting further pressure on global funding sources. New Zealand corporates need to be aware of their funding risk and be proactive in executing their refinancing plans to ensure that funds are secured in sufficient time at an affordable price. On the other hand, banking relationship management was ranked sixth in importance for large organisations but fourth equal and fourth respectively for medium and small organisations, possibly reflecting their higher reliance on domestic banks as a source of funding.
- Foreign exchange risk and interest rate risk have always been a key area of focus for treasurers. The importance of foreign exchange risk is probably understated in a question of this nature given not all organisations are subject to foreign exchange risk and those that are not would likely give it a low ranking (note that 21% of all respondents do not hedge foreign exchange exposures consisting of one large organisation, four medium organisations and 15 small organisations). Nevertheless, when foreign exchange risk is a factor, it is often a significant concern and this is reflected by it being in the top half of treasury activities for large organisations (ranked third) and medium organisations (ranked fourth equal) but was low in importance for the respondents from small organisations (ranked sixth), although over half of these are not hedging foreign exchange risk. Interest rate risk was in the top half of treasury activities for all categories.
- Counterparty risk and commodity risk were the two treasury activities of lowest importance for all sized organisations. In terms of counterparty risk, this is probably a reflection of the confidence that organisations have in the strength of the New Zealand banking sector, with its domination by the subsidiaries of the four major Australian banks. Commodity risk was the lowest in importance overall and for small and medium sized organisations, potentially reflecting an immaterial exposure to commodities or difficulty in identifying and managing this risk class. It would be interesting to know to what extent lack of expertise has impacted a fact-based assessment in ranking the importance of commodity risk management relative to other treasury activities with its potential to deliver real value to New Zealand organisations.

***Has lack of expertise impacted a fact-based assessment in ranking the importance of commodity risk management with its potential to deliver real value to New Zealand organisations?***

# Bank relationships

## 9 Number of core banks used for cash management activities

The results show that over half (53%) use two core banks or less for cash management activities, with 61% of small organisations reliant on a single core bank. Conversely, 32% of respondents have four or more core banks. Not surprisingly, it is the large organisations that fit into this category with 58% of large organisations having four or more core banks. While there is no comparative data to provide any trends in relation to whether the number of core banks per organisation has increased or decreased following the GFC, this metric will be monitored going forward along with reasons for change and client perceptions of their own importance to their banks.

| No. of core banks | Overall | Large | Medium | Small |
|---|---|---|---|---|
| 1 | 27% | 9% | 19% | 61% |
| 2 | 26% | 27% | 31% | 19% |
| 3 | 15% | 6% | 28% | 8% |
| 4 | 17% | 27% | 14% | 8% |
| 5 or more | 15% | 31% | 8% | 4% |

**53%**

of respondents use two core banks or less for cash management activities

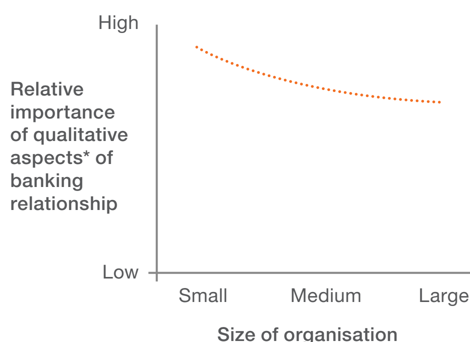
# 10 Importance of banking relationship attributes

*Respondents were asked to rank seven categories of banking relationship attributes in order of importance with one being the most important and seven being the least important.*

***With 28 points to be allocated (1 + 2 + 3 + 4 + 5 + 6 + 7) by each respondent across seven categories, 4 (28/7) represents an average score. The mean was then determined for the 95 responses for each category and ranked in order of importance. A subset of the results by size of organisation was also determined which shows some interesting variances.***

The following observations were made in relation to this question:

- Overall, the two most important attributes were quality of service/advice and participation in the core financing of the group. Interestingly, quality of service/advice was the top attribute for small organisations but second for medium and large organisations. Knowledge of the business was also lower for large organisations (fourth) versus medium (third) and small (third) organisations.




Not to scale.

** Defined as quality of service/advice and knowledge of your business*

This tends to indicate that smaller organisations are more reliant than larger organisations on the qualitative aspects of the relationship such as advice and knowledge. On the other hand, large organisations, with the benefit of more treasury resource, have a general preference for "skin in the game" via participation in the core financing of the group (first) or coverage of services received (ranked third). In saying that, quality of service/advice still rates highly for large organisations (second) and cannot be ignored by the banks. The key takeaway for banks is that the customer-centric strategies they are pursuing would seem to be on the money. Banks need to continue investing in understanding their clients' businesses to enable increased value to be delivered from their ideas and advice being more tailored and innovative.

- The size of banking fees was relatively low in importance being fifth for large organisations and fourth for medium and small organisations. This could reflect their relative size and impact on the business or the perception of value being delivered from the banking relationship.
- Counterparty risk was the sixth most important banking attribute across the board, again reflecting the respondents general confidence in the strength of the New Zealand banking sector.

***Overall***

| | | |
|---|---|---|
| 1. | Quality of service/advice | 2.72 |
| 2. | Participating in core group financing | 2.83 |
| 3. | Knowledge of your business | 3.57 |
| 4. | Coverage of services received | 3.89 |
| 5. | Banking fees | 3.97 |
| 6. | Counterparty risk | 4.98 |
| 7. | Other | 6.04 |
| | | 28.00 |

***Large organisations***

| | | |
|---|---|---|
| 1. | Participating in core group financing | 2.57 |
| 2. | Quality of service/advice | 2.79 |
| 3. | Coverage of services received | 3.73 |
| 4. | Knowledge of your business | 3.82 |
| 5. | Banking fees | 4.48 |
| 6. | Counterparty risk | 4.67 |
| 7. | Other | 5.94 |
| | | 28.00 |

***Medium organisations***

| | | |
|---|---|---|
| 1. | Participating in core group financing | 2.75 |
| 2. | Quality of service/advice | 2.92 |
| 3. | Knowledge of your business | 3.42 |
| 4. | Banking fees | 3.64 |
| 5. | Coverage of services received | 3.94 |
| 6. | Counterparty risk | 5.28 |
| 7. | Other | 6.05 |
| | | 28.00 |

***Small organisations***

| | | |
|---|---|---|
| 1. | Quality of service/advice | 2.35 |
| 2. | Participating in core group financing | 3.27 |
| 3. | Knowledge of your business | 3.46 |
| 4. | Banking fees | 3.77 |
| 5. | Coverage of services received | 4.04 |
| 6. | Counterparty risk | 4.96 |
| 7. | Other | 6.15 |
| | | 28.00 |

# Foreign exchange risk

## 11 Foreign exchange exposures hedged

***Organisations are hedging more risks related to off-balance sheet (unrecognised) exposures such as committed orders (59%) and forecasts (48%) than on-balance sheet (36%).***

**Do you hedge foreign exchange exposures?**

Yes 79%

No 21%

In addition, the hedging of translation risk (18%) and contingent risk (7%), while not common, is still undertaken by some organisations. Again, we do not have comparative data to determine any trends, but potential drivers for the popularity of hedging off-balance sheet exposures may be that longer term hedging strategies are perceived to provide better protection or smoothing of volatility, particularly with uncertainty being the new normal in financial markets.

On the other hand, any inaccurate or optimistic forecasting can give rise to an adverse hedging experience with organisations facing the potential double blow of not only their foreign exchange hedges making a loss, but these losses not being fully offset by corresponding gains on underlying sales contracts if the latter do not materialise. This is certainly a risk to be considered when determining hedging strategy in today's global economic climate.

There is not always a right or wrong approach to foreign exchange hedging and there is certainly no one-size fits all approach. What is important is to clearly identify the risk exposures and hedging objectives, then keep adapting the hedging strategy to ongoing changes in the business and ensure that the parameters of the strategy as governed by the treasury policy remain in line with the company's business model and overall corporate strategy.

**What types of foreign exchange exposures do you hedge?**

| Exposure | % |
|---|---|
| Committed orders (not on balance sheet yet) | 59% |
| Forecasts | 48% |
| On balance sheet (eg accounts receivable/payable) | 36% |
| Translation risk | 18% |
| Contingent risk (eg tenders) | 7% |

*Note: These percentages are not intended to add to 100%*

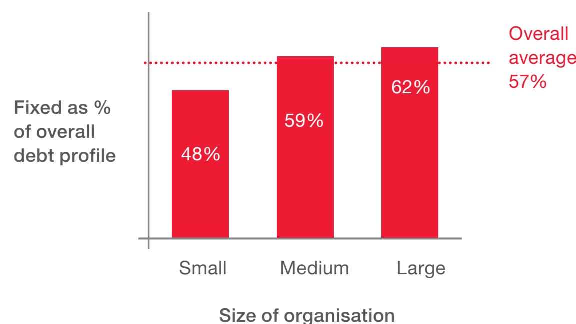
# Interest rate risk

## 12 Interest rate profile

***Respondents were asked to provide their current fixed/floating interest rate profile as an approximate percentage.***

The results show a higher proportion of fixed interest rate exposures in New Zealand organisations with approximately 57% of interest rates fixed versus 43% floating. What was interesting is that larger organisations have a higher fixed interest rate proportion than smaller organisations with the following average fixed-floating splits observed: large organisations 62-38%, medium-sized organisations 59-41% and small organisations 48-52%. As a comparison, floating rate lending within the residential mortgage sector per data published by the Reserve Bank of New Zealand has shown as increase over the last two years in mortgages floating from 26% in December 2009 to 61% in December 2011.

Our supposition is that larger organisations are likely to be subject to more formal treasury policies which place greater emphasis on certainty of cash flows to enable budgets and analyst projections to be achieved. On the other hand, those with more flexibility such as smaller organisations and residential mortgage borrowers have clearly preferred floating interest rates in recent times. The optimal fixed-floating profile will vary for each organisation depending on its circumstances and risk appetite, but the divergence in profile by size of organisation is certainly noteworthy in the current low interest rate environment. It will be interesting to see whether this changes in a higher interest rate environment.



# Commodity risk

## 13 Exposure to commodities

*The majority of participants (65%) recognise that they have some form of significant commodity exposure, with the most common identified exposures being oil (35%), electricity (26%) and agricultural (16%).*

Yes 65%

No 35%

**Do you have any significant commodity exposures?**

However, as noted earlier, only 34% of organisations are actually managing commodity risk. It would not be surprising if businesses operating on low margins have realised that the increased volatility in commodity prices over recent times has the potential to significantly reduce or completely erode their profits. By enhancing their understanding and management of commodity risk, organisations can achieve greater stability in corporate earnings and improve the likelihood of meeting forecasts. We therefore expect commodity risk to become increasingly managed in New Zealand corporates the same way other market risks such as foreign exchange or interest rates are managed.

In terms of "other" commodity exposures considered significant by respondents, the most noticeable mention was carbon risk given the introduction of the Emissions Trading Scheme (ETS) in New Zealand in 2008-09. This is likely to be an emerging area of risk management activity in New Zealand for corporates exposed to carbon risk; particularly once some of the uncertainties are resolved around how the ETS will evolve beyond 2012 in the post transitional ETS period.

**What type of commodity exposures are significant to you?**

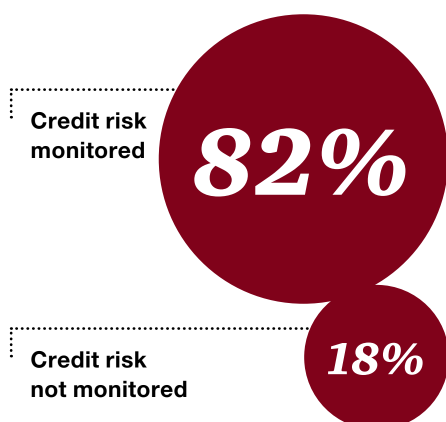
| | |
|---|---|
| Oil | 35% |
| Electricity | 26% |
| Agricultural | 16% |
| Metal | 13% |
| Gas | 7% |
| Wood | 6% |
| Paper | 5% |
| Other | 8% |

*Note: These percentages are not intended to add to 100%*

# Counterparty risk

## 14 Monitoring of counterparty risk

***As shown in section 8, counterparty risk management was low in importance for all organisations.***




A concern from these results, however, is that counterparty risk is considered so low in importance by 18% of respondents that it is not even monitored. For those that do monitor counterparty risk, the checking of published credit ratings is the easiest and most popular method performed by 72% of respondents. The calculation of credit limits and their utilisation is variable in terms of the use of nominal amounts, fair value and the consideration of potential future exposures with no clear themes to be drawn.

Our view is that exposures should be measured against limits on a fair value basis with potential future exposure taken into account to reflect the fact that derivative contracts are more volatile in terms of limit utilisation. In addition, there should be limits to manage concentration risk to ensure sufficient diversification across counterparties.

Organisations should also think about looking beyond published credit ratings and consider more real-time indicators such as bond yields, share prices and credit default spreads where available and considered reliable. This enables credit exposures to be reduced on a more timely basis when an undesirable credit risk emerges.

It is acknowledged that the approach to counterparty credit risk, particularly for small organisations, will be constrained by the technology and information sources available. However, counterparty risk should not be ignored and a practical and pragmatic approach should be agreed by management with those responsible for governance.

| How do you monitor counterparty risk? | |
|---|---|
| Check published credit ratings | 72% |
| Establish credit limits on a fair value basis | 8% |
| Establish credit limits on a nominal amount basis | 43% |
| Monitor Credit Default Swap (CDS) spread evolution | 2% |
| Take into account potential future exposure | 23% |

*Note: These percentages are not intended to add to 100%*

# Investment

## 15 Investment of excess cash

*Overwhelmingly, bank and money market deposits are the preferred location for excess cash with 100% of respondents with excess cash utilising this option.*

Very few of the other categories are utilised with government bonds, corporate bonds and commercial paper showing some usage, but each by less than 5% of respondents. The result probably reflects the limited supply of recognised alternatives in the New Zealand market. Overseas, particularly in Europe and the United States, money market funds (funds that invest in short-term money market instruments) are considered an attractive alternative to short-term bank deposits and are subject to well-defined regulatory frameworks. Some of their benefits include diversification of counterparty risk, competitive money market yields (particularly when the yield curve is steep and the weighted average maturity of the fund is longer than a few days) and typically same-day liquidity with no redemption penalties. However, as noted in the PwC Global Treasury Survey 2010, questions over liquidity have been raised and they do have different types of risk/return profiles rather than being a relatively homogenous group as was often wrongly assumed. As such, further regulatory and market initiatives have been occurring in recent times to standardise definitions and practices in relation to money market funds. The question remains will New Zealand see any product innovation in this space in the foreseeable future with the development of other popular alternatives to invest excess cash?

**Where do you invest your excess cash?**

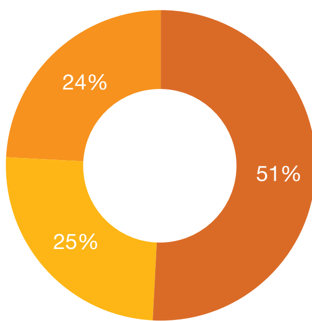
| | |
|---|---|
| Bank and money market deposits | 100% |
| Government bonds/notes | 4% |
| Corporate bonds | 4% |
| Commercial paper | 2% |
| Other | 0% |

*Note: These percentages are not intended to add to 100%*

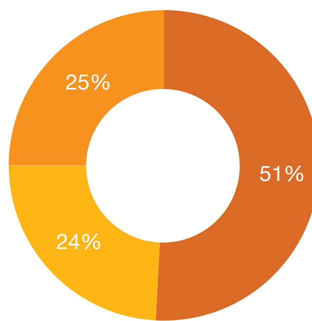
# 16 Importance of investment principles

***Allocate 100 points across the investment principles of security, liquidity and yield to rank their relative importance to you.***

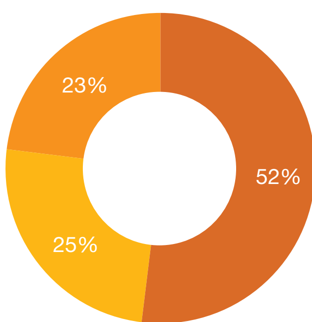
Overall



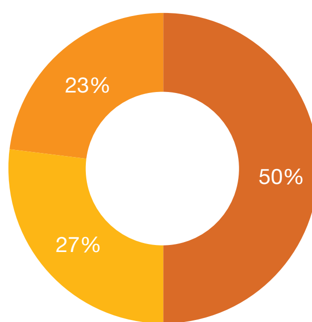

Large organisations



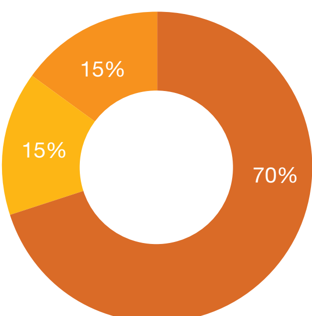

Medium organisations




Small organisations




Top ranking investment principle




- Security
- Liquidity
- Yield

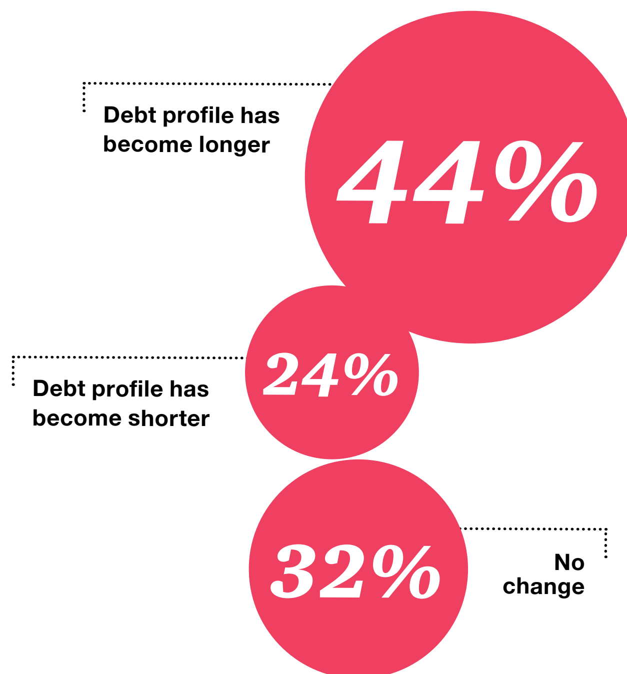
Respondents were asked to allocate 100 points across the investment principles of security, liquidity and yield in terms of their relative importance when investing. The average points allocated, which add to 100, were 51% to security, 25% to liquidity and 24% to yield. There were no major variances in the results in terms of organisation size. In terms of the investment principle with the highest importance, security was ranked top by 70% of respondents and liquidity and yield were each ranked top by 15% of respondents.

Not surprisingly, protection of funds invested and their repayment at maturity is the number one priority for the majority of respondents following the international experience of the 2008-09 GFC and the sovereign debt crisis in Europe, along with the local finance company collapses of the last few years. Going forward, it will be interesting to see whether there are any significant movements in importance in these investment principles. In particular, will more New Zealand corporates begin to chase yield once confidence in the global financial situation returns?

# Funding

## 17 Average tenor of debt profile

*The results show that for the 92% of respondents that have debt, 44% have a longer debt profile, 24% a shorter debt profile and 32% have no change compared to two years ago.*




The general trend for longer average tenor is consistent with anecdotal evidence that suggests treasurers are proactively seeking to secure funding for longer terms in order to avoid having to refinance again during these volatile times, particularly with the uncertain situation in Europe and the projected global wall of refinancing occurring over the next few years that will likely impact both availability and cost. Note that a third of those with a shorter average tenor have established bond and private placement programmes for which the progression of time is the likely cause of them having a shorter overall debt profile than two years ago.

Consistent with the PwC Global Treasury Survey 2010, it would not be surprising if there is an increased focus on spreading the maturity dates of funding programmes. Some had previously seen it as more efficient to fund the bulk of their long-term debt in one shot to achieve critical mass. However, many may have now realised that this presents an unacceptable concentration risk if you then need to refinance at the wrong time for either you or your financial counterparties.

# 18 Type of debt used

*Respondents were asked to identify what types of debt they use and to provide an approximate percentage of the extent that each type of debt is used.*

The three most popular types of debt across all respondents as a percentage of their total debt is bank loans (62%), bonds (13%) and credit facilities (8%). As expected, there are variances between size of organisation with large organisations having a much smaller percentage of their total debt as bank loans (51%) compared to medium organisations (67%) and small organisations (72%). This is also reflected by a much higher percentage of bond usage (23%) and private placements (10%) by large organisations compared to medium and small organisations. The establishment of bond programmes and private placements will, however, be inaccessible or inappropriate for many small and medium sized organisations due to such factors as the size of their borrowing requirements, their credit profile and/or their lack of treasury resource.

Overall, the pressure on availability of funding over the last few years has delivered a clear reminder of the importance of diversity. Treasurers need to ask themselves whether they are doing everything they can to avoid over-reliance on a particular funding source because the consequences of getting it wrong can be disastrous.

***Overall***

| | | |
|---|---|---|
| 1. | Bank loans | 62% |
| 2. | Bonds | 13% |
| 3. | Credit facilities | 8% |
| 4. | Private placement | 6% |
| 5. | Commercial paper | 4% |
| 6. | Other | 4% |
| 7. | Overdraft | 3% |

***Medium organisations***

| | | |
|---|---|---|
| 1. | Bank loans | 68% |
| 2. | Credit facilities | 10% |
| 3. | Commercial paper | 8% |
| 4. | Bonds | 6% |
| 5. | Private placement | 3% |
| 6. | Other | 3% |
| 7. | Overdraft | 2% |

***Large organisations***

| | | |
|---|---|---|
| 1. | Bank loans | 51% |
| 2. | Bonds | 24% |
| 3. | Private placement | 10% |
| 4. | Other | 6% |
| 5. | Credit facilities | 5% |
| 6. | Commercial paper | 2% |
| 7. | Overdraft | 2% |

***Small organisations***

| | | |
|---|---|---|
| 1. | Bank loans | 72% |
| 2. | Credit facilities | 11% |
| 3. | Overdraft | 5% |
| 4. | Bonds | 4% |
| 5. | Private placement | 3% |
| 6. | Other | 3% |
| 7. | Commercial paper | 2% |

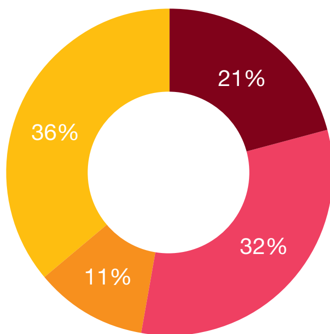
# 19 Ease of funding

53% of survey respondents said that it is either easier or somewhat easier to get funding than two years ago, with 36% saying there has been no change and only 11% saying that it has got harder. Interestingly, medium sized organisations (63%) are finding it easier or somewhat easier than larger (48%) and smaller organisations (45%).

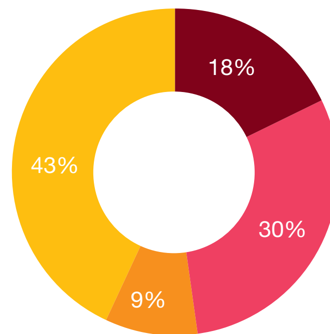
This question needs to be set in the context that two years ago was a year or so after the collapse of Lehman Brothers, with the effects of the GFC fresh in the minds of lenders and borrowers alike. Even so, access to funding is perceived to be getting easier for New Zealand corporates which should have a positive flow-on impact for New Zealand's investment activity and economic growth. It will be intriguing to monitor this gauge in our next survey with the continued volatility of the situation in Europe over the last few months.

***Is it easier or harder to get funding than two years ago?***

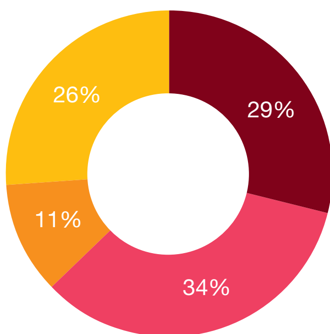
Overall



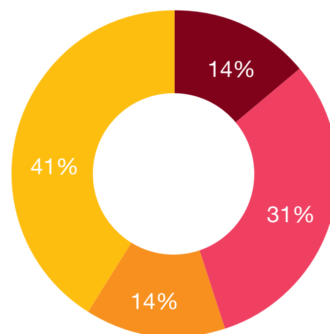

Large organisations




Medium organisations




Small organisations




Easier
Somewhat easier
Harder
No change

*Access to funding is perceived to be getting easier for New Zealand corporates which should have a positive flow-on impact for New Zealand's investment activity and economic growth.*

# Hedge accounting

## 20 Application of hedge accounting

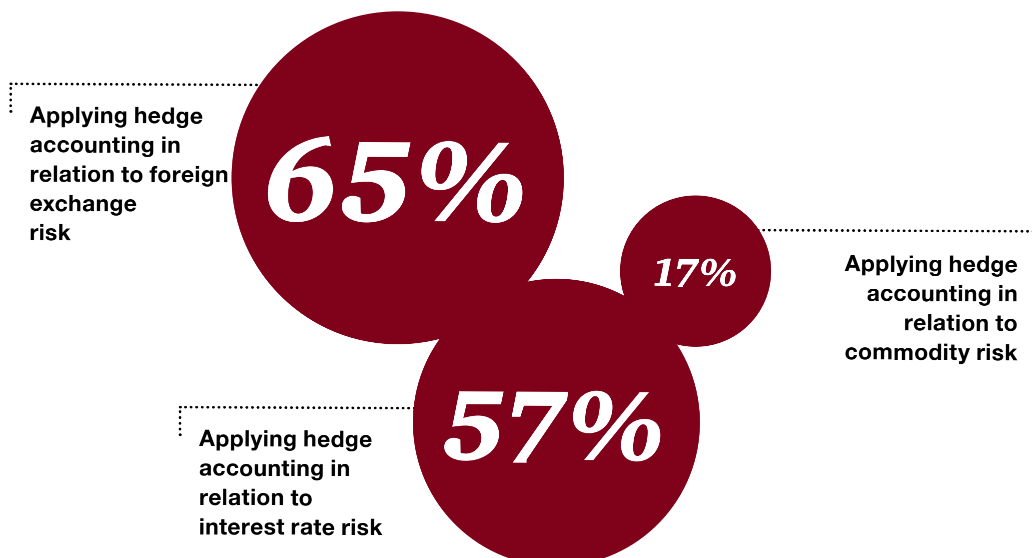
***Hedge accounting under NZ IAS 39 is aimed at reducing the volatility in the income statement caused by the requirement to measure derivatives on the balance sheet at fair value.***

78% of all respondents are applying some form of hedge accounting in their financial statements. In terms of the risks hedged, 65% of all respondents are undertaking some form of hedge accounting in relation to foreign exchange risk, 57% in relation to interest rate risk and 17% in relation to commodity risk.

Hedge accounting is clearly more important to large (85%) and medium (86%) sized organisations than small organisations (58%). This is not surprising given the higher public scrutiny of the financial performance of issuers, which are typically larger in size.

There is also the effort of undertaking hedge accounting which requires expertise and resource but with arguably no impact on the economic value and cash flows of the business.

In terms of reasons given for not applying hedge accounting, common reasons include the complexity of the accounting standards, the weight of administrative burden, exposure to volatility not being material and reduction in hedging flexibility resulting in uneconomic outcomes for the business.



Applying hedge accounting

**78%**

Not applying hedge accounting

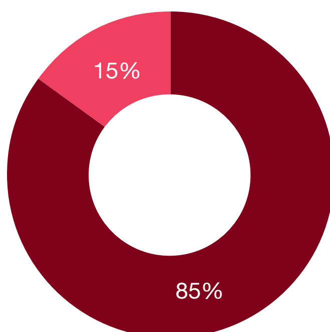
**22%**

However, as the Little River Band sang in the late 1970s, "Hang on... help is on its way". In particular, IFRS 9 *Financial Instruments* is coming which is likely to be good news for many. Whilst the detail is still being finalised, key proposed changes include:

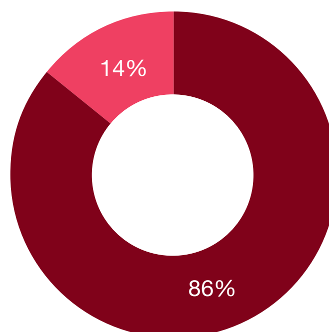
- The removal of the 80%-125% 'bright line' hedge effectiveness range. This will allow hedge accounting treatment to be achieved even where the effectiveness ratio is outside the somewhat arbitrary 80%-125% threshold (although any actual ineffectiveness must still be measured and reported in the profit or loss);
- The relaxing of the rules on using purchased options as hedging instruments. Under the current hedging rules, the time value of purchased options is recognised on a mark-to-market basis in the income statement, which can create significant volatility in profit or loss. In contrast, it is proposed that the initial time value (that is, the premium generally paid) will be recognised in profit or loss either over the period of the hedge if the hedge is time related, or when the hedged transaction affects profit or loss if the hedge is transaction related. Any changes in the option's fair value associated with the time value will only be recognised in other comprehensive income (OCI). This should result in less volatility in profit or loss for these types of hedges and will remove one of the key reasons for a common bias against using options as a hedging instrument under the existing standard;
- The ability to designate a net position as the hedged item (currently not allowed under NZ IAS 39) if it is consistent with an entity's risk management strategy. This will better reflect what treasury management teams are often doing in practice. However, if the hedged net positions consist of forecasted transactions, all hedged transactions have to relate to the same period; and
- The ability to hedge the risk components of non-financial items provided the risk component is separately identifiable and reliably measurable. This will allow entities to more easily hedge non-financial items for a commodity price risk that is only a component of the overall price risk.

Overall, the new standard should provide a better basis for aligning accounting with risk management economics. However, it remains to be seen if the new standards will reduce the complexity and administrative burden currently posed by the hedge accounting rules. The finalisation of proposals in relation to hedge accounting is now expected to occur in 2012 with a likely effective date beginning in 2015 with early adoption permitted.

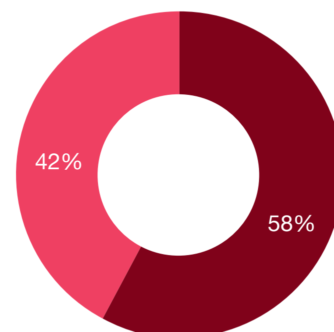
## Large organisations




## Medium organisations




## Small organisations




Applying hedge accounting
Not applying hedge accounting

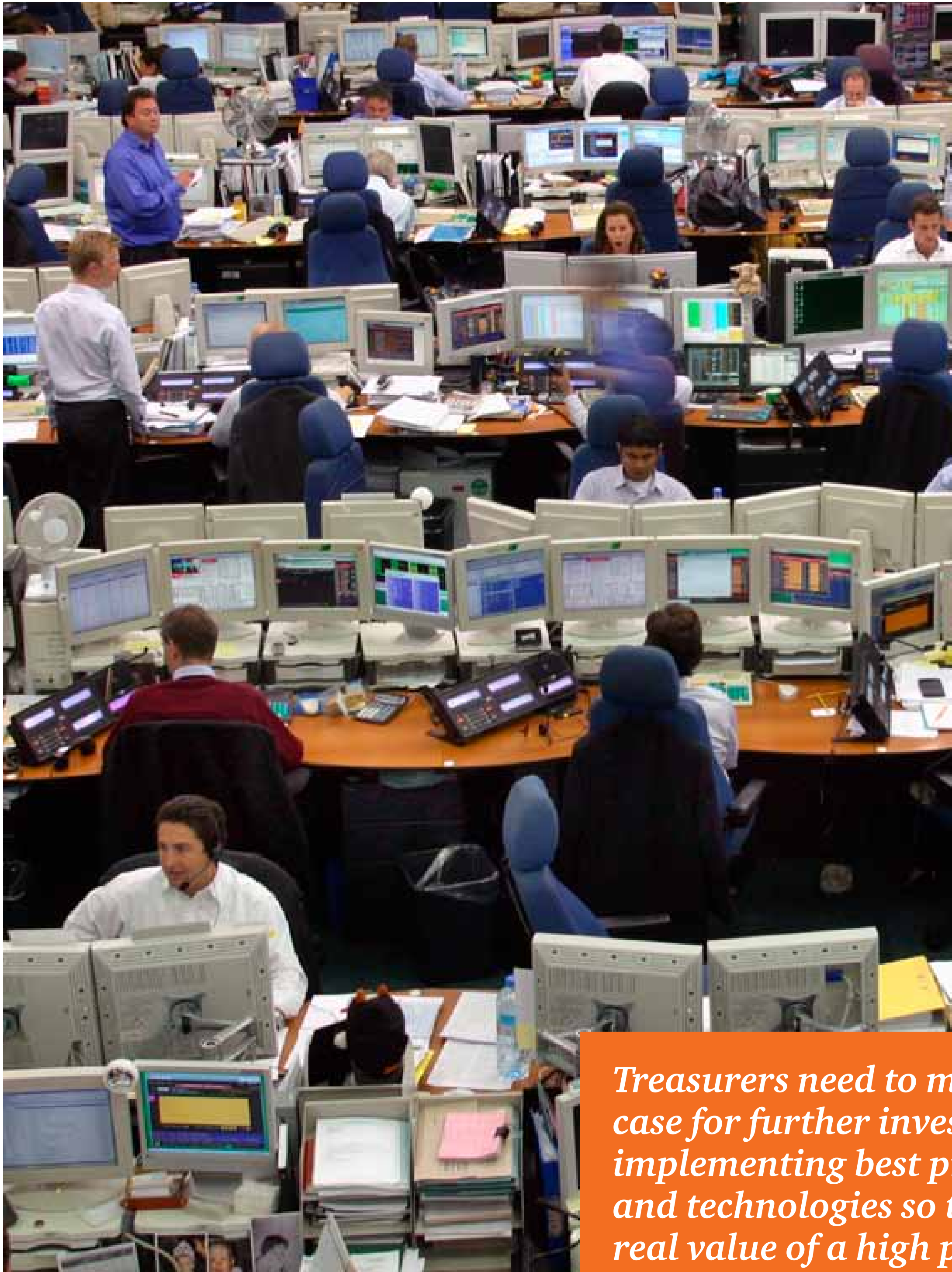
# 21 Top of the treasury agenda

We asked respondents to tell us what is on top of their treasury agenda at the moment. Some themes that came through include:

- Delivering funding certainty and funding diversity to the organisation, particularly when refinancing activity is on the horizon;
- Responding to the continuing strength of the New Zealand dollar (predominantly against the US dollar), with exporters wanting to protect their profit margins;
- What to do about interest rate hedging with continued uncertainty as to when interest rates will rise from their current low levels;
- Undertaking a fundamental review of the appropriateness of the treasury policy (as the cornerstone treasury document) for today's environment; and
- How can the treasury function add more value to the organisation and demonstrate it through enhanced reporting.

This represents a number of challenges facing New Zealand treasury functions. In addition, one of the most common words used throughout the responses was "volatility" and how to deal with it. Whilst many treasurers would probably like to invest in a crystal ball to deal with volatility, they need to be making the case for adequate technology and manpower to ensure they are sufficiently equipped going forward.

With the importance of the treasury function better understood by the board and executive team following the GFC, treasurers need to capitalise on this opportunity and make the case for further investment in implementing best practices and technologies so that the real value of a high performing treasury function can be realised. ***The time to act is now!***



*Treasurers need to make the case for further investment in implementing best practices and technologies so that the real value of a high performing treasury function can be realised.*

# PwC corporate treasury solutions

## Our services

### *Debt advisory*

Our team of experienced treasury professionals can assist with anything from advising on alternative debt financing solutions and managing the debt raising process to providing independent assurance to the board that your debt transaction is consistent with current best practice. This will assist you in ensuring your chosen debt solution is appropriate for your organisation and the terms and conditions (including pricing, fees, security requirements and covenants) have been optimised.

### *Policy and controls*

We have specialists with extensive multi-disciplinary experience across treasury, accounting and auditing who can upgrade your treasury governance and controls framework. Our team can compliment your internal audit team to provide focused value-add reviews around treasury policy and procedures, controls and reporting.

### *Commodity risk management*

PwC has a global team of experts dealing with hedging and risk management issues in relation to commodities such as agriculture, oil and gas, electricity, metals and carbon. We can help you navigate through this complex field by assisting in the development and implementation of your strategy and approach to managing commodity risk.

### *Financial risk health checks*

A financial risk health check involves a comprehensive suite of diagnostic tests that can be tailored to your specific needs. It will empower your organisation to understand its vulnerabilities and develop a plan to manage your financial risk more effectively.

### *Treasury value and efficiency reviews*

A treasury value and efficiency review is a considered analysis of your treasury function to determine how it can drive more efficient and value-adding behaviour in financial risk and cash management activities. This can support the business case for increased investment and allow the treasury function to deliver greater impact for your organisation.

### *Financial instrument valuations*

Our team of specialist valuation professionals are at the forefront of valuation developments and can assist you in determining accurate product and portfolio valuations using cutting edge technology, including advanced modelling and access to a wide range of accepted pricing suppliers. We have a cost efficient valuation solution for all your requirements ranging from individual financial products to complex portfolio valuations of any size.

### *Treasury outsourcing*

Fully integrated middle and back office outsourcing provides the ideal solution to upgrade your organisation's risk management capabilities by reducing costs, improving efficiency and providing you more time to extract value. Our services are underpinned by Visual Risk™, a leading treasury solutions system, and is backed by our highly experienced operations team.

### *Risk analysis and treasury reporting*

Outsourcing time consuming and costly risk analysis and treasury reporting to us. We have powerful tools and experienced experts to help you develop best practice analysis and reporting that will ensure the right information is delivered in a clear and concise format to decision-makers on a timely basis.

***We work locally and internationally with a diverse range of clients and offer a comprehensive range of treasury services.***

***treasurysolutions.pwc.co.nz***

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