New Zealand

New Zealand may be regarded as a 'safe haven' economy, but its treasurers still have plenty of risks to manage, says Mahesh Chhagan

Geographically isolated and occupying a lonely spot near the bottom of the globe, New Zealand is probably best known as Middle Earth. In fact, few things are more iconically Kiwi than Hobbits and our patriotic devotion to our unbeatable national rugby team, the All Blacks. But believe it or not, New Zealand, distant from most of its trading partners, has also become known for its dynamic, bustling, export-orientated, high-growth economy.

New Zealand's economic growth and employment levels have outpaced most other developed economies since 2012. Strong growth, record inward migration and elevated export commodity prices led the Reserve Bank of New Zealand to tighten monetary policy in 2014, while most of the world's developed economies were still in recession or early recovery.

Prices for the country's main export commodity, milk, have recently fallen dramatically from the record highs of 2013, however. Furthermore, the New Zealand dollar has fluctuated markedly, reaching highs above 0.8800 against the US dollar in mid-2014 and lows of just above 0.7000 more recently (a 20% depreciation). Likewise, long-term New Zealand interest rates have traversed a 2% range. In short, New Zealand has not been sheltered from the global volatility headwinds.

Auckland, New Zealand's largest city

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New Zealand relies heavily on external trade as a source of revenue. Exports accounted for 29% of GDP in 2014. Yet, despite being the 54th largest economy in the world, it has the 10th most commonly traded currency, which is often targeted by currency speculators due to its high volatility. Greater levels of private indebtedness require relatively higher interest rates to attract a constant flow of international investment. As a result, local organisations are exposed to numerous global risks and market forces. Hence, risk management is a major concern for almost all New Zealand organisations.

Country file

Population size: 4.57 million
Geographical area: 268,021km^2
% GDP growth in 2014: 3.5%
Median age: 29.8 years
Type of govt: Constitutional monarchy
Official languages: English and Māori
Capital city: Wellington **Largest city:** Auckland
GDP (2013): $182.6bn
Central govt debt as a proportion of GDP (2013): 35.9%
Currency: New Zealand dollar (NZD)
Currency rate against the euro: €0.60

Treasury matters

Recently, PwC published the results of its 2015 *New Zealand Treasury Management Survey*. While the survey is New Zealand-focused, many of the key findings may have global relevance – particularly for SMEs.

The survey results are broken down into eight key themes:

- Governance and policy issues;
- FX risk management;
- Interest rate risk management;
- Commodity/energy price risk management;
- Investment criteria;
- Funding and bank relationships;
- Hedge accounting treatment; and
- Treasury management systems.

This article covers some of the high-level findings from the survey. But the survey does delve into some granular detail, so if you would like further information, you can get it by downloading the publication from http://tinyurl.com/qeet3nh

The governance section of the publication highlighted that, despite the complexity of risks that treasury functions are managing, most organisations (83%), particularly in the small- and medium-sized categories, have one or less full-time equivalent treasury staff member.

Surprisingly, the result is higher even than that observed in the 2011 survey, where it came in at 67%. We expected the global financial crisis and subsequent events to have resulted in a greater realisation by boards of the scale and importance of risk that understaffed treasury functions are managing. One possible explanation for this trend could be the treasury advisory and outsourcing services that exist in New Zealand, where specialist external advisers and treasury outsourcing functions are available to fill the void.

Respondents were asked about their organisations' overall approach to managing FX and interest rate risks. For the purposes of this survey, the following options were provided:

The passive approach: The mechanical hedging approach to exact percentage limits that involves no active management (ie limited scope for discretionary decision-making).

The active approach: Dynamically increasing or decreasing hedging levels and/or shortening/lengthening the hedging horizon within policy limits where hedging decisions rely on factors influencing the market price movement of market FX and interest rates (for example, macroeconomic, correlations between different products, etc).

Not managed approach: No hedging is entered into with derivatives, but a material risk is present.

The majority of New Zealand organisations are actively managing their FX and interest rate risks. This is interesting for two reasons. Firstly, New Zealand organisations operate with an understaffed treasury function, yet the majority of these organisations actively manage their risks. Hedging under an active framework is a complicated activity that requires substantial resources. Deciding if one should hedge, how much to hedge, what choice of instrument to use, where to place the maturity of this hedging and also when to hedge (ie timing) is a complex process.

History has shown that derivative usage, coupled with a lack of expertise, can result in material trading losses, which ultimately could be a value-destroying proposition for an organisation. New Zealand organisations may be able to cope with extreme values over a short horizon, but over longer horizons, these extremes may lead to profitability and competitiveness issues. Management, therefore, has an obligation to protect the shareholders' interests from these adverse risks and thus, risk management is becoming more strategically focused.

Forward exchange contracts for FX risks and interest rate swaps for interest rate risks are clearly the favoured derivatives. New Zealand organisations overlook optionality. Such findings may be explained by the difficulties associated with hedge accounting for options or volatility movements. The lack of optionality may also be due to a lack of understanding. The decision to use forward exchange contracts or interest rate swaps over an option is often because of the upfront premium payments associated with options. The use of optionality should consider the premium costs in points, break-even analysis and the potential participation benefits.

Funding and liquidity

The funding and bank relationship section of the survey also produced concerning results. There are questions over whether New Zealand organisations are becoming too comfortable with their funding and liquidity risks.

We found that the majority of organisations surveyed are sole-banked and comfortable with this position. In addition, there seems to be a heavy reliance on bank funding, particularly for organisations with low and medium debt levels. This signals an over-reliance factor. Evidence also suggests that there may be a declining appetite for longer-term debt funding. This comes as a surprise given the fall in New Zealand credit spreads.

The current environment suggests that it is more advantageous to lengthen tenor. Developments in the New Zealand debt markets have seen the availability of longer-term debt at credit margins lower than before the global financial crisis. Respondents also indicated that it is easier (or, at least, not harder) to obtain funding than it was two years ago, which may be the reason for the observations made in this section.

New Zealand organisations should consider spreading their funding sources over multiple counterparties, not only to introduce competition (and hence possibly favourable pricing), but also to remove the concentration risk. Organisations should look to extend debt maturities, not only to take advantage of historically low credit spreads, but also to ensure that they have long-term commitments secured.

Good practice is a key theme drawn upon throughout the publication. This involves having procedures and policies in place that promote effective risk management. It entails making continuous enhancements to the organisation's risk management approach and capabilities as opposed to being overwhelmed by the need to make a transformational change following a crisis. It's about planning ahead and identifying areas of focus and priorities for investment, whether this entails the implementation of a new treasury management system, reviewing the treasury policy or digging deeper into specific areas such as FX risk.

Conclusion

Over recent years, New Zealand organisations and their treasury functions have dealt with financial markets that have been consistent only in their unpredictability. The nation's heavy reliance on external trade has meant that its economy is significantly exposed to global market conditions. Treasurers have had to tackle concerns surrounding their exposure to these volatile markets, which has been crucial for New Zealand's economic development.

New Zealand organisations are exposed to risks that have the potential to be vastly material and hence it is important that they devote the resources necessary to manage these. Treasury management should continue to be a major concern for every organisation, and risk management ought to rank highly on the boardroom agenda.

FIVE TOP TIPS FOR DOING BUSINESS IN NEW ZEALAND

1. **Be conscious that, as an export-oriented economy, New Zealand has a heavy reliance on its major trading partners and, therefore, has a significant exposure to global market conditions.**
2. **New Zealand has a population of just 4.5 million people, so if your business requires critical scale, it may pay to bear this in mind.**
3. **New Zealand is predominantly an agricultural nation (apparently there are more than 20 sheep to every person). Accordingly, there are massive opportunities and demand for innovation in the agricultural industry.**
4. **Due to New Zealand's small financial market and a tight financial community, building a long-standing reputation for integrity matters.**
5. **If you're not wearing black on the night of an All Blacks test match, you might as well declare bankruptcy.**

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