BANCORP
BANCORP TREASURY SERVICES LIMITED

Barrington TREASURY SERVICES

TREASURY TRENDS

ISSUE 412

27 June 2017 | www.bancorptreasury.com

PAYMENT PLATFORMS HEAD IN NEW DIRECTION

"We are stuck with technology when what we really want is just stuff that works" - **Douglas Adams**

Payment innovation and usefulness on the up

The speed of innovation and disruption in the payments area of treasury risk management has quickened in recent years and looks set to continue with huge amounts of time and money being spent by the likes of central banks, fintechs and banks. In previous editions of *Treasury Trends*, we have highlighted some of these developments including Australia's New Payment Platform and distributed ledger technology or blockchain. Not to be outdone SWIFT, the provider of secure financial messaging services, is stepping up and looking to do some disruption itself. Since 2015, it has been working on major changes to the international payment space.

Making international wire or telegraphic transfers payments has long been viewed by corporates as a necessary evil. From the perspective of originators, as well as beneficiaries, cross-border payment processing has been something of a *"black box"* — with payments going in but no certainty on when they would be posted in the beneficiary's account, how much would be deducted in fees along the way by intermediary banks, or if remittance information would be delivered intact, if at all.

Frustration with this highly inefficient system and the desire by corporate treasury professionals to find a faster, more transparent process was the impetus behind the development of SWIFT's global payment innovation ("gpi") initiative.

SWIFT gpi

SWIFT gpi is a new tool to significantly improve the customer experience in cross-border payments by increasing the speed, transparency, integrity and end-to-end tracking of these transactions.

Launched globally in February, but still to arrive in New Zealand, the first phase of SWIFT gpi focuses on business-to-business payments with the aim of helping corporates grow their international business, improve supplier relationships and achieve greater treasury efficiencies. This new service, called Customer Credit Transfer, has the following key features:

- Faster — Same day for use of funds for corporates in the same time zone. Improves liquidity, reduces cost of working capital and reduces risks.
- Transparency of fees — Insight into any fees deducted from payments by intermediary banks and information on the value of the credit posted to the beneficiary's account. By providing full transparency, it will increase efficiency and solve disputes that arise due to funds not arriving in full or not in accordance with the terms of the contract.
- End-to-end payments tracking — The payer receives positive confirmation that their supplier or counterparty's account has been credited, a marked improvement on supply chain communications and efficiency. SWIFT gpi includes a Tracker 'in the cloud' using the SWIFT database to provide corporates with status updates as payments move through the process and indicates precisely where the payment is at any given time as they are processed by gpi banks.
- Remittance information transferred unaltered, enabling corporates to include up to 140 characters of remittance information that is carried unaltered across the payments process. This facilitates reconciliation of payments and prompt posting to accounts, which should improve working capital efficiency and reduce errors and investigations.

Among the many advantages of SWIFT gpi is that its improvements have been built into the existing payments infrastructure and do not require a whole new model – practically speaking, this will avoid many of the challenges associated with launching new processes. This is a major plus for corporates, as well as banks, which are looking for cutting-edge solutions that do not require reinventing the wheel.

SWIFT's gpi is already delivering benefits to corporate treasurers in other countries whose banks have implemented the system. Over 110 banks from Europe, Asia Pacific, Africa and the Americas are signed up, including the big four banks in Australia and New Zealand. SWIFT announced earlier this month that gpi will go live in Australia later in 2017, with New Zealand after that.

Continued on page 4

AUSTRALASIA ECONOMY & MARKETS

Bank credit ratings under pressure

Publicity surrounding the credit ratings of the Australasian banks has increased recently with Moody's Investors Service ("Moody's") downgrading the ratings of the 'big four' banks. In Australia, ANZ Bank, Commonwealth Bank, National Australia Bank, and Westpac had their long term ratings lowered from 'Aa2' to 'Aa3'. In New Zealand, the long term ratings of ANZ Bank New Zealand, ASB Bank, Bank of New Zealand, and Westpac New Zealand were downgraded one notch, from 'Aa3' to 'A1', equivalent to S&P Global Ratings ("S&P") 'AA-' to 'A+'.

The banks' credit rating downgrades raise counterparty credit limit issues for both investors and borrowers. Some might question the need for a minimum rating to apply for a borrower given that the rating usually applies to the entity being lent the money. However, the lower the lender's credit rating, the higher will be its cost of funds, which will most likely be reflected in the margin it charges.

In addition, a corporate may have derivative contracts (such as interest rate swaps and foreign exchange contracts) with a bank and it is common practice for a Treasury Policy to stipulate a minimum credit rating for all the external entities with whom these contracts are transacted. A corporate's derivative contract that is 'in the money' constitutes an exposure for the corporate as, in the event of the bank's insolvency, the corporate will lose the benefit of its contract. A deteriorating credit profile could also impact on a bank's lending appetite, an important consideration for any borrower.

Funding markets are changing

In both Australia and New Zealand, there is an increasing presence of non-Australian banks in the corporate lending space. This is largely due to the increase in funding costs and credit growth of the 'big four' Australasian banks, which has been passed on in the form of higher lending margins.

The non-Australasian banks have not had the same rise in funding costs and are now able to compete more effectively on pricing. These banks generally have lower credit ratings. If corporates are considering borrowing from these offshore banks, they need to ensure that the lender is sanctioned by the Treasury Policy's counterparty credit requirements.

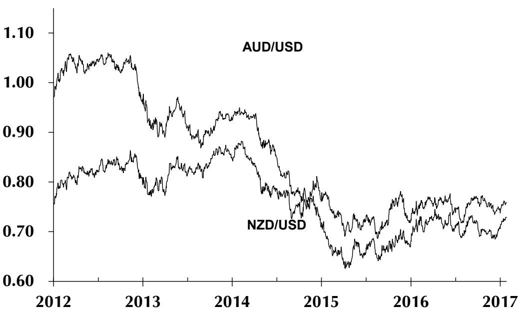
For investors, counterparty credit limits are a fundamental component of the investment process, with the limits usually stipulated in either the Statement of Investment Policy ("SIPO") or the Investment Policy Statement ("IPS"). These documents will detail the minimum credit rating for a particular entity, e.g. a bank, and often will incorporate differential limits, with a lower rated entity having a lower permissible investment limit.

The SIPO or IPS will also detail the process to be followed when a counterparty's credit rating falls below the required minimum. This usually involves setting a maximum time limit for the investment to be liquidated (which may not be possible for a term deposit due to regulatory stipulations), or sanctioning the continued holding of the investment as a policy exception. This issue arose with the recent downgrading of Kiwibank in New Zealand.

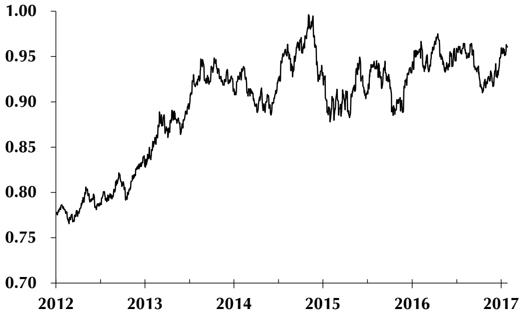
One problematic area for both borrowers and investors alike is where a policy allows the credit ratings of more than one agency to be used. Moody's, S&P and Fitch Ratings ("Fitch") all provide credit ratings for banks, financial institutions and corporates but their views and ratings are not always aligned. To assess the relativity between the three agencies rating bands, there is a widely recognised matrix which details what a rating for one agency correlates to for the other two agencies.

The recent downgrade of Australasian banks by Moody's is a classic example. Moody's now rates the big four New Zealand banks at 'A1' which correlates to an S&P rating of 'A+' but S&P currently rate these banks as 'AA-', one notch higher. This poses the dilemma of which credit rating to use. Put simply, it can either be the highest rating or the lowest rating but, whichever of the two, it must be clearly stipulated in the Treasury Policy, SIPO or IPS which one will apply. It is always best to address such issues before they become urgent, so a reasoned approach is taken and an appropriate risk management solution reached.

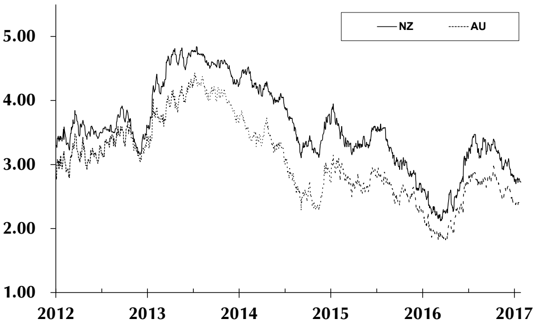
New Zealand dollar and Australian dollar/US dollar



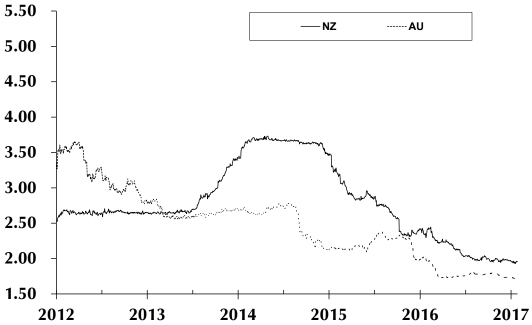
New Zealand dollar/Australian dollar



10 year government bonds



90 day bank bills



WORLD ECONOMY & MARKETS

Canadian ratings downgrades — sound familiar?

Moody's downgraded the big six Canadian banks by one notch in May, citing a *"more challenging operating environment for banks in Canada for the remainder of 2017 and beyond."* Specifically, Moody's was concerned about the high levels of consumer debt and elevated house prices leaving consumers and the banks more vulnerable to downside risks than in the past.

Toronto-Dominion Bank dropped to Aa2, while Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, and Royal Bank of Canada dropped to A1.

Moody's downgrades in Canada came before the downgrades in Australia and New Zealand, but the parallels cannot be ignored. Canada, as in Australia and New Zealand, has seen unprecedented house price growth and an alarming rise in household and consumer debt levels. Developments in the Canadian banking sector foreshadowed developments here.

European bank bailouts highlight structural weakness

Cracks are beginning to show in the European banking sector that could have implications for the global banking system. In early June, Banco Popular, Spain's fifth largest bank, with EUR100 billion in loans, was determined by European regulators to be *"failing or likely to fail,"* and therefore auctioned off. The bidding must have been rather dull because Banco Santander paid all of one euro for it.

Banco Santander said it would raise EUR7 billion to fund the purchase and a projected EUR7.9 billion debt write down. The deal was done under new European Union rules designed to keep European taxpayers from having to bail out failing lenders. The ultimate onus is put on bond holders and investors within the banking sector, rather than the public. Banco Popular had suffered a run after depositors began withdrawing money on concerns about liquidity, which of course fuelled more concerns about liquidity.

The cracks have only widened as the European summer wears on, with two Italian banks requiring bailouts. Veneto Banca and Banca Popolare di Vicenza were also determined by regulators to be "*failing or likely to fail.*" The European Central Bank ("ECB") said that the two banks had *"repeatedly breached supervisory capital requirements"* and that it had *"given the banks time to present capital plans, but the banks had been unable to offer credible solutions going forward."*

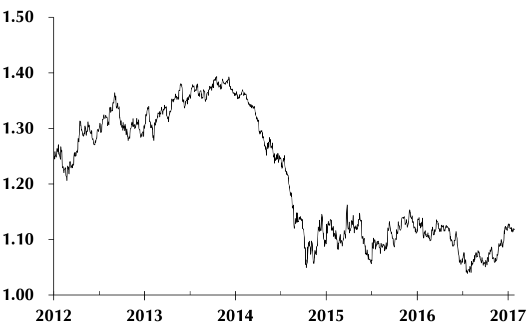
The liquidation of the two Veneto region banks follows the winding down of four small banks in central Italy. Another midsized regional lender, Genoa's Carige, is considered at risk of enforced resolution if it fails to shore up its balance sheet.

The bidding must have been even duller in Italy, because Intesa Sanpaolo ("Intesa"), Italy's largest retail bank, paid just one euro for both banks' 'good' assets. Intesa took over the assets on the condition that it did not hurt its capital ratios, which regulators approved. Intesa can also initially tap EUR5.2 billion in funds from the Italian government to maintain its capital ratios, while the state has said that it will make funds available to protect retail depositors and junior bondholders from any shortfall in winding up the two banks' 'bad' assets.

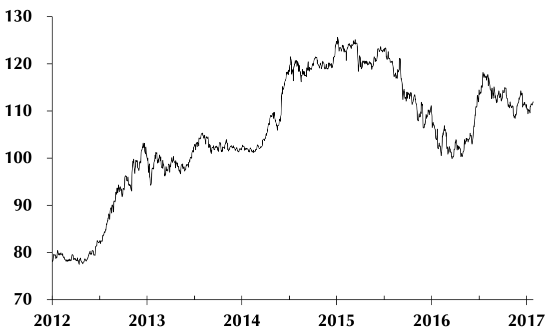
The Italian banking system is saddled with bad loans estimated at about EUR350 billion, or a third of the Eurozone's total bad bank debt. The regulations put in place by the ECB since 2008 appear to be working to stop the dominoes falling and more European banks failing, and to put the losses on those who took the risks, not the taxpayers. The concerning number of banks in trouble highlight the structural weakness in many Eurozone economies.

On a more positive note, Allied Irish Bank has floated a 25% stake in the bank, raising EUR3 billion and valuing it at EUR12 billion. The float comes seven years after the bank was bailed out with the Irish government taking a 99.9% stake for EUR20.8 billion and takes the total funds returned to the Irish government to nearly EUR10 billion, just in time for the next crisis.

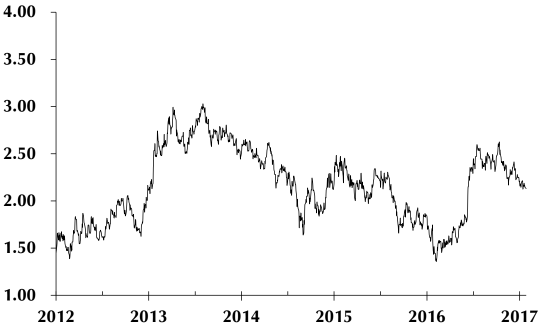
Euro/US dollar



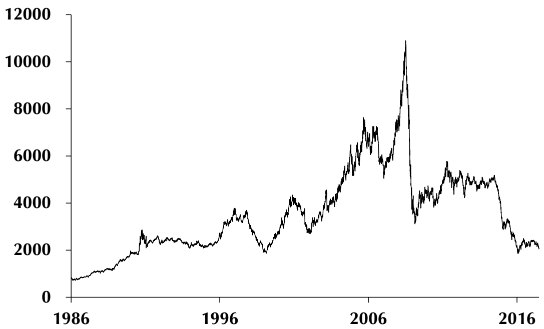
US dollar/Japanese yen



US 10 year government bond



Standard & Poor's Goldman Sachs Commodity Index



PAYMENT PLATFORMS HEAD IN NEW DIRECTION

Contd. from front page

The first phase of SWIFT gpi will deliver a much improved customer experience but it is just the first step in a multi-year programme of continuous improvement. Phases two and three have been planned and will include; being able to stop a payment no matter where it is in the correspondent banking chain, to include rich data with the transfers and, potentially, to move to a blockchain/distributed ledger platform.

Sometimes, taking small steps is the best approach to resolving a big problem. We think the SWIFT gpi strategy of incremental and continuous improvement is a realistic means for improving a system that encompasses thousands of banks. It also means that, initially, corporates will be able to use the gpi services without requiring changes on their existing systems.

We believe the combination of demand from corporates and investment by the biggest banks in global payments will generate the necessary critical mass to enable gpi to become a standard, expected and effective service.

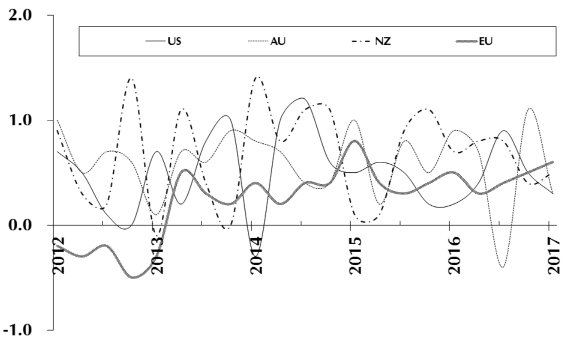
Bank downgrades

Credit ratings agencies and central banks in Canada, Australia and New Zealand have been harping on for some time about the potential risks to the health of the banking sector and financial stability from rising household debt and surging house prices. In recent weeks, the credit rating agencies have acted on those concerns and downgraded the main banks in Canada, Australia and New Zealand.

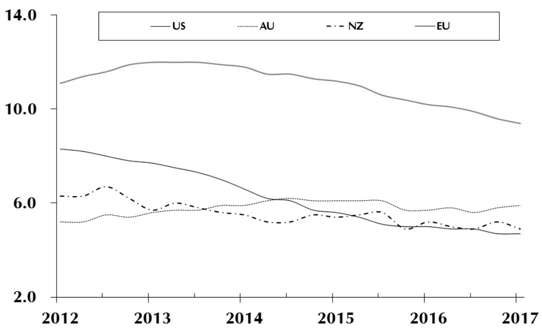
Although there has been some relief and action taken by the central banks, the underlying issues remain and make the Canadian, Australian and New Zealand economies vulnerable to shocks, which is precisely why the respective central banks are worried.

Treasury managers can do little about external shocks but there is much they can do about their own organisation — reliability of (confidence in) business forecasts, up to date and relevant treasury policies, monitoring and reporting, and open communication channels with senior management and the Board.

GDP growth (QoQ)



Unemployment rates



Text finalised date 27 June 2017

Bancorp Treasury Services Limited

Auckland
Level 11
AXA Centre
191-201 Queen Street
PO Box 4270 1140
Phone +64 9 912 7600
Fax +64 9 912 7601

Wellington
Level 7
Wellington Chambers
154 Featherston Street
PO Box 3007 6140
Phone +64 4 473 0804
Fax +64 4 473 0814

Christchurch
356 Memorial Avenue
Burnside
PO Box 173 8053
Phone +64 3 374 2193
Fax +64 3 374 2195

Email: admin@bancorptreasury.com
Website: www.bancorptreasury.com

Barrington Treasury Services Pty Limited

Sydney
183 Ourimbah Road, Mosman
NSW 2088
PO Box 462 Spit Junction NSW 2088
Freephone 1800 425 079
Email: admin@barringtontreasury.com
Website: www.barringtontreasury.com

BANCORP
BANCORP TREASURY SERVICES LIMITED

Barrington
TREASURY SERVICES