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ANOTHER WAVE OF REGULATORY CHANGE ABOUT TO HIT OUR SHORES

"In the future, financial firms of any type whose failure would pose a systemic risk must accept especially close regulatory scrutiny of their risk-taking" — **Ben Bernanke (former Chair of the Federal Reserve)**

A history lesson — a decade on from the GFC

The Global Financial Crisis ("GFC") was unprecedented in living memory and exposed many companies and individuals to the excesses of cheap credit and a misallocation of risk. It also exemplified how interconnected the global financial system had become. While somewhat insulated from the worst of the global meltdown, most Australasian treasurers certainly experienced first-hand the evaporation of credit, wild swings in currencies and interest rates, disruption in supply chains, and a loss of confidence in banks.

The lessons of diversifying funding sources and staggering debt maturity terms are thankfully more widely adopted considerations that are encouraging a growing number of larger corporates to explore various debt capital market funding options. Domestic funding market dynamics are also encouraging this move, with the big four banks casting a more discerning eye over funding opportunities for themselves and their corporate customers. While each funding market has its pros and cons, a clear and forward looking funding plan remains imperative for borrowers.

The GFC has also shown how financial markets are prone to shocks that can affect funding. In July, US corporate credit spreads approached their lowest level since the GFC. However, as the recent escalating tensions between the US and North Korea showed, credit markets are still prone to shocks, albeit small ones. The effects of shocks or crises, such as these, or scandals (and there have been plenty, thanks to Trump) have been relatively short lived. There are plenty of risks on the horizon that could cause a major blowout in credit spreads such as; a US economic slowdown, an escalation of the conflict between US and North Korea, or a banking crisis in Europe or China.

How the bank sees you

Another cause of a change in credit costs is banking regulation. The GFC exposed banks' illiquidity and funding instability. Since then, banking supervision and regulations have undergone significant change (tightening) to ensure financial stability in the banking sector. Internationally, the Basel Committee on Banking Supervision introduced the Net Stable Funding Ratio ("NSFR") part of Basel III, a key international banking reform to ensure a more robust banking sector.

The NSFR is a longer term structural ratio that measures the amount of a bank's available stable funding to its required stable funding. The purpose of the NSFR is to provide incentives for banks to use stable sources of funding and address liquidity mismatches along with mitigating funding risks over the longer term. Under Basel III, banks have until the beginning of 2018 to meet the NSFR requirement, although the majority of Australian banks are already in a position to exceed the requirement.

The NSFR provides different weightings depending on the tenor and counterparty, with longer tenors receiving a higher weighting and shorter tenors weighted accordingly.

Other regulatory changes include the Fundamental Review of the Trading Book, which is a new framework that establishes the amount of capital required for supporting capital market activities by 2019/2020.

Closer to home, the Australian Prudential Regulation Authority ("APRA") has set out new capital adequacy targets that must be held by banks, which will influence the way the Australasian banks operate in New Zealand.

In New Zealand, the Reserve Bank of New Zealand ("RBNZ") has not adopted Basel III but operates under its own framework. The RBNZ aims to have more conservative capital requirements than international peers due to New Zealand's higher risk profile from a higher concentration of risk, namely the dairy and housing sectors.

So what does this mean for borrowers? Changes in banks' appetite to lend are influenced by changes in regulation and banks are coming under tougher capital requirements. Anecdotally, some businesses have found it more difficult to obtain bank lending.

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AUSTRALASIA ECONOMY & MARKETS

Increased presence of Chinese banks

Over the past year or so, we have become increasingly aware of a heightened presence by offshore banks in the Australasian lending markets. In Australia, this has been confirmed by recent data released by APRA which showed that, in the year to June 2017, Chinese banks increased loans and advances to the corporate sector by 23%, from AUD26 billion to AUD32 billion. Indeed one senior banker indicated that Chinese banks increased their direct property lending in Australia over the past year by about 50%, while over the same period the 'big four' banks only increased direct property lending by around 2%.

There are a number of factors which have led to this increased Chinese lending. The 'big four' Australasian banks have had tighter regulatory requirements imposed on them by APRA which has required them to hold more capital against their lending books. This has caused them to reduce their lending, with the Chinese banks prominent in filling this gap. In many cases, the local banks have reduced their exposure to a particular borrower and have brought in additional banks in a bilateral or syndicate arrangement.

Also, the Australasian banks have seen their cost of funds rise which has resulted in them increasing lending margins. The Chinese banks have not been subject to the same cost pressures and therefore their lending margins have not increased commensurately. As a result, the Chinese banks have in many cases been able to match or better the 'big four' on price, with an increased flow of business their way.

Traditionally, many corporate and institutional borrowers have not considered going outside the 'big four' for bank funding, given that it was readily available and attractively priced. This has changed, even for borrowers with a very high implied credit standing.

We are aware of cases where the reduction in appetite for the refinancing of existing debt from one or more of the 'big four' Australasian banks has come with little warning. We strongly advise that borrowers plan refinancing early, engage with the bank regularly and be prepared to look beyond the traditional sources of funding.

Regulations driving changes

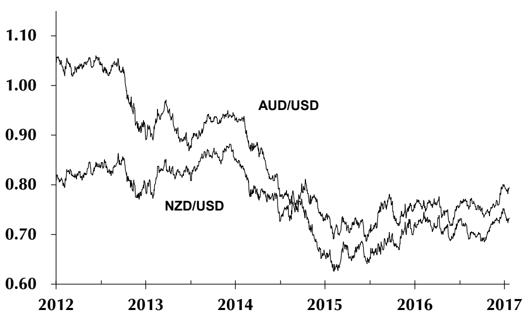
The main international regulatory response to the GFC went under the broad banner of 'Basel III'. This has involved a higher minimum quantity of capital and also a better quality of capital. While the new Basel III requirements are still being phased in, many national regulators, including APRA in Australia and the RBNZ in New Zealand, have moved ahead of the Basel III timetable.

The Final Report of the Financial System Inquiry ("FSI") in Australia recommended bolstering Australian banks' capital ratios so that they are *"unquestionably strong."* APRA is implementing the FSI recommendations. This has resulted in a number of capital raisings by the Australian banks over the past year, as well as sourcing more funds via locally sourced term deposits to improve the banks NSFR. APRA has indicated that its desired final position on *"unquestionably strong"* local banks is not far away.

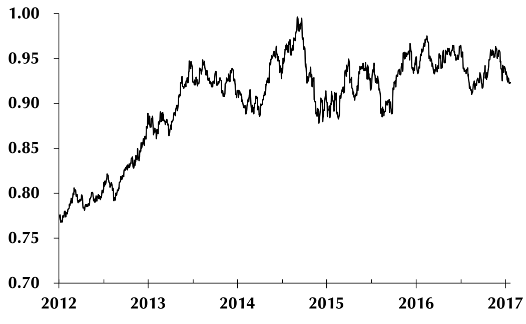
The increased competition for term deposits, particularly deposits from households and small businesses, is because these products are classified as more stable sources of funding under the proposed NSFR, which comes into effect in Australia in 2018. Accordingly, banks are preparing their balance sheets for the implementation of the NSFR by offering higher interest rates on term deposits with longer maturities. This effectively increases the cost of the banks' overall funding books. To ensure profit margins are maintained, the banks are passing these additional costs on to borrowers via higher lending margins.

The exact same scenario has played out in New Zealand, but is currently being dictated by the Australian parents of the big four banks. The RBNZ is in the middle of a review of bank capital requirements which will not be completed until early next year. This could bring about harsher capital requirement regulations for the local banks, which will likely mean that wider lending margins are here to stay.

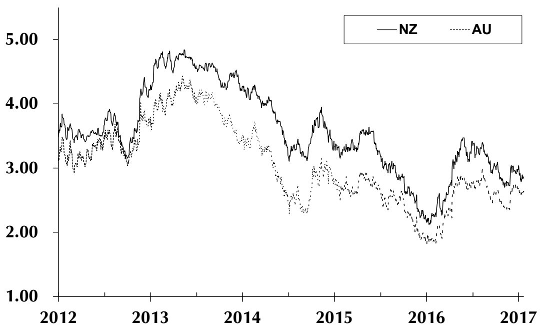
New Zealand dollar and Australian dollar/US dollar



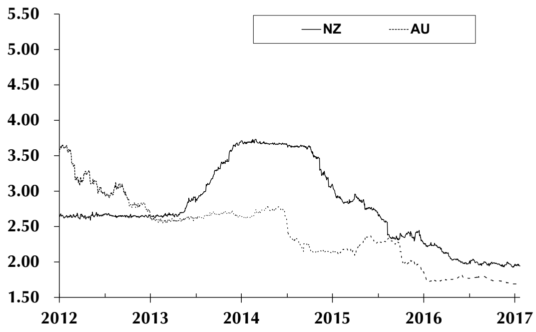
New Zealand dollar/Australian dollar



10 year government bonds



90 day bank bills



WORLD ECONOMY & MARKETS

It's quiet. Too quiet!

Businesses have enjoyed a period of low and relatively stable interest rates over recent years, while currency movements of late could also be described as rather dreary. The CBOE Volatility Index, widely considered the best gauge of fear and volatility in financial markets, recently closed at one of its lowest levels in recent history.

The stability in financial markets has become so pronounced of late that many are now wondering if markets have perhaps grown a little too complacent.

The prevailing sense of serenity comes at a time of transition for the major central banks, with the US Federal Reserve ("Fed") embarking on a gradual interest rate tightening cycle and imminent unwinding of its bond buying programme, and some expectations that the European Central Bank may not be too far behind. We may finally be passing the peak of this unprecedented period of global monetary policy experimentation.

There has been no repeat performance of the 2013 'taper tantrum', which saw huge moves in share prices, currencies and bond yields after the Fed announced that it was poised to scale back its quantitative easing programme.

Comatose financial markets have even managed to take the worrying global political disorder largely in its stride, despite rhetoric between the US and North Korea recently escalating to nuclear levels, something that should be enough to worry even the most lethargic observer.

While policymakers can perhaps be forgiven for sponsoring a positive vibe, Fed Chair Janet Yellen's recent prediction that we will not see another financial crisis in our lifetime may be a tad presumptuous (although she is 71). History strongly suggests that this unusually calm period will be interrupted at some point, as currently unforeseen worries garner market attention and disrupt the status quo — the much hyped Black Swan event.

Note to self: Don't become complacent!

With proven treasury risk management tools at their disposal, there is little excuse for businesses to be unprepared. This starts with having an appropriate risk management framework, typically documented within a Treasury Policy.

The Treasury Policy should highlight the organisation's financial risks, prescribe the methods for managing these risks and assign responsibility. The chosen approach will vary from company to company and should be reviewed over time to ensure that it remains sufficient to safely steer a company through good and bad times.

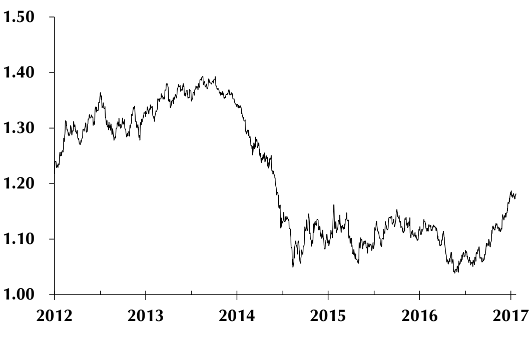
Those responsible for managing financial risks should be regularly reviewing their risk management strategies, in line with market dynamics, and reporting compliance back to the Board. If the hedging strategy is consistently out of step with the Treasury Policy, then a refresh is due.

While a Treasury Policy may not necessarily have changed much since the GFC (a policy will typically provide a reasonable degree of management flexibility around hedging strategy), positioning within the hedging bands, as well as hedging product selection, should certainly have evolved to reflect the post GFC world.

With volatility an essential input into option pricing, the largely benign financial environment may represent an attractive time for utilising optionality as part of a hedging programme. Adding some worst case protection in times of stability can provide flexibility and security during times of market turmoil. As they say, there is no point thinking about insurance once the house has burnt down. Not all products promoted by banks will necessarily be appropriate risk management tools, so the usual disclaimers apply around understanding what you are signing up for. If you cannot succinctly explain the strategy or product to the Board, it is not for you.

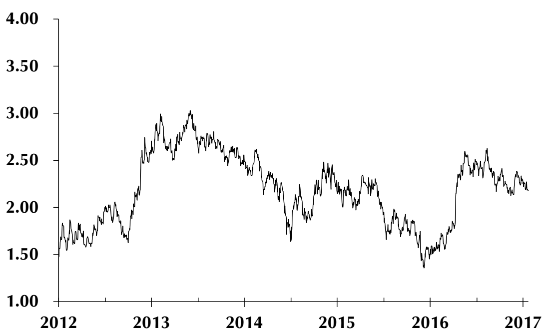
For those currently enjoying the calm: the statistically most frequent month for the start of a banking crisis? September. By a long margin.

Euro/US dollar

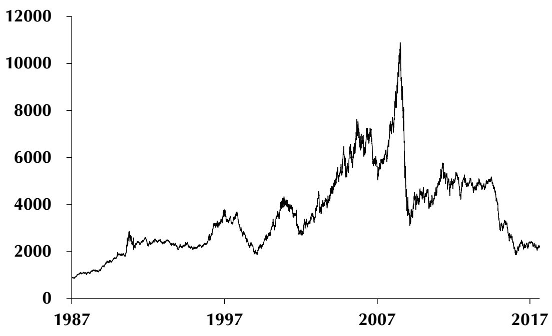


US dollar/Japanese yen

US 10 year government bond



Standard & Poor's Goldman Sachs Commodity Index



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Expectations are that it will remain that way. The ANZ's July Business Outlook survey showed that a net 27% of New Zealand businesses surveyed expect it to be tougher to get credit over the next year.

Given that these regulatory changes will affect banks' lending appetite and borrowers' costs, companies should pay close attention to funding risk and ensure that an appropriate funding policy and strategy is in place.

Companies should also maintain a good relationship with their banks, plan for any refinancing or new borrowing well in advance and do not assume that, although banks may have had the appetite to lend to your business in the past, this will remain the case.

Anti-money laundering changes

Under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, New Zealand will roll out reforms to ensure confidence in the country's financial system and align New Zealand with international standards

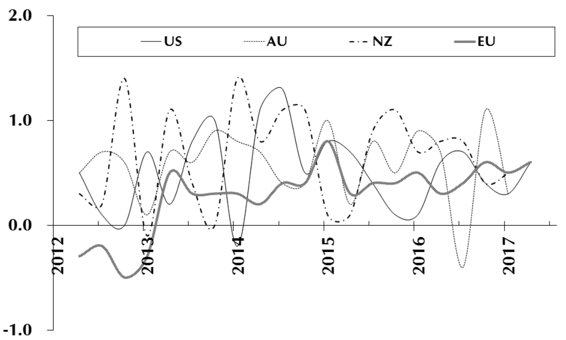
Under Phase one, businesses such as banks, casinos and certain financial service providers are required to provide details of international transfers and domestic cash transactions above certain amounts from November this year.

Phase two will see rules rolled out to a number of businesses starting next year, including accountants in practice, lawyers, the NZ Racing Board (TAB), dealers in high value items, and conveyancers. These entities will be required to file reports and to follow an approach that tackles possible money laundering and terrorism funding. The rules also detail means of enforcement. All of this will involve additional costs and resourcing for these businesses.

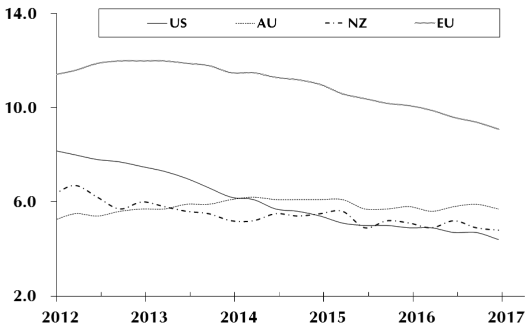
These reforms highlight the importance of understanding how cash and financial risks are managed. Companies are coming under increasingly sophisticated criminal attacks. Therefore, it should be no different for any business to ensure adequate processes are in place to detect fraudulent activities.

These changes highlight the importance of having appropriate policies and procedures for all treasury activities — after all the treasury function is at the heart of where these cash and financial risks are managed. A Treasury Policy identifies, measures, controls and reports on risk within a controlled framework. Given the increasingly sophisticated attacks on and regulations relating to treasury activities, has your treasury policy been reviewed?

GDP growth (QoQ)



Unemployment rates



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