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Brexit's impact on natural resource-intensive industries and commodity trading?

Finance and Treasury Management Switzerland

A hard Brexit and its consequences for trading on British commodity exchanges

The immediate implications of a withdrawal of the United Kingdom (UK) from the European Union (EU) without a treaty or without specifying the status of UK marketplaces regarding the forex markets and the European monetary policy were discussed and analyzed in past newsletters (for instance, the "End of IBOR"). Commodities traders and commodity-intensive industries, that are deemed as Non-Financial Counterparty Minus (NFC-) under of EMIR[1] and that trade in commodity derivatives on different UK exchanges will have to face further challenges in connection with applicable EMIR rules.

If the status of UK exchanges remains uncertain, all of the trades currently deemed as ICE[2], LME[3] and LCH[4] (and others) will, as of 1 January 2021, be considered as OTC derivatives according to the regulation. Which means that, as of that date, they will have to be included in the calculation of the clearing threshold. This could cause companies previously categorized as NFC- to exceed the EMIR-defined clearing thresholds and thus become NFC+[5] according to EMIR. This, in turn, will have specific repercussions on reporting, clearing and margining duties and will require the use of further risk mitigation techniques, thus making it considerably more expensive to trade. It could even call forth a lower rating.

Market participants now hope that the EU Commission in cooperation with the ESMA[6] will leave the status of UK exchanges unchanged after the Brexit, thus avoiding the reclassification of certain derivatives as OTC transactions. However, it is still uncertain whether and when this will happen.

Three options for NFC- companies

Generally, companies that enter into financial derivatives and who are deemed to be NFC- according to EMIR calculate whether the notional value of concluded OTC derivatives that do not have a measurable risk-mitigating effect exceeds the pre-defined clearing threshold[7] in an asset class. In the event of a "hard Brexit", the calculation method should be reviewed to make sure it properly allocates OTC derivatives and to check whether any clearing thresholds have been exceeded.

Below, we would like to draw attention to three different options which could help avoid a potential exceedance of the clearing thresholds.

[1] European Market Infrastructure Regulation
[2] Intercontinental Exchange
[3] London Metal Exchange
[4] London Clearing House
[5] Non-Financial Counterparty Plus (NFC+): companies that fall into this category will be subject to EMIR regulations
[6] European Securities and Markets Authority
[7] According to the Commission delegated Regulation (EU) 149/2013 Art. 11

1. Taking on the risk of exceeding a threshold
If it should be impossible to implement the following options because of regulatory reasons or because they are too expensive, the company will have to examine the additional EMIR requirements due to having been identified as an NFC+ and implement relevant measures. The resulting clearing and margining obligation and the associated implementation and ongoing costs for clearing fees, liquidity maintenance, processes and IT, can lead to significant additional expenses for the companies concerned.

2. Reducing the number of OTC derivatives
Probably the most "pragmatic" solution to avoid exceeding the clearing threshold is to reduce the number of commodity derivatives traded on UK exchanges or to examine to what extent derivative trading on ICE, LME or LCH is necessary and those can be replaced with any EU-based exchanges. Should other market participants also switch to alternative trading venues for hedging transactions, a decrease in liquidity for commodity derivatives on the UK exchanges is to be expected, which at the same time would have a detrimental effect on the costs associated with the trading of derivatives.

3. Reduction of relevant derivative contracts with objectively measurable risk reduction
Other options may be found in the application guidance[8] issued by the BDEW[9]. Derivatives used to hedge a company's or group's business activity, liquidity or financial management risks within the scope of "portfolio consideration" (cf. Commission delegated Regulation (EU) 149/2013 recital 18, 3rd sentence) may be excluded when calculating the clearing threshold. To demonstrate the evidence, companies will have to verify whether derivatives traded at an exchange meet any of the following criteria stated in Commission delegated Regulation (EU) 149/2013 Chapter VII, Article 10(1):

a) that risks of potentially changing the value of assets, services, inputs, products, commodities or commitments are covered.

b) that risks of a potential indirect impact of fluctuating interest rates, inflation rates, exchange rates or credit risk of the values mentioned in a) are covered.

c) that it is classified as a hedge.

If an OTC derivative contract does not fulfill any of these criteria, they may still be recognized as objectively measurable risk mitigation for the company's or group's business activities, liquidity or finance management if it hedges risks as part of a proxy hedge or a portfolio hedge (cf. Commission delegated Regulation (EU) 149/2013 recital 18, 2nd and 3rd sentences) or because they have to be concluded as they have become redundant due to changed circumstances (cf. Commission delegated Regulation (EU) 149/2013 recital 19). It is generally recommended to review whether these criteria are fulfilled and to consult your auditor of financial statements or EMIR auditor.

Another drawback that should not remain unmentioned: In view of the calculation procedure stated in Article 10(1)(a) of Regulation 648/2012 (EMIR) which was amended with Regulation no. 2019/834 (EMIR-REFIT), the clearing threshold is determined through the aggregated average month's end exposure of the NFCs in the respective derivative class for the past twelve months. Moreover, if there is a short-term exceedance of the clearing threshold, the company or group will be granted a four-month-long period to adjust the exposure. As such, a bit of time remains until the new threshold calculation takes effect, so that the new measures do not necessarily have to be implemented by January 1st, 2021. To what degree the new OTC transactions affect the threshold calculation depends on the trading volume of each company or group and will have to be examined individually.

[8] BDEW application guidance for the implementation of the EU Ordinance "EMIR" that regulates over-the-counter derivatives trading, BDEW, 10.02.2014.
[9] Bundesverband der Energie- und Wasserwirtschaft (German business association for the energy and water industries)

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The end of hedge accounting under IAS 39?

Finance and Treasury Management Switzerland

In recent newsletter articles we have repeatedly discussed the improvements in IFRS 9 concerning hedge accounting when compared with IAS 39. However, there are still plenty of companies that have elected to continue applying IAS 39 for hedge accounting as they transition to IFRS 9. This standard setter allows this for the transition period until the macro hedge accounting project is completed. This is currently being pursued under the name 'Dynamic Risk Management'.

Originally, the transition period was to end at the end of 2017. Until now, no new date has been set. However, after some delays, the project is now picking up speed again, and in October 2020 the so-called "Core Model Outreach" took place, with feedback on the core model expected in Q2 2021. Therefore, in this article, we would like to use a tangible example to illustrate what a possible end to the application of hedge accounting under IAS 39 will mean for companies in practice.

The companies that currently still apply IAS 39 largely use interest rate and currency hedges. Using the so-called 'hypothetical derivative method' under IAS 39 provides two key advantages for these hedges. Their effectiveness is easy to measure, as the hypothetical derivative is often a reflection of the derivative that was actually entered into. As a result, there are usually no significant sources of ineffectiveness under IAS 39. This approach cannot, however, be easily transferred to IFRS 9. For example, when hedging with forward exchange contracts or cross-currency interest rate swaps, the currency basis mentioned in IFRS 9 may not be included in the hypothetical derivative, despite the fact that it is always part of the actual derivative.

This example shows that hedge relationships are not readily transferable from IAS 39 to IFRS 9 and that the change to IFRS 9 will not simply be a matter of rewriting the hedge documentation. What does this mean for companies that still use hedge accounting under IAS 39?

The changeover of hedge accounting to IFRS 9 will definitely come, even if it is not expected for 2021. However, there may be several advantages to starting the implementation already next year. In this context, some questions that should be asked are:

- Which reporting options does IFRS 9 offer for my hedging relationships?
- What advantages and disadvantages do they entail?
- Can I continue to reduce unplanned fluctuations in the income statement or even reduce them even more compared to the current application status?
- Is it possible to better align the accounting reporting with my actual risk controlling?
- What do the leading treasury management systems currently offer in the standard in terms of IFRS 9 accounting and valuation requirements?

In principle, it is always better to start at early stage adoption of new standards and planning for any necessary IT resources and budgets. Where appropriate, an IAS 39 / IFRS 9 hedge accounting transition can be combined with a treasury management system update or a change of systems. An early adoption can avoid being forced to move quickly once the IASB's Dynamic Risk Management Project is finalized.

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Does cash flow equal cash flow?

This is how financial and liquidity planning align!

Finance and Treasury Management Switzerland

Essential aspects for the going concern of a company are a reliable forecast of future cash flows and making sure that liquidity is available. A reliable planning is meant to ensure that the necessary control measures are initiated in the right time. For this, companies regularly consult a relevant financial budget, including an indirect cash flow statement, which is often prepared by the controlling department. At the same time, Treasury also prepares a liquidity planning to ensure the company's solvency and to identify any potential shortages. Besides using a distinct approach, these two items usually have a very different timeline, degree of detail and frequency of updating.

Consequently, the results of these two cash flow forecasting methods usually diverge from each other. In the worst case, one method foresees a positive operational cash flow and the other a negative one. This undermines the trust placed in these planning processes and quickly puts the business departments in need of explanation. But reconciling these two seems to be nearly impossible. Attempts at harmonization are often made under tremendous pressure, and the reconciliation process uses valuable time and resources, which unfortunately, very rarely result in creation of any lasting structures during these phases. The problem is that symptoms are fought rather than the root causes. Therefore, it's usually right "back to square one" with the next reporting or planning.

Looking for the needle in the haystack: where are the discrepancies?
The finance functions are confronted with a wide variety of challenges when looking for the causes of variances. Analyzing the sources of discrepancies can be very difficult, as they may have their origin in the varying planning items and units, different source systems or planning data sets.

We took a closer look at the aspects mostly responsible for the diverging financial and liquidity planning.

• **Planning items**: Identifying liquidity planning items generally is more a question of setup, depending on corresponding source of funds, and thus do not find a direct equivalent in financial planning, which essentially consists of income statement and balance sheet items. In order to arrive at a consistent result, the company should determine the non-payment-relevant items in the indirect method. Changes in receivables and payables, for example, are comparatively easy to determine. This becomes more complex for some other items, such as procurement and the valuation of goods, which could be partially cash-relevant or not, depending on the accounting standards applied.

• **Fundamental data:** The data pools and reporting systems used for financial budgeting and liquidity planning are explicitly separated and are not reconciled with each other. This results in different underlying data sets used for the derivation of the two planning processes. In the direct method, usually the value date is used, whilst for the indirect one, the posting date is used.

• **Planning units:** The granularity of the financial budgeting is often limited to the level of the group or the business unit. However, if financial planning is to be the used as the base for liquidity planning, a specific granularity at the level of the company is necessary to ensure the continuous capital coverage. Another challenge, when determining data, are the intercompany cash flows.

• **Frequency and granularity:** In general, Treasury planning is much more detailed in terms of time than the one done in Controlling, which reduces the comparability of both results. This is especially true when payments are delayed around the end of a period, causing the value dates of those transactions to slip into the new period. While Treasury may be able to take this into account at the latest in the course of cash forecasting in liquidity planning, it can surely lead to discrepancies in financial budgeting.

• **Planning assumptions:** The basic assumptions used in preparation of liquidity and financial planning are not necessarily aligned with each other. may not always be the same. For instance, Controlling generally may depend much more on planned foreign exchange rates, whilst Treasury increasingly uses forward curves. Similar differences also exist in regard to the anticipated business development, for instance in terms of assumptions made for the cost of material or inventory build-up and reduction.

• **Depth of information:** In some cases, Treasury and Controlling have of divergent knowledge regarding the details and situation of various planning items. For instance, Controlling has in-depth knowledge about CAPEX, while Treasury can serve with a high level of understanding about cash development.

Process efficiency is impaired by duplicated work and reconciliation efforts
Even though the data sets of both planning approaches are usually clearly delineated from one another, for example in the form of separate databases and reporting systems, in terms of content the two planning approaches often overlap.

In the worst case, this overlapping data is requested from the same specialist data suppliers, such as sales or procurement departments. However, once gathered, the processing of the data is performed separately for the financial budget or the liquidity planning. This leads to duplication of activities within the value chain, which causes inefficiencies in data processing.

Both planning approaches (but especially financial budgeting) are often strictly time-bound, for instance during the budgeting period or at the end of the quarter. This also means that the reconciliation of the planning results often takes place under great time pressure. Frustration caused by the validation of the individual cash flows can therefore occur, as there is often not enough time to reconcile these properly.

Transparency and efficiency gains through planning harmonization
There are several advantages in overcoming the challenges of a misaligned financial and liquidity planning. For instance, the discrepancies between Controlling and Treasury are reduced, and the remaining deviations become more transparent. Performing a detailed variance analysis offers the opportunity to uncover their causes and create increased understanding of the individual results.

The reconciliation effort of both plans is reduced by harmonizing planning assumptions and processes, resulting in a more efficient workflow. Further time savings result from a high degree of integrated automation and help to reduce the pressure during the planning.

Process efficiency may be improved when preparing the medium and long-term liquidity planning by automatically fetching data from the financial budget. The situation is similar for backtesting. Harmonization achieves comparability, which greatly simplifies the analysis of plan deviations.

Additionally, integrated processes and data flows in harmonized plan preparation also allow both sides to benefit from the knowledge of the counterparty. Treasury often has a good overview of the development of individual cash-relevant items in the near future. Controlling, on the other hand, often has better business know-how needed to map the long-term planning horizons. A systematic exchange of the expertise helps both parties to plan more accurately. In addition, often both parties need to calculate KPIs thus need the experience of the other party. For instance, in the case of bank covenants, both short-term and long-term input parameters play a role. The targeted transfer of knowledge generates synergy gains and the harmonization approach allows these to be realized systematically.

Preparation task: Align framework and process steps

In order to harmonize approaches of Controlling and Treasury, certain conditions must be met. To begin with, the framework conditions of the financial and liquidity planning must be aligned. Specifically, this means that the items in the liquidity planning have to be selected in such a manner that they have a direct offsetting item in financial budget, for example net sales in the financial budget finds its offsetting item in cash inflows from sales in the liquidity planning. The identification of non-cash elements, such as write-offs, depreciation and amortization, provisions or accruals and deferrals, must be ensured. For instance, it is necessary to explicitly separate provisions in financial planning into utilization and increase/reduction in order to be able to transfer the cash-effective component of utilization to liquidity planning.

Historical cash flows at the level of individual line items, including their respective document and value dates, serve as the data basis. These can be made available via various data analysis methods or, for example, via in-house software in the form of dedicated SAP applications. Using the historical dataset, one can calculate the actual Days Sales Outstanding (DSO) and Days Payables Outstanding (DPO) in the past. And such gained knowledge may further be applied to the values in the financial and liquidity planning going forward.

The DSOs and DPOs are used to plan working capital for the financial budget. For medium and long-term liquidity forecasting, DSOs and DPOs are used for each planning item to determine the expected value date of the cash flows and thus to distribute the financial planning data. Thus, all cash flows in the liquidity planning correspond, in their absolute amount, to those of the financial budget. For the short-term view, a separate reconciliation of the specific planning assumptions per planning item must be carried out.

Therefore, it is necessary to harmonize not only the plans, but also the data flows and the resulting reports. In this way, many heterogeneous recipients in the various departments may be kept up-to-date with a centralized report. This saves time for internal coordination and enables a more accurate decision-making process.

Review individual opportunities and costs

Harmonizing financial and liquidity planning offers great potential for reducing costs and risks in corporate management. However, getting there requires much time and coordination work. Therefore, a company should weigh its options carefully whether it makes sense to radically align the financial and liquidity planning and whether, with the systems used, is even feasible at all.

In principle, it is highly recommended to carry out initial backtesting to validate and ensure the quality of future forecasting approaches before starting the project. Subsequently it should be determined which assumptions are considered most important by Treasury and Controlling in order to avoid frictions at a later stage.

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Increasing Significance of Green Finance

Finance and Treasury Management Switzerland

Current developments in green finance

The trend towards a sustainable growth and funding strategy has been on the increase across all industries. Investors, banks and other market participants increasingly demand that environmental, social and governance (ESG) targets also become part of a company's corporate finance strategy.

For this reason, in the last few years we have seen the emergence of many different green finance instruments that relate to various ESG topics or targets in their structure and design.

Including sustainable financial instruments in a company's overall corporate strategy meets the governance requirements of the market and ensures access to a large investor base. Simultaneously, sustainable funding strategies may receive favorable terms if their margin is linked to sustainable objectives.

The dynamic development of the green finance market is also apparent in the market data. For instance, in the first nine months of 2020 already 97 ESG-linked and green loans as well as promissory notes, with a total volume of EUR 47.5bn, were issued in Western Europe. In the same period, also 438 green, social and sustainable bonds with a total volume of EUR 166bn were issued in Western Europe. This is an incredible increase of 272 and 152 percent, respectively, of the total volume in the period from September 2016 to September 2020. This also means that the persisting corona crisis has not put a dent into the green finance market.

The development makes clear just how significant this new finance segment has become and shows that it is by far not a fluke but rather, a newly established form of funding.

A wide range of possible structures

The green finance market has taken on many different forms, which cannot be defined uniformly or delimited very clearly. For instance, among bonds, green bonds are now wildly popular. They are used to finance specific green (i.e. sustainable) projects. Projects that are specifically eligible for such funding include those that offer clear advantages for the environment, for instance because they combat climate change or preserve natural resources. Green bonds are very often issued by governments, utility companies and banks.

Social bonds that finance projects with a positive social impact are another category of bonds that are experiencing an increase. Specific project objectives could include for instance the promotion of socio-economic development. Typical issuers are state-run development banks, commercial banks and municipalities.

An increasing number of issuers also chooses sustainability bonds, which combine green and social projects.

Process guidelines meant to improve transparency and market integrity have been developed for all three types of bonds, the so-called Green and Social Bond Frameworks.

Even in the area of corporate loans and promissory notes, various structuring possibilities have become common in the market. Starting in 2016, green loans were mostly used to fund sustainable projects. Measuring whether the loan adhered to the criteria of sustainability was generally performed either by looking at how the loan was utilized or in combination with an external ESG rating.

In the meantime, ESG-linked loans have also become a common item when it comes to raising funds for operational aspects. In practice, these structures take on many different forms. For example, a margin downgrade could be tied to pre-defined sustainability performance indicators, which are generally derived from the company's sustainability strategy. As an alternative, the margin could also be linked to the adherence to external ESG ratings. And past transactions in this segment demonstrate an increasing tendency to structures with relevant ESG ratings.

Green and ESG-linked loans, as well as traditional, green and ESG-linked promissory notes, are at the top position in the ranking, however, the range of green, financial instruments is by far not exhausted yet and is constantly evolving.

For instance, Dürr issued a convertible bond with an ESG component in September 2020. The machine engineering company hedged the bond's interest rate risk with an interest rate swap, which itself was linked to the ESG rating of the company.

This transaction once again shows how flexible market participants can be, which makes the green finance market so attractive to a variety of companies in very different industries. Important issuers from past transactions not only include (development) banks, governments and utilities but also retail, clothing and consumer goods companies

Conclusion
It is interesting to observe that companies are increasingly integrating green finance instruments into their existing financing structure. In that respect, this segment has become a real financing alternative that creates versatile funding solutions and structures.

KPMG's team offers an independent advice on the possible use of green financial instruments in your company's funding structure.

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