



BANCORP

BANCORP TREASURY SERVICES LIMITED

Barrington
TREASURY SERVICES

TREASURY TRENDS

ISSUE 377

June 2011 | www.bancorptreasury.com

THE ROLE OF GOVERNANCE AROUND TREASURY

“The wise man doesn’t give the right answers, he poses the right questions”. **Claude Levi-Strauss**

Don’t assume. Ask questions!

Directors are responsible for preparation of the financial statements in accordance with generally accepted accounting practices.

Continually evolving accounting standards bring the challenge of ensuring that internal processes are kept up to date and reflect those changes. There is understandably a sense of frustration at the insurmountable task of keeping abreast of changes given the wide range of responsibilities directors already have. Directors need to rely on management to some degree to ensure the relevant risks are being managed, but must decide to what extent they can do so when ultimate legal accountability lies with the director.

No one can be expected to be an expert in everything. However directors are expected to have at least asked probing questions to ensure risks have been identified and are being managed. In the notes to their financial statements companies are required to explain the risks and how they are managed in a way that investors can understand. Some argue that current accounting standards make this task difficult however some of these issues are addressed in new standards and changes being introduced.

Many of the disclosures in the notes directly relate to what is in a Treasury Policy. Given the Board approves the Treasury Policy, this should not be too daunting. Treasury is but one risk to manage, but the risks are substantial, and therefore it comes as no surprise, with Boards under increasing scrutiny, that Treasury has moved up the priority list.

What are the appropriate tools?

When approving the Treasury Policy careful consideration must be given to the types of products used to manage risks. The appropriate products need to be used to ensure competitiveness is maintained. How a company manages risks should take into account how competitors manage risks as failure to do so can be disastrous.

Many directors endorse the mantra of keeping things simple. For instance, if you don’t understand how a product works and the risks inherent in them then don’t enter into them – or at least ask

questions until you do. There are countless examples of companies getting into difficulty after entering derivative structures they did not understand or which were not appropriate for managing the business risks. This was especially true for some exporters prior to the 1998 Asian Crisis. In some cases high levels of long term cover, including risky products such as ratio options, were taken when the exchange rate was strong. Following the Asian Crisis, business volumes were significantly reduced and this left some exporters in an over-hedged position while the exchange rate continued downward. This highlights the importance not only of understanding the business risks and exposures, but of managing those risks with the appropriate products and using a suitable hedging timeframe.

Changing priorities

The Global Financial Crisis has seen in a change in the importance of some risks. A recent PwC global survey of Treasurers found the two top priorities are funding and cash management. Previously these were further down the list, with bank relationships at the top. The move of funding to the top spot is hardly surprising given how funding risks have changed.

Bank margins on undrawn facilities used to be a small part of funding costs however now they have increased to levels similar to drawn margins. This increases the focus on managing facility headroom efficiently to minimise costs.

Not only is there the increased cost of facilities to contend with but the time taken to negotiate facilities has extended. The availability of funding can no longer be assumed and hence the importance of ensuring that the refinancing process is commenced well ahead of maturity. Typically a Treasury Policy will have guidelines such as when refinancing of maturing debt should be completed. Guidelines for spreading maturities and having a variety of funding sources may also be appropriate, though for the majority of businesses having various sources of funding is not an option, since a single bank facility is sufficient for their needs. In this case maintaining the banking relationship becomes all the more important.

Continued on back page

AUSTRALASIA ECONOMY & MARKETS

We are not alone

The past three or so years since the Global Financial Crisis (“GFC”) have taught us how much economies and financial markets are connected. Like all learned truths, that lesson carries both positive and negative outcomes, especially for trading and creditor nations such as Australia and New Zealand.

It’s been more than a century since Australia and New Zealand became independent from ‘Mother England’ but now both are heavily dependent on Asia (predominantly China) for trade and on the global investment community to fund their public and private sector deficits. In addition, Australia is New Zealand’s largest trading partner, further cementing their connectedness.

Our place, together in the world

Australia and New Zealand are linked, not just by historical, cultural, political and even sporting ties but by their proximity to each other, distance from the rest of the world and the complementary contrast between their key commodity exports. Both are regarded as solid investments, as evidenced by the recent rumours that the China Investment Corp, a state owned wealth fund, is looking to diversify away from the US dollar and has allocated 2.0% of its fund to invest in Australia and 1.5% in New Zealand.

Both the Reserve Bank of Australia (“RBA”) and the Reserve Bank of New Zealand (“RBNZ”) are balancing their respective favourable places in the world and high inflation against hopes that price shocks are temporary, against the growth and inflation constraining effects of very high exchange rates and against the contrasting growth stories between separate sectors of Australia and New Zealand.

The lucky country

Australia has ridden the commodity booms of both pre and post GFC, benefiting from strong demand from its Asian trading partners. Australia’s terms of trade have risen to very high levels

and Australia has reported monthly trade surpluses in all but one of the past thirteen months. Much of the commodity-sourced bonanza has been reinvested back into the resources sector and into associated infrastructure, including services and transport.

At its June meeting, the RBA Board recognised the positive contribution to growth, terms of trade and inflation from the resources sector, in response to high commodity prices. However, it is a different story outside that sector, especially the household sector and the heavily populated eastern states.

The sunshine and grass economy

The RBNZ’s June *Monetary Policy Statement* contained more upbeat growth forecasts, a higher inflation track and, significantly, a faster and higher path for the 90 day rate from December this year than posited in the March and December statements. It noted recent high prices for New Zealand’s export commodities, the best terms of trade position in almost four decades, indications that capacity slack has reduced and an unnerving rise in inflation expectations.

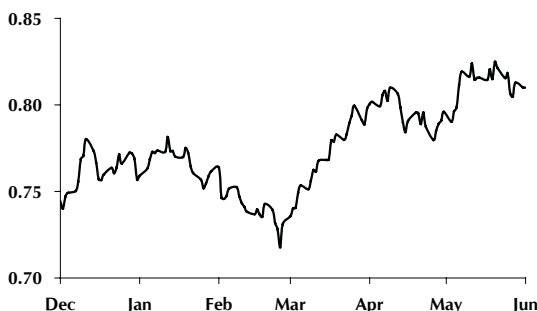
The RBNZ laid out its key assumptions: construction cost inflation will be subdued relative to its mid-2000s peak, households will continue to reduce debt and inflation expectations will ease. It stressed that the timing and intensity of the rebuild of Christchurch will be key to OCR rises in 2012 and 2013. Barely was the ink dry on the MPS when the aftershock in Christchurch on 13 June wiped out much of the RBNZ’s upbeat growth projections.

Conditionality, uncertainty and volatility

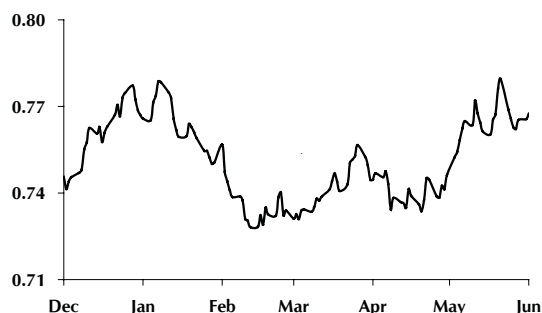
Recent statements from the RBA and RBNZ contain much conditionality and hints that they have no control over key external influences, notably commodity prices, investor risk appetite, banking and sovereign debt problems and natural disasters.

All this potential volatility makes a robust and disciplined risk management regime a necessity for today, not a luxury to be implemented in the future.

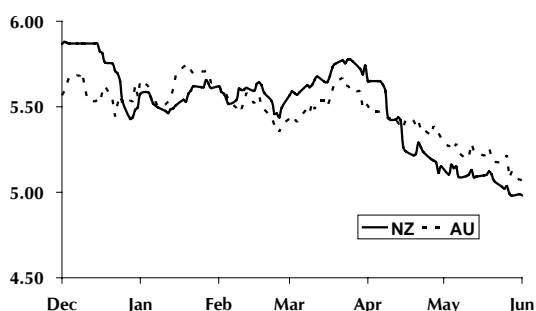
New Zealand dollar/US dollar



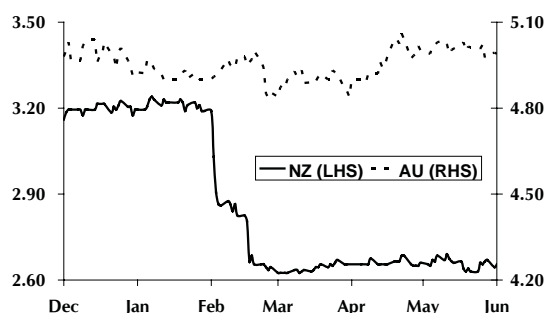
New Zealand dollar/Australian dollar



10 year government bonds



90 day bank bills



WORLD ECONOMY & MARKETS

Just-in-time or just-too-late?

Management theorists may be busy rewriting the text books following the recent Japanese disasters and the large-scale disruption to global supply chains that followed. Shortages, particularly in vital electronics and car componentry, have rippled beyond Japanese borders, impacting household names such as Boeing and Apple and causing many companies to reconsider inventory and stock control models.

While some early reports put the drop in global car production as high as 30%, just three months after the quake it now appears that any lingering supplier shortages outside Japan are limited. It turns out that the global linkages responsible for the initial disruption are also proving invaluable in quickly reorganising key supply channels.

While extreme, this recent scenario is just one example of how growing interconnectivity is impacting everyday business, with the expanding global marketplace providing both new challenges and opportunities.

The currency / commodity correlation

Any commentary around the recent surge in the Australasian currencies will undoubtedly make reference to equally buoyant commodity prices and the China story. The correlation between these linkages has been overwhelming of late, underpinning the NZD and AUD despite significant domestic events such as the Christchurch quakes and Queensland flooding. For now at least it seems that the domestic dollar is simply a proxy for global commodity prices. China's rise has also fostered strong regional links among the integrated economies of Asia, a changing dynamic that presents a new set of business opportunities for those quick to adapt. However, the degree to which China is responsible for global growth suggests that volatile conditions are here to stay.

Debt contagion

Financial institutions have embraced the global age, smothering the world in a tangled web of commercial linkages that facilitate

modern society. It took the credit crisis to expose the true significance (and folly?) of this system, where one weak link can threaten the whole edifice. The ramifications are still playing out, particularly in Europe where unprecedented efforts have been taken to prop up insolvent nations in order to prevent wider contagion.

Recent figures from the Bank for International Settlements show that French, German and UK institutions directly hold almost a third of Greece's EUR340 billion of debt. While Greece's sovereign debt rating continues to be whittled away towards default status, Moody's has also warned that it may downgrade the three largest French banks over their potential losses on Greek bonds and banking operations. There are real concerns that the unending Greek crisis could infect the rest of the euro area and ignite another global event.

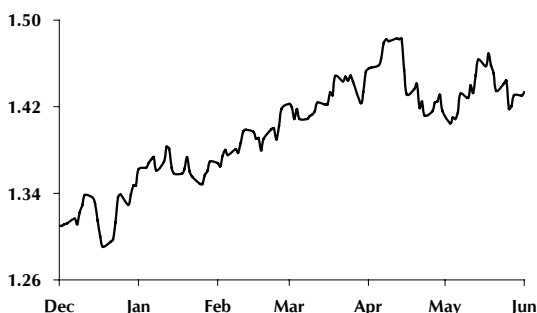
Like those of Lehman Brothers, Greek tentacles spread far and wide. US investors hold bonds of European banks with exposure to Greece, while US financial institutions have written more than USD30 billion in credit guarantees on Greece. Bank of America alone has quantified its exposure to Greece at almost USD17 billion, according to a recent filing.

As highlighted by the 2008 credit crisis, panic can spread quickly once given a trigger, with the opaque linkages of the global financial system causing widespread uncertainty, credit to seize up and confidence to evaporate.

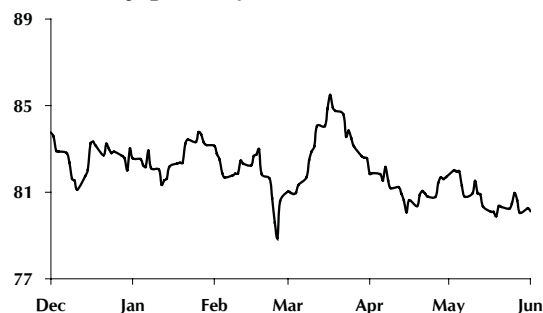
Decoupling revisited

While it could be argued that the world has undergone some degree of decoupling from the US economy over recent years, it appears that those allegiances are simply being redirected towards China. It is clear that globalisation is resulting in an increasingly complex business environment, represented by ever-widening interconnections. Greater financial integration and trade has surely increased the potential risk of contagion.

Euro/US dollar



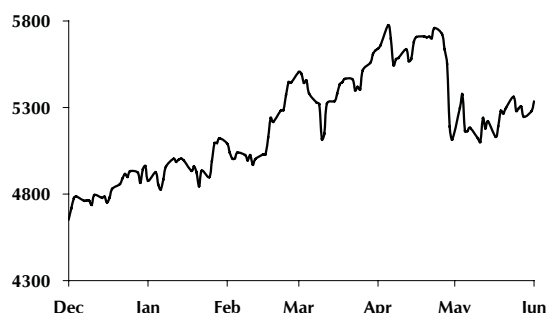
US dollar/Japanese yen



US 10 year government bond



Standard & Poor's Goldman Sachs Commodity Index



GOVERNANCE AND TREASURY

Reporting is vital

Once the Treasury Policy is established, discretion is given to management to manage risks within the guidelines of the policy. The Board's main focus therefore becomes the issue of compliance, and hence the need for quality reporting. As a director how do you know Treasury is compliant with policy?

Many Boards receive a monthly report that specifically declares compliance with, for example, interest rate risk management policy, funding policy etc. Designing a useful report takes skill and the old saying 'a picture paints a thousand words' speaks volumes. For example, rather than using numbers and text to explain where hedging is within policy bands a chart can illustrate the same thing but require only a fraction of the time to understand the position. Reporting needs range from a few pages to a large document with appendices, with the shorter extreme being exception reporting. Regardless of what form reporting takes, it needs to show clearly whether there is compliance. Any breaches should be approved by the Board and impending breaches need to be flagged.

Another important reporting requirement is performance measurement. Management is given discretion to manage risk within certain guidelines, so how are they performing? There is some discussion around how performance measurement should

be done. One method is to measure hedging outcomes against Treasury Policy midpoints and base performance as a gain/loss against those midpoints. If there was a large mark-to-market gain in the actuals, but the midpoint of Policy would (theoretically) have resulted in a higher gain, performance could be measured as a loss. This would undoubtedly spark debate among management.

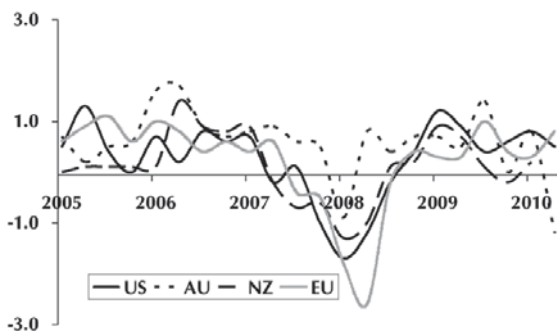
Where to from here?

From a governance perspective the Directors' detailed responsibilities may seem overwhelming. However by asking the right questions there can be some assurance that risks have been covered.

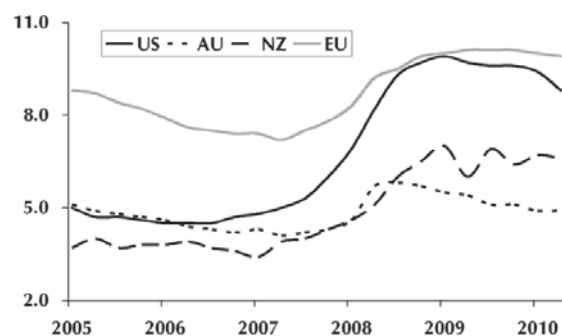
The framework in which Treasury risks are managed is ideally in a Treasury Policy, approved by the Board. The Treasury Policy needs to be reviewed regularly, typically annually, and updated to reflect changes to the nature of the business. Some risks, such as commodity risk, have become more significant and may therefore require a risk management framework to be developed.

As a director, treasury is an important area of responsibility with substantial risks. There is no place for assumption; make sure questions are asked. And then ask some more.

GDP growth (QoQ)



Unemployment rate



Text finalised 21 June 2011

This document has been prepared by Bancorp Treasury Services Limited ("BTSL") and Barrington Treasury Services Pty Limited ("Barrington"). Whilst all reasonable care has been taken to ensure the facts stated are accurate and the opinions given are fair and reasonable, neither BTSL, Barrington, nor any of their directors, officers or employees shall in any way be responsible for the contents. No liability is assumed by BTSL or Barrington, their directors, officers or employees for action taken or not taken on the basis of this document. ACN 46 050 931 541 Operating under AFSL Licence No. 244594

Bancorp Treasury Services Limited

Auckland

Level 11
Qantas House
191-201 Queen Street
PO Box 4270 1140
Phone +64 9 912 7600
Fax +64 9 912 7601

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

Wellington

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

Christchurch

Level 2
Bradley Nuttal House
79 Cambridge Tce
PO Box 173 8140
Phone +64 3 374 2193
Fax +64 3 374 2195

Barrington Treasury Services Pty Limited

Sydney

Level 1, Bridgepoint, 1-3 Brady St, Mosman
NSW 2088
PO Box 420 Spit Junction NSW 2088
Freephone 1800 425 079
Email: admin@barringtontreasury.com
Website: www.barringtontreasury.com



BANCORP

BANCORP TREASURY SERVICES LIMITED

Barrington
TREASURY SERVICES