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Green Finance

New Record High and More Transparency Thanks to an EU Initiative

Finance and Treasury Management Switzerland

Just as expected, the market for green finance (i.e. financing that may be used exclusively for sustainable projects or where the interest expenses are linked to the key sustainability figures of a company) is heading towards a new high this year. On a global scale, "green bonds" alone were expected to reach a volume of USD 250bn in 2019, and that is without including loans that have a sustainability component and green notes payable. Even if actual numbers will probably fall short of these forecasts, an increase of around 20% in comparison to the previous year still makes green finance a driving force.

The number of corporations (as opposed to financial institutions and government institutions) involved in this kind of financing is getting closer and closer to 50%. Even German corporations that had been rather inactive in this market segment in 2018, called attention to themselves with some transactions (for instance, Porsche with its green bond, Voith with its green loans and Baywa with its green bond).

The numbers as well as current surveys show that more and more companies are also considering ESG (Environment, Social, Governance) factors in their financing activities. What is crucial here is that they change the perception of a company. The public increasingly expects that companies meet their social and ecological responsibilities (especially related to the climate protection goals). Surveys showed that the majority of companies involved with green finance are not necessarily in it for a pecuniary advantage due to better conditions. The main reason for engaging in this type of financing are expected marketing advantages.

A further reason is investors' great demand as many investors include sustainability components in their investment decisions. Research in 2019 showed that 78% of institutional investors include sustainability factors in their investment process (globaltreasurer.com). In comparison to the previous year, this is an increase of nearly 15%. In part, the drive to include ESG criteria is no longer a purely company-internal decision related to risk and profitability aspects. Rather, it is influenced by EU law. For instance, the European Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (IORP II Directive) prescribes that these institutions shall provide information to what extent ESG aspects have been taken into consideration in their investment decisions. Apart from the fact that investors are increasingly demanding green investment possibilities (thus augmenting the potential for green financing at corporates), in the future, treasurers should also be prepared to meet regulatory requirements which may necessitate that investments are also scrutinized for sustainability factors.

Whilst the development is rapid, it could become even faster. Ever since the ESG criteria have become a part of investment and financing processes, one of the main pain points is that there are few standardized criteria in order to make green financing (bonds, debt instruments, loans) more comparable.

ESG ratings provided by agencies, such as MSCI, ISS Environmental & Social Quality Score, RepRisk and Sustainalytics, are good indicators but in view of their individualized yardsticks used to measure the concept "sustainability", they are not necessarily comparable. The same is true for admission criteria to sustainability indices, such as the MSCI World ESG Index, the Dow Jones Sustainability Index (DJSI) and the FTSE4Good Index. Another general problem is the fact that ratings as well as indices only become relevant for companies of a certain size.

The G20 and the European Commission also recognized this problem some time ago and decided to tackle it with the help of several initiatives and technical expert groups. The goals of these initiatives are:

- Realigning capital flows to sustainable investments in order to create sustainable growth;
- Managing financial risks caused by climate change, environmental deterioration and social aspects;
- Pushing for transparency in financial activities and making these more long term.

Specifically, these goals were addressed in the following initiatives:

- The development of a classification system valid across the EU (the so-called taxonomy) in order to determine whether an economic activity is sustainable;
- An EU standard for green bonds;
- Benchmarks for climate-friendly investment strategies;
- Recommendations to improve ESG-relevant data in companies' financial reports.

Especially the first two points have come a long way:

Taxonomy

The report published in June is the base for future EU legislation used to classify companies' activities that is binding. It contains criteria to determine whether entrepreneurial activities in the sectors production, agriculture, forestry, energy, transportation, water management, garbage disposal, information and communication technologies and the building and construction industry are sustainable. This comprehensive view of the various sectors in connection with the use of scientific methods to determine the impact on sustainability, including the use studies, is without parallel at this time. Moreover, the report not only scrutinizes trades that are already deemed sustainable but it also takes a look at where investments would make the most sense to bring about a change to a more sustainable economy.

EU standard for green bonds

The EU standard for green bonds currently under development goes hand in hand with the taxonomy described above. The proceeds must benefit one or several of these goals (e.g. the avoidance of pollution) described in the taxonomy and should not be to the detriment of another goal. In doing so, defined social standards have to be adhered to.

Furthermore, the company must publish a framework, which states in detail how it intends to ensure the achievement of its goals. The decisive element in this process will be the binding use of an allocation report (how the company intends to use profits) as well as an impact report (what kind of impact the action has on the environment). Both the framework and the allocation report must be verified by an external verifier. It is expected that after an initial transitional phase, the ESMA (European Securities and Markets Authority) will be mandated to do this. These requirements are not fundamentally new and to a large degree already applicable today. However, Corporate Finance should consider the specific criteria of the taxonomy and think about getting an accreditation for EU Green Bond in order to mitigate any market disadvantages that could arise due to a lack of certification.

Corporate Finance departments and treasurers that do not consider green financing just another fad should examine the EU initiatives on improved comparability of green financial instruments carefully. Studies made with asset managers showed that they will be using the EU taxonomy when

implementing their investment strategies. Whilst the taxonomy is geared mostly to bonds, the criteria may also be used by banks when granting so-called green loans. The taxonomy is not yet complete by far and focuses mainly on the E in ESG. However, this is a work in progress and will continue over the coming years and as such, should remain on the radar of treasurers. It has been known already for some time that treasurers will have to become more aware of demands for and the monitoring of ESG factors. The development of the taxonomy means that standardization has come a step closer, possibly allowing for more meaningful and comparable ESG KPIs and benchmarks.

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The end of IBOR

Effects on the Financial Reporting of Financial Instruments under IFRS

Finance and Treasury Management Switzerland

The reform of the IBOR interest rates essentially means that the method for determining IBOR interest rates has changed. Up to now, IBOR interest rates had been determined on the basis of the interest rates charged by 11 to 18 big banks, i.e. the rates which the latter would charge London's interbank market for unsecured credits (reported on a daily basis).

At the moment, it seems that the interest rates succeeding the old IBOR interest rates won't be standardized. Rather, the respective central banks will decide individually on how they are going to determine the method. However, these future approaches are all likely to have a closer link to actual transactions. The hope is that linking IBOR interest rates closer to actual transactions will make it harder to manipulate them.

The IBOR reform will have a noticeable effect on the Treasury, the Finance and the Accounting functions of virtually every company. There will be obvious effects on the fair value valuation of financial instruments and the interest rate framework connected to this in treasury management systems. Apart from the valuation of financial instruments, the IBOR reform will also affect the basic contracts in Treasury (i.e. debt financing, inter-company financing, cash pools, etc.). Finally, companies have to clarify whether and how financial reporting according to IFRS will be affected by the IBOR reform. An early and comprehensive analysis of the effects in Treasury is therefore essential in order to prevent unwanted surprises and to make available sufficient resources for any necessary adjustments. Below, we expand on the effects on the financial reporting.

The effects on the financial reporting of financial instruments according to IFRS can be manifold. In order to cope with the uncertainties in connection with the IBOR reform, the IASB has introduced the project "IBOR Reform and Its Effects on Financial Reporting". The initial phase of this project, which included some adopted changes in IFRS 9, IAS 39 and IFRS 7, is now complete. It regulates hedge accounting; the second phase, on the other hand, mainly addresses the classification and the valuation of financial instruments.

With the IBOR reform, institutions would have run the risk that numerous hedging relationships could no longer be continued under the existing regulations. Possible reasons for this are the fact that the criterion of a high likelihood of secured interest cash flows is not fulfilled because of changes made to the reference interest rates, insufficient proof of effectiveness or the non-identification of designed risk components. In order to avoid having to end hedging relationships because of the changes made to the reference interest rates, the IASB amended IFRS 9 and IAS 39 in an initial project phase; these amendments should make it possible to keep the existing hedging relationships during a transitional period.

For instance, the IBOR reform should have no effect on the high probability of occurrence criterion. Companies may thus assume that the interest rate on which hedged cash flows are based will not change. Therefore, when estimating the likelihood of occurrence of hedged cash flows, the same cash flows should be used as a basis as they would have been used without any uncertainty stemming from the IBOR reform.

Likewise, when evaluating the financial relationship between the underlying and the hedging instrument according to IFRS 9, one should assume that the reference interest rate on which the hedging relationship is based will not change because of the reform. If hedge accounting is being used in accordance with IAS 39, the effectiveness range of 80% - 125% no longer applies to the retrospective measurement of effectiveness if the exceedance or the shortfall of the effectiveness limits is caused by changing reference interest rates. Instances of ending hedging relationships because of prospective ineffectiveness (IFRS 9) or retrospective ineffectiveness (IAS 39) resulting from insecurities in connection with the interest rate reform can thus be avoided.

An evaluation of whether a risk component is to be identified separately is now only necessary at the start of a hedging relationship. An additional evaluation of whether a risk component is to be identified separately at a later time is no longer necessary and is indeed unlawful. Accordingly, ending existing hedge relationships because new evaluations have separately identified designated risk components is neither necessary nor allowed.

These changes become applicable for reporting periods starting on 01.01.2020, subject to EU endorsement. The rules are no longer applicable if the insecurities concerning the date or size of the cash flows based on reference interest rates no longer exist or if the hedging relationships have ended. To sum it up, the effects of the IBOR reform on the financial reporting of hedging relationships are limited because of the amendments made to IFRS 9 and IAS 39. Because of amendments made to IFRS 7, significant reference interest rates that have an effect on hedging relationships and that are affected by the IBOR reform must be disclosed. In addition, the extent of the exposures which are affected by IBOR as well as the nominal volumes of the affected hedging transactions have to be specified. Finally, it must be disclosed how the transition to the new reference interest rates was implemented, specifying significant assumptions and evaluations.

These reporting requirements in the notes necessitate the identification of the affected hedging relationships and the analysis of effects of the IBOR reform on the (secured) interest rate exposures of companies. An analysis of the affected hedging relationships should be at the heart of the impact analysis of the IBOR reform performed by Treasury.

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Digital Treasury Summit Zurich 2019

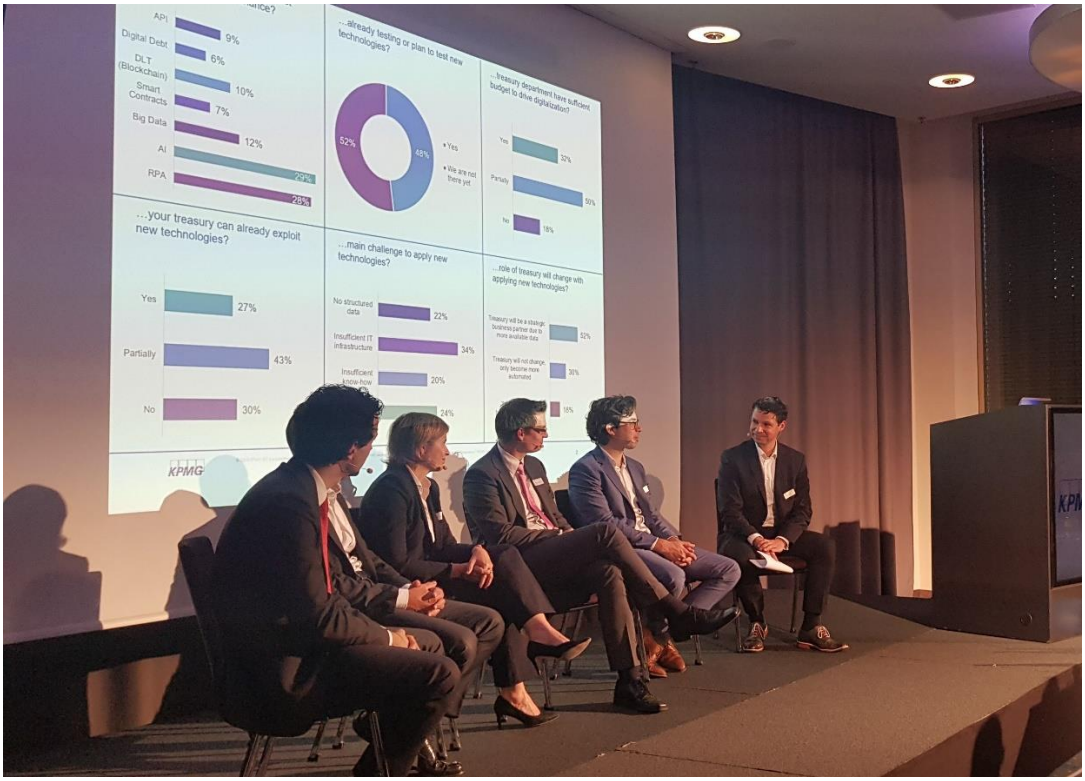
Finance and Treasury Management Switzerland

On November 5, the Swiss Treasury Community gathered at Zurich Renaissance Tower to attend the Digital Treasury Summit. Over 100 treasurers and senior finance professionals from all over Switzerland gathered for the event, which entailed a series of key note presentations, a panel discussion and a showcase featuring 10 treasury solutions and software providers.

Among others, the presented and discussed topics included predictive cash flow forecasting with the help of Artificial Intelligence (Nicolas Christaen, Cashforce), cloud and blockchain-enabled trade finance (Frank Lutz, CRX Markets), digitalization of KYC processes (Sebastian Niemeyer, SWIFT), the future of work (Caroline Pfeiffer, Lee Hecht Harrison/Adecco) and the implications of SWIFT GPI for corporates (Giovanni Gaggioli, UBS). During the panel discussion, the keynote speakers discussed the future of Treasury and how digitalization will affect the role and daily life of Treasurers. If you would like to read up on the presentations, please find the keynote speakers' presentations here.

The vendor exhibition featured JP Morgan with its JPM Coin and the blockchain-based Interbank Information Network, Loanboox with its digital debt platform, FIS with a showcase for smart dashboards, the Swiss Fintech Association who brought along three Fintech startups (including

Blockstate, N'Cloud Swiss and ViaCash) and Kyriba that demonstrated its active liquidity management solutions.



A survey conducted during the event clearly showed which technologies caught the treasurers' fancy. They were asked to think about which technologies hold the greatest potential to help streamline their processes and whether their treasury departments were already sufficiently centralized to benefit from new technologies. Here [insert link] is a brief summary:

- The technologies perceived to have the greatest potential in Treasury are Artificial Intelligence and Robotic Processing Automation.
- Approximately half of the participating treasurers currently are testing or plan to test the use of new technologies.
- Apparently most treasurers do not have the budget, resources or senior management support to drive digitalization initiatives, as only a third stated they have the budget and authority to do so.
- While most Treasuries are sufficiently or partially centralized, allowing them to exploit new technologies, a third nonetheless revealed they first have to optimize processes and centralize and structure data.
- Over a third of the participating treasurers stated that the main obstacle to using the new technologies is IT infrastructure that is often not sufficiently powerful, followed by unclear benefits, lack of structured data and insufficient know-how.
- Finally, the majority of treasurers stated that with increasing digitalization, the role of Treasury will be more that of a strategic business partner, while the rest answered that treasury activities will just become more automated and analytical.

All in all, there seems to be a consensus within the treasury community that digitalization holds potential to improve treasury processes and to enable treasurers to evolve into a strategic business partner. In this context, it still holds true that one of the main barriers to benefiting from the digitalization trend are the lack of centralized and harmonized treasury data. In most organizations the fragmentation of the IT landscape poses an insurmountable challenge to treasurers and the entire organization. In the past, this led to large IT standardization projects.

Thanks to recent technological developments around smart interfacing and structured messaging, the concept of a well-integrated ecosystem of treasury applications, referred to as "best-of-breed" approach, has become very realistic and practical. This trend has facilitated the rise of smaller and highly specialized software vendors that excel at what they do and whose products integrate

seamlessly with other systems already in place. As a consequence, the "One System Fits All" approach is no longer the only way anymore to realize treasurers' vision of highly efficient and centralized treasury setup. Instead, treasurers can now rely on a variety of niche treasury systems that are connected to each other through smart and structured interfaces.

Should you wish to learn more about any of the vendors and keynote speakers that attended the event, please feel free to reach out, we will be happy to share our insights and connect you with the person.

If you liked the event or did not have the chance to attend but would like to attend next time, please feel cordially invited to join the next Digital Treasury Summit in November 2020. The event will again focus on the latest technological advancements in treasury and finance and focus on practical and real-life examples for corporates who will have the chance to present their use cases as well as first-hand insights on digitalization in treasury.

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