

# Strategies for safeguarding dividends from foreign currency areas

Corporate Treasury

Investments in foreign companies are made for a number of reasons. Generally, assets are invested in a foreign currency area because that is where they serve the company's purpose for a certain time.

From the economic perspective of Treasury, these transactions are usually an investment in a foreign currency area. Simply put, after an initial payment (possibly in the foreign currency), there is either a continuous cash inflow in that foreign currency (e.g. directly in the form of investment income) or value is created which will lead to a one-off cash inflow upon the sale of the investment in the future (payment of the purchase price). The resulting currency risks are often described as translation risks, which also have a transactional character as of a certain point in time (e.g. at the time when the dividend is decided on or when a sales price is defined).

On the balance sheet, such transactions lead to a currency risk due to the creation of the contractual right to the asset in another currency (dividend decision or recording of the purchase price receivable), which then ends with the payment and conversion of the foreign currency into the company's functional currency. From Risk Management' point of view, risks are already present when it becomes clear that funds are to be withdrawn from that particular currency area. This moment may occur even earlier, for example, at the beginning of the investment or the planning of the dividend strategy.

Therefore, Treasury frequently sees the need to hedge the resulting currency risks at this earlier point in time by using derivatives. When doing this, groups are usually faced with the challenge of implementing the same economic risk management strategy for the single-entity financial statements as well as the consolidated financial statements under IFRS so that the P&L is not exposed to uncontrollable volatility. IFRS and commercial law offer different ways to map such events, either as hedge accounting or as a valuation unit. Sometimes the regulations are somewhat contradictory, as the following points illustrate:

According to IFRS, dividends are not permissible underlying transactions, while investments in a foreign operation can be turned into hedge accounting very easily by using a "hedge of a net investment / HoNI". In the future under IFRS 9, the designated hedging purpose must also correspond to the economic hedging purpose. According to commercial law, however, dividends could be permissible underlying transactions, whereas the hedging of investment book values is generally not. At the same time, the expected underlying transactions must be highly probable for both accounting policies. Evidencing this is difficult for dividends over a longer projected period; the same is true of many sale considerations.

Risks that are obvious financial risks are usually easy to hedge with derivatives; however, compromises must generally be made on the accounting side. Having said that, we have developed practical solutions for many of these issues over the past few years:

For instance, under IFRS, a company's value in a foreign currency, which should pay dividends over the next three years, can be hedged with three derivatives by means of a HoNI. Although it is not possible to collect the dividend at the hedging exchange rate, the derivative's valuation effects can be recorded without effect on income. Since a different risk interpretation is usually designated for the purposes of commercial law, three valuation units are available as underlying transactions for the planned dividend payment.

As a rule, Treasury presents the entire business process as a cash flow in the opposite direction. The same applies, however, to strategic company decisions. For this reason, it is important that such cash flows are also included in the risk management strategy and presented in the balance sheet using the cost-by-cause principle. Although the regulations here vary widely depending on the accounting standards used, there is usually a solution available that at least reaches the most important objectives.

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# Treasury 4.0

## Bringing Light into the Obscurity of International Payments with SWIFT GPI

Corporate Treasury

The timespan a web user is willing to wait until a website has loaded is mere seconds. We make payments using PayPal in real time. We use Twitter to learn about events halfway around the globe in seconds. We buy items online with a few clicks if we don't have time to go buy them in real life; depending on the mailing option, the item could already be in front of our door by the end of the day. If the item ships from abroad, we can track where its whereabouts every step of the way. It is clear: our world moves in real time, satisfying our need for immediate availability.

And yet, when it comes to payment operations we are willing to accept that cash being sent may take days (especially if it is sent to/from abroad), it is untraceable and sometimes carries ridiculously high fees.

It's a no-brainer that such a model cannot survive for much longer.

But what will take its place? Maybe it is indeed already possible to make payments abroad in real time? So how will the way international payments are executed at banks and companies change and how can Treasury benefit from such changes?

We would like to show the current developments of what could await us in the future by taking a closer look at the "Global Payments Innovation" initiative.

### **SWIFT GPI - Overview**

Since SWIFT (Society for Worldwide Interbank Financial Telecommunication) announced a new service to improve and accelerate international payments with its "Global Payments Innovation", banks and companies have been following this with great interest because this would significantly ameliorate the correspondent bank business and facilitate the settlement of cross-border payments.

Upon the launch of the service in February 2017, already 12 banks were connected to this system and 30 further banks had implementation projects in the pipeline. In the meantime, nearly 100 banks in 224 countries are participating, making up about 75% of all cross-border payments. Just about half of all participants are located in the EMEA area, 20% in the Americas and 30% in Asia..

In order to be able to participate in the GPI initiative, companies and banks had to register for the service with SWIFT. The GPI concept foresees that participating banks, using an SLA framework, are given access to special products and are able to communicate with each other. The service levels defined for this create new possibilities to make international payment operations faster and more transparent. The adherence to these SLAs is constantly and centrally overseen by so-called SLA observers.

### **Timeline and Phases**

But let's back up a bit: In 2015, SWIFT first announced its GPI initiative. This was followed by marketing efforts, a presentation of the pilot version at SIBOS in Singapore, the subsequent pilot phase and the definition of strategic road maps by 2016. The service went live in its first phase in February 2017. It includes the intra-day availability of capital (as long as the GPI partner is in the same time zone), provides transparency on the fees, offers end-to-end tracking of payments and communicates important remittance information securely and unalterably.

A second phase will follow soon, the so-called digital transformation. It should allow the cancellation of payments anywhere along the path of the correspondent banks. Moreover, the transfer of enhanced payment information will be made possible to automatically perform compliance checks and reconciliations of related invoices. Furthermore, the communication with participants will be improved in the Cloud to lower the number of errors when generating payments in view of the many different local standards and/or regulatory requirements and duties.

In a third phase, SWIFT will look into the using and unlocking the potential of new technologies such as blockchain.

### **Taking a detailed look at SWIFT GPI: so where is all of this innovation?**

The disadvantages of the current system of settling payments with correspondent banks are the delay between a sender's releasing a payment and a recipient's being credited, not to speak of the absence of transparency when it comes to the fees. Add to this the fact that the long path of correspondent banks makes it difficult to track the transfer without gaps until the confirmation has arrived at the sender's.

This is where the GPI initiative would like to change something and provide more transparency with unified standards and the possibility to track the payment. Moreover, remittance information should be transmitted along the entire path to facilitate the reconciliation and booking of payments.

Using SWIFT and the underlying worldwide network guarantees factors such as security, robustness, global availability and compliance.

Due to the constant updating of the debits and credits as well as the end-of-day statements, the correspondent bank model currently used is very complicated and costly for both banks and their clients, which is why SWIFT initiated a feasibility study together with the leading transaction banks in the meantime. This study is to find out whether the use of blockchain and banks' distributed-ledger technology (DLT) could assist in reconciling the nostro account securely and efficiently. By using their own blockchains and closed user groups as well as strictly regulated data access rules, costs and liquidity for reconciling nostro accounts will be improved and risks reduced.

Despite all of this, the initiative would like to remain open-minded and flexible towards new technological market trends standards. For instance, SWIFT is currently working out guidelines together in a task force together with the Payments Market Practice Group (PMPG) to secure compatibility with ISO20022.

In the future, payments using GPI should be faster, more transparent and trackable at all times without compromising security.

Implementing transparency and end-to-end tracking in real time looks as follows:

A GUI will enable clients to see the current status of their payments. From the moment the order is placed to the moment it is credited to the recipient, every single step of the way is recorded by all of the correspondent banks in a cloud-based tracking database; this information can be queried in real time.

This means that the institutions involved, the places, arrival and forwarding times, reference IDs and any individual fees are visible in real time.

The summary also contains the current status, the full duration of the transfer, the sum of the fees and the general tracking ID.

The tracker can also be integrated into client systems through an API, thus allowing for further processing. In this manner, information on the payment status can be integrated into a treasury management system or payment operations system, where it can be mapped and analyzed.

#### **A next step to Treasury 4.0**

The SWIFT GPI initiative shows once more that payment operations are developing into real-time processing as we speak. Parallel to the development regarding SEPA instant payments, cross-border payment operations are also evolving. The wish for more transparency, efficiency and speed as well as an increase in automation when it comes to comparing and reconciling accounts does not end at country borders.

The positive impact is especially obvious for Treasury: improved localization of liquid funds and timely confirmations by counterparties, increased transparency concerning fees (and their future reduction) as well as efficiency gains due to faster available capital (i.e. on the same day). In addition, the risk of delayed payments is lower, resulting in lower contractual penalties.

Another compelling case for such systems is the fight against cyber criminality: the improved transparency and faster payment confirmations as well as security concepts based on the latest technologies will improve things significantly.

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# Treasury 4.0. Braking is losing

## Or why Treasury projects have to be tackled and implemented faster

Corporate Treasury

The speed with which digitization is progressing is breathtaking. Digitization is not only relevant to the processes and systems specific to Treasury but to the entire company, even affecting the company's business model. While it used to be that the big fish ate the small ones, this is no longer the case: these days, the fast ones eat the slow ones. Only companies managed in real time, i.e. those with immediate access to data, will survive. So here's the question for today: If our claim above is correct and it is indeed a question of speed, not only in reacting to changes but also in creating the prerequisites for fast reactions, we may need a reality check as changes in treasury are often excruciatingly slow.

Let's look at a concrete example: at t0 a company realizes it should centralize its payment operations in a shared service center. Step 1 is a feasibility study, which lasts 2 months. To support this, an advisor is required. Selecting one takes about one month. The results should therefore be available in 3 months. Usually, there are delays with project contracting or because employees who work elsewhere need to be included in the project - so that the project results are now available only after 4 months. The outcome of the feasibility study is that the project makes sense, i.e. that costs will be lowered and compliance improved. But the results also show that the company is banking with too many different institutions and that it would make sense to re-organize the account structure so that not all accounts have to be maintained in an unmanageable number of different local formats, which would really delay the business case on hand. After a period of deliberation, the company decides to bring some order into its accounts and banking relationships. In the meantime, we have arrived in the fifth month. An RfP for selecting a bank is set up, sent to the various banks and the returns are analyzed. Banks are interviewed and agreements negotiated. This lasts about two months, which brings the project to month number 7. The company's global footprint and its KYC processes cause further delays, which means that at best, the bank can expect the new account structure to be implemented at the earliest in another 6 months. Delays of two months seem plausible: after all, vacation periods at banks and at the company need to be factored into the whole project. The result is that after 15 months, the company disposes of a new bank account structure. In the meantime, it has also selected a new bank account management (BAM) system, which will be implemented starting at t12. The implementation of this system takes another six months. Upon taking stock, we now see that the company has a new BAM system and a new account structure after 18 months. However, what is still missing is the setup and roll-out of a centralized payment operations platform, with or without

payments on behalf of customers but in any case offering internal offsetting. Until the last entity has gone live, 18 months have gone by. All in all, this project took 36 months and that is without even factoring in greater delays.

36 months from today would be about June 2020. If you look back, this would be June 2014. Think of all the technical, political and economic changes our world has undergone in that period!

So how could this process be accelerated? As an advisor it would be a little too cheap to just say: why not just shop for know-how and resources, because it is not always know-how that is missing. If the wrong approach is used, throwing more resources at a project will not improve things either. Therefore, it is much better to look for reasons why a project should not be fraught with complexity that would cause unacceptable delays.

So let's analyze where the complexity is hidden in the above (fictive) project.

1. *Sequential working*: The understanding of what should be done is usually already apparent at  $t_0$ . The journey's destination is already visible in its general outline. So why bother with a feasibility study? All of those involved understand that the account structure has to be optimized. All know the risks of a decentralized payment operations structure. Business cases could be made within days. The target for the system environment's architecture can already be discussed and developed now because it is mostly independent of the final account structure. And it replaces the old-school static selection process that is entirely incompatible with the dynamics of an IT landscape design. The same is true for strategic cornerstones such as banking connectivity and formats. So why wait 18 months? Instead, a business case could be set up, a target design sketched (IT, processes, etc.) and an interim solution implemented in parallel, where a third party could perform the format conversion. This may not be the most elegant or sustainable solution but maybe show a better cost/benefit ratio – especially in terms of time!
2. *Interminable decision-making*: A common dictum is that not making decisions also means not making any errors. This is wrong. Ignoring speed (with the necessary due diligence of course) in times of extreme change is a recipe for disaster, especially if the rest of the company is pushing for the latest technology and Treasury lags behind. Of course, there are no sure-fire solutions. In the meantime, there is some fairly robust technology that without doubt serves the purpose. So summon your courage and make a decision!
3. *No focus on profitability*: Projects with a long duration mean that the company can reap the benefits only much later. Setting up project steps in parallel, signing up external resources, service providers or changing internal priorities of tasks, distinctly accelerates the reaping of the benefits.
4. *Project lassitude*: Do you think that employees will be more motivated if they think the project is going to take 36 months and their work burden increased for that duration? Or can their enthusiasm be improved if they know that the project will take a mere 18 months, meaning high stress for three to four months?

So what now? Of course, you can continue to work sequentially and only implement whatever is manageable with your own resources, trying not to push people over the brink doing this, i.e. one step at a time. But something Mario Andretti, a former Formula 1 and indy race driver once said might make more sense: "If you think you have everything under control, you are going too slow."

And we haven't even started talking about the further steps necessary in such a project: simultaneously, you will also need an automated, dynamic reporting, get Controlling and the tax department on board, upgrade the treasury management systems and start implementing the exception-based management of IFRS 9. And don't forget the optimization of the liquidity planning because strangely enough, the business model is evolving and cash flows just are not doing anymore what they are expected to do.

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